

# Financial/Fiscal Support, Incentives and Guarantees

For projects that have been appraised under the process described herein, as not being bankable without support, such support may be offered by government and can comprise various types and sources. This is to ensure that with such support, the project is, ultimately, financially viable and is therefore attractive to bidders. Any proposed subsidy will be finally determined through competitive bidding to ensure the lowest liability for Government.

It should be noted that funds available to support projects are limited and therefore only the highest priority projects will likely receive financial or fiscal support.

Such support can include the following:

## Project Development Facility Funds

In order to put PPP projects out to tender successfully and to obtain the best possible deal, the implementing agency of Government needs to understand, plan and structure the project.

The Government, in order to undertake full and proper studies as described below under the project cycle, may establish a fund to properly resource feasibility studies which may cost from several hundred thousand dollars for small projects to several million dollars for large complex projects. This may be a revolving fund with the study costs reclaimable from winning bidders in some instances, for example where the project is financially feasible.

## Viability Gap (VG) Concept

The Government will provide viability gap funding, or targeted subsidies, for PPP projects that are economically and socially justified but fall short of financial viability. In theory subsidies should not exceed the net economic benefit of a project, but firstly fiscal space for subsidies will be limited and secondly several countries have capped their VGF to a maximum of 20% of the total project cost.

## Guarantees and the Guarantee Fund

Risk sharing and contingent support may be available where studies indicate that a project is considered financially viable but where there are higher than acceptable risks such as fuel prices, traffic demand etc. The future fiscal impact of contingent guarantees will be quantified.

As part of the government's risk framework, a guarantee fund would need to be set up which will cover and monitor all guarantees for PPP projects.

### Longer Term funding Support

An Infrastructure Project Funding Facility may be considered to provide residual long-term funding at commercial rates for PPP projects.

### Government Incentives

PPP Projects will be eligible for fiscal and other investment incentives, which will be listed and available to all interested PPP participants.

### Other Direct and Indirect Support

PPP Projects may receive other direct and indirect support. In general the need for other types of support should be established by the Government's transaction advisers when preparing the project feasibility study such that all potential tenderers will be aware of, and take into account, such support within their bids.

### Ceilings for PPP Project Support

Ceilings are normally established for support to PPP projects. Such ceilings could be general caps and include those related to the VG and financing funds, as well as the fiscal space for guarantees and the maximum volume of the future annual annuity payments. Other caps could be related to individual projects.

## Financial Support and Guarantees

### Initial Approach - Select bankable projects

The selection of bankable projects is essential if PPP projects involving Project Finance are to become a success. However since "bankable" depends largely on the constraints and opportunities of both the definition of the project and the environment in which this project is to be implemented, there are either no bankable projects, or all projects can be considered as bankable.

For example, if the private sector has to fund development, land acquisition and construction costs on the basis that it has to take all the planning risks and can recover the investment only through raising tolls even though tolls are capped and all projections indicate that traffic would be low, there will probably be no project that is bankable. If, on the other hand, the public sector takes all the planning risks, pays cost overruns and agrees to repay the private sector through a cost plus fee system, virtually all projects may be considered bankable.

Bankability is therefore determined by how the project is defined (e.g. starts after land has been acquired by public sector following the completion of the planning process) and the constraints that are imposed, or the incentives that are provided, in respect of

the implementation through the Concession Contract or Regulations. This means that many projects could be made bankable if well defined and if the environment provides sufficient incentive.

The process of selecting bankable projects, therefore, comprises selecting projects that can be given a serious chance of success by providing sufficient incentives through Government support and Regulations, whilst keeping these incentives within acceptable limits and in line with risk transfer objectives.

### Governmental support and Guarantees

Government support to a PPP project can be provided in various forms and serves primarily to facilitate its financing. The instruments and level of support provided depend on the risks involved for transfer to the private sector and the financing requirements of the project once a risk allocation structure has been established. These instruments do not however include structures whereby the public sector is 100% responsible for either funding or cost recovery.

Government support could be provided in the general framework for PPP solutions (Financial regulation) or as a result of direct negotiations in setting up the PPP structure for a particular project. It consists of:

#### *Tangible support*

**Direct Financial Support** in the form of grants, capital and operating subsidies, tax holidays, provision of land, provision of existing roads, VAT relief, etc.

Direct financial government support relates to instruments that will form part of the project funding or the income recovery instruments. They can be provided in the form of:

- **Capital funding** in the form of grants or capital subsidies, share capital or subordinated loans, whereby the precise form will depend on the project structure, the depreciation aspects, the profit sharing arrangements, etc.
- **Operating subsidies** in the form of traffic related payments or as fixed annual contributions.
- **Indirect financial contributions** could be provided in lieu of capital funding in respect of the provision of land or of connecting roads and interchanges for example or possibly in respect of some operational activities.

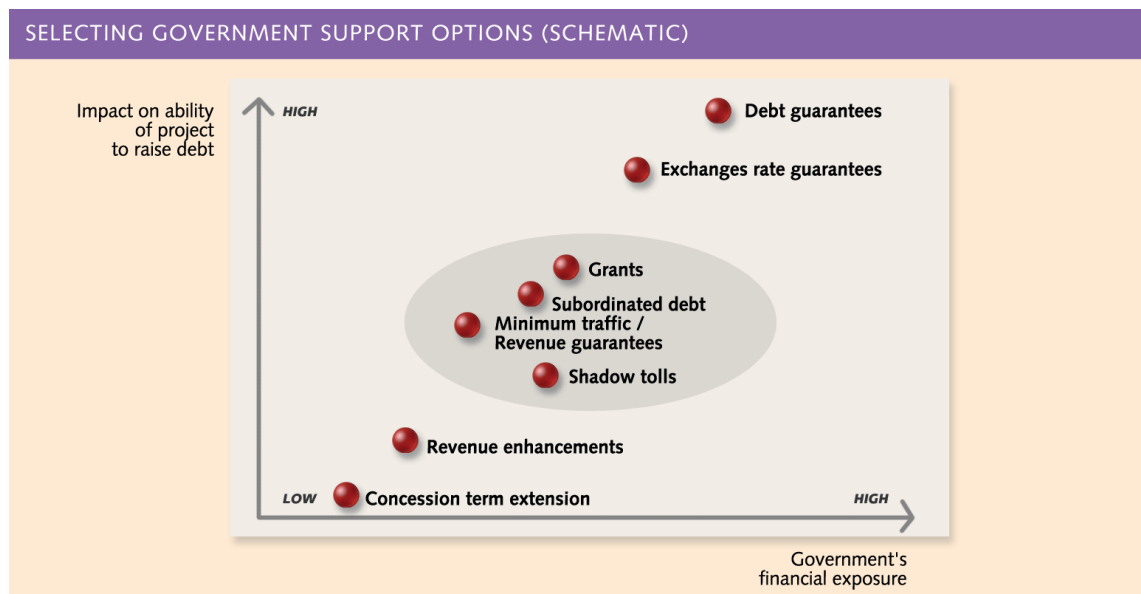
Both the amounts required in respect of capital funding and operating subsidies depend on the ability of (i) the project to service debt and equity and (ii) the ability and intentions of the public sector to make up-front contributions or not. The possibilities of providing indirect contributions depend largely on the individual project structures and such support in respect of operations is unlikely to be significant compared to the financial requirements and might even contradict the general efficiency aims of setting up a PPP.

**Intangible support**

This includes the implementation of restrictions on using existing parallel roads (for example weight restrictions for long distance traffic), the creation of new parallel (free) roads, introducing tolls on connecting roads, major changes in law or regulations affecting the project economics, etc.

Most of the intangible support items are very project specific and/or are difficult to define when creating the project and establishing the public-private partnership. Whereas for example the public sector can accept the consequences if parallel roads are created, it can never fully guarantee that such roads are not built. This means that if the construction cannot be avoided, the partners will review in good faith their contractual relationship, whereby the extent to which such a review will take place depends on the quality and impact of other forms of support that may have been put in place.

The chart below compares in schematic way the various types of Government support to PPPs.



Source: *Private Financing of Toll Roads. Fishbein and Babbar. 1996.*

**Guarantees**

The most common form of government contingent liability support is a guarantee, which in broad terms is a commitment to bear a risk or more specifically, “a contractual arrangement under which a third party (the guarantor) agrees to fulfill the financial or other obligations of the guaranteed party (the principal obligor) to another party (the beneficiary) in the case of default by the principal obligor”.

Other forms of contingent support instruments are: State insurance schemes, bailout of sub national entities or financial system, and disaster relief, among others. Guarantees can be structured in respect of debt, foreign exchange, demand, construction cost, interest rates and other forms.

Guarantees differ from each other depending on the kind of risk that they shield against and also in the proportion of the underlying obligation value that they cover for. Hence, there are guarantees on political and regulatory risks, exchange risks, force majeure risks, interest rate risks, default and credit risks, construction cost risks, and demand risks, among many others. Simultaneously, these guarantees are categorized in full and partial guarantees, depending on the level of support a government considers convenient to provide and the degree of risk exposure it is willing to bear.

Commonly used guarantees are:

- **Partial risk guarantees**, which offset risks associated with specific concerns regarding the host government;
- **Partial credit guarantees**, which back debt payments for certain periods of maturity, or certain proportions of total loan obligations, in case of project default arising from a variety of risks;
- **Full coverage guarantees**, which cover against all risks and where the guarantor is committed to fully pay the liabilities of the project to a lender in case the former defaults due to any risk;
- **Counter-guarantees**, where the government undertakes to compensate an external guarantor for all amounts disbursed due to the activation of the guarantee.

Simultaneously, these guarantees mentioned above may take the following forms:

- **Equity guarantees:** The public sector could accept to buy out the private sector under certain circumstances at a price that provides a minimum return.
- **Debt guarantees:** The public sector accepts to guarantee all or part of the debt service requirements or to refinance the debt at maturity in case of a bullet repayment. This guarantee can be called for whatever reasons or in respect of some well defined circumstances and can be provided to the private sector as a whole or to lenders through a direct Agreement for example.
- **Foreign exchange guarantees:** If the devaluation of the local currency in comparison with the currency in which the project is financed surpasses certain limits, the public sector could cover (part of) the difference. In turn, the public sector could require a share in the benefits if devaluation is significantly less than assumed.
- **Traffic & revenue guarantees:** If traffic (or revenue) is below expectations, the public sector could provide financial support to cover (part of) the difference, whereby a revenue guarantee is wider than a traffic guarantee as this also covers the toll rate risk. In turn, the public sector could require a share in the benefits if traffic (revenue) is substantially more than assumed.

Guarantees are instruments devised to facilitate risk sharing between the economic agents involved in a project. Sound and rigorous design and monitoring of these instruments can allow objectives to be attained with no excessive costs being shifted to the government while still attracting private investment. For instance, provision of partial guarantees (covering less than 100 percent of the underlying loans) may moderate the moral hazard that the guaranteed party would incur by aligning its interests with those of the government, rather than if it had been offered a full guarantee.

Limiting guarantees to cover debt payments, and not equity returns, or charging a premium on the guarantees issued may also encourage the guaranteed party to perform thorough risk assessments and to check its operations. It may also deter the guaranteed party from conducting the careless operation of projects, expecting the government to bail it out in the event of a negative situation.

If the expected costs of guarantees remain hidden within the government fiscal system, they have the tendency to stealthily accumulate risk and thus financial exposure on the part of government. Therefore, guarantees can ultimately result in ultimately, becoming a severe burden on a country's fiscal resources especially in the event of an economic downturn. Hence the importance of estimating the cost of guarantees, and making provision for them.

### Guarantee costing

Guarantee costing is a powerful course of action to reduce the likelihood of moral hazard implied by a non-priced guarantee, decrease investors' temptation to demand for excessive coverage, shift the cost of the guarantees to the consumers of the services provided by the guaranteed project rather than to the general taxpayer, and allow governments not only to cover downside risk, but also to share the upside potential through the acquisition of warrants on the relevant project.

Four general approaches to guarantee costing can be listed:

The first two, actuarial and econometric models, are disadvantageous for infrastructure-related guarantees since there is no usually available historic data on such projects from which to run calculations.

The third approach is based on stock option pricing theory, where a guarantee is regarded as a (European) stock buying and selling option, and may employ stochastic techniques to overcome the drawback of lacking historic data.

The fourth method, defaultable bond analysis, perceives the guarantee as the difference between a risk-free bond and a defaultable bond, and thus employs rating agencies' data or financial market assessments to value the guarantee. Further details are provided in Almeyda and Hinojosa (2001).



Revision of State-of-the-Art Contingent Liability Management. Almeyda and Hinojosa. 2001.

### Residual risk, contingent liability

The private sector is often reluctant to bear some of the risks implied by the nature of infrastructure projects. Due to the prolonged construction periods entailed by these projects, investors in infrastructure generally confide their financial resources to host-countries over very long periods, even decades. Unlike portfolio investments, investors lack the option of promptly withdrawing their resources in the case of political instability or economic volatility.

Thus, infrastructure investors face not only business risks that are considered normal for any investment, such as commercial and financial risks, but also risks that might be under the direct control or influence of the governments of host-countries, and directly associated with policies undertaken over extended periods of time.

The perceived existence and degree of these risks determine the risk assigned to a given country by investors, and thus the rate of return required by them in order to allocate their funds in that country. Country risk assessments are commonly offered to international market participants by credit rating agencies such as Standard & Poor's™, Moody's™, and Duff and Phelps™.

Generally, investors are willing to allot their funds at low capital cost in countries with low country-risk, that is, with macroeconomic and political stability, and strong and credible regulatory frameworks. In contrast, in cases of high country risk, the cost of capital will be substantially elevated, and it may even be difficult to attract investments at all.

### Recent Developments in Planning for Contingent Liabilities

When governments seek private investment in infrastructure projects, they usually find themselves asked to provide grants, guarantees, or other forms of fiscal support. If they make the wrong decisions, the costs can be high. Seeking to provide support without any immediate spending of cash, for example, governments often agree to shoulder project risks and sometimes encounter fiscal problems later. Yet even when governments have chosen to provide cash subsidies they have not always achieved their apparent goals. In still other cases, governments' decisions not to provide support may cause problems: some governments might arguably have averted opposition undermining private projects if they had temporarily continued to provide the subsidies they had implicitly been giving to loss-making state-owned enterprises. Governments that do not provide support to reduce political and regulatory risks may fail to obtain investment at all.

This Toolkit sets out a framework intended to help governments make good decisions about the provision of fiscal support (such as output-based cash subsidies, in-kind grants, tax breaks, capital contributions, guarantees of risks under the government's control, and guarantees of risks not under the government's control). It provides tools to facilitate analysis and the decision making process.

The Toolkit considers five possible government goals:

- internalizing externalities in infrastructure markets,
- overcoming failures in markets for financing infrastructure,
- mitigating political and-regulatory risks,
- circumventing political constraints on prices or profits, and
- redistributing resources to the poor via infrastructure.

And it considers six possible fiscal instruments designed to achieve those goals:

- output-based cash subsidies,
- in-kind grants,

- tax breaks,
- capital contributions,
- guarantees of risks under the government's control, and
- guarantees of risks not under the government's control.

Because each infrastructure project is different, the Toolkit does not try to draw universally applicable conclusions about the usefulness of the various instruments of fiscal support available to the government. It argues, however, that output-based cash subsidies have two valuable features: they can be carefully targeted towards the achievement of the desired objective, and their costs are usually clear. This does not imply that cash subsidies are always cost-effective; in practice, they often appear poorly targeted.

Whenever another instrument is used, however, the question naturally arises: is this instrument being used because it most efficiently achieves the objective or only because its cost is opaque and its use not subject to standard expenditure controls? In some cases, instruments other than output-based cash subsidies should be considered. In particular, political and- regulatory risks are likely to be best addressed through government guarantees of the particular political-and-regulatory risks of concern.

Government decisions are rarely driven solely by the dictates of cost-benefit analysis. Generating good decision making about fiscal support also requires processes for decision making that facilitate good analysis and temper the influence of self-interest. Fundamentally, such processes ensure decisions are made by people or organizations that have enough information, and strong incentives, to make good decisions-either by assigning decisions to those who already have good information and incentives or by improving the incentives of, and information available to, existing decision makers.

Several policies can enhance the collocation of information, incentives, and decisions: giving responsibility to people working on the objective (rather than the instrument or the infrastructure service); separating decision making from delivery; involving those responsible for costs; utilizing decision making forums that emphasize tradeoffs; routinely generating information on costs and benefits; requiring routine disclosure of information; charging for certain types of support; and ensuring accountability for decisions.



Public Money for Private Infrastructure - Deciding When to Offer Guarantees, Output- Based Subsidies, and Other Fiscal Support Timothy Irwin August 2003 World Bank Working Paper No. 1

In cases of high country risk, contingent liability instruments have been widely employed by governments to attract private capital to infrastructure projects at satisfactory rates to support them. Through these instruments, governments share some or all of the risks listed above, with the private sector thus lowering investor's required rate of return.

Contingency is defined by the International Accounting Standards Committee as a situation or condition whose ultimate outcome is determined only by the occurrence, or non-occurrence, of one or more events. Hence government support committed through a



contingent liability instrument, is provided only in the presence of an event determined ex-ante. In such case, the commitment becomes a direct liability for the government.

The flexibility of contingent liability instruments and specifically guarantees, offer some advantages to governments: as indicated before, they might drive down the cost of capital for a project in a given country; they help reinforce commitments of government agencies and sub national entities; they can be shaped to cope with a wide assortment of risks that are not subject to project or country limits and they do not represent immediate cash outlays.

On the other hand, contingent liabilities pose potential fiscal risks to governments and create moral hazard in the markets. They are often not officially reported, in other words, they are not directly associated with any existing budgetary program, which obstructs their monitoring and control. Since they are not current outlays and they are not reflected in the budget, contingent liabilities allow politicians to pursue policy goals that are not necessarily budgeted and may also compel governments to delay structural reforms. This situation can encourage short-term minded policymakers to provide concealed government support to determined projects and interest groups, while simultaneously accumulating excessive contingent commitments whose fiscal costs may not be disclosed for an undetermined period of time until a discrete event activates the claims against the government's resources. Such behavior generates uncertainty about future public financing requirements and endangers future fiscal stability.

Basic guidelines are provided in this section to assist policy makers in managing contingent liabilities.

## Fiscal Guidelines

### Fiscal Transparency Code

The International Monetary Fund has drawn up a comprehensive set of guidelines conducive to the sound control of contingent liabilities on the part of national governments. In particular, the IMF Code of Good Practice concerning Fiscal Transparency provides a series of steps oriented towards enhancing the accuracy of fiscal planning and reporting in the presence of contingent liabilities, thus improving the credibility of fiscal policy through public disclosure and government accountability in the face of risk, to ultimately ensure macroeconomic stability and economic growth.

In this respect, the Code asserts that "Statements should be published with the annual budget giving a description of the nature and fiscal significance of contingent liabilities, tax expenditure, and quasi-fiscal activities".

Accordingly, section 2.1.3 of the corresponding Manual on Fiscal Transparency offers relevant examples of contingent liabilities, both explicit and implicit, warns against the risks that they might entail and the shortcomings of traditional cash flow based budget accounting. The Manual further describes the advantages of accurate reporting of contingent liabilities in the management of fiscal risks and in the design of policies that involve risk-sharing between the government and the private sector.

It also recommends the inclusion of a statement of the main central government's contingent liabilities, and that they should be reported as part of a broader fiscal risk assessment. It is suggested that the statement should include a brief indication of the nature of each contingent liability and the beneficiaries, both to enable adequate assessment of "potential fiscal significance and to reduce the possibility of abuse through preferential treatment".

Finally, it advises: a) the inclusion of an estimate of the expected cost of each contingent liability (up to the limit set by technical possibilities); b) the provision of information about the basis on which the estimates have been calculated and, c) the registration of those contingent liabilities reported in the previous year's budget resulting in expenditure during the current year.

To the extent that these guidelines may be gradually adopted by IMF members, and thus might eventually serve as a benchmark of sound fiscal policymaking, it is advisable for national governments to take into consideration the measures proposed by the Code, in particular regarding contingent liability management.

### Public management of contingent liabilities

Four different approaches to controlling and managing fiscal risks entailed by contingent liabilities are suggested by Schick:

- the first one requires a publicly open stance on the part of the government regarding the types of risks it faces, as well as the volume and eventual costs these commitments will represent, and an estimation of the probability that such contingent obligations will be eventually triggered;
- the second approach implies the incorporation of risks assumed by the government in the current budget process, where the more direct and explicit the risk, the greater the suitability of budgeting proper resources to cover for the estimated costs of the existing contingent liabilities;
- in the third approach, the government should limit risks before they are taken by establishing criteria ruling whether or not governments should assume contingent commitments;
- the fourth approach envisages the reliance of governments on market-type mechanisms to either entirely or partially transfer risk, or risk assessment, to the private sector.

In line with Schick's first three points, Lewis and Mody (1997) advocate an integrated risk management approach to be implemented by governments, comprising:

- compilation, identification and classification of risks confronted;
- measurement of risk exposure;
- incorporation of risk exposure figures in national accounts and budget;
- determination of the government's tolerance to risk and definition of criteria for the establishment of adequate unexpected loss reserves;
- implementation of risk exposure supervisory and controlling systems.

As can be perceived, these authors agree that governments should systematically monitor and acknowledge their exposure to future liabilities. They should therefore record, assess, budget, and publicly acknowledge the risk exposure resulting from their contingent liability holdings.

The next subsections will describe the components of an integrated risk management approach following Lewis and Mody's proposal.

### Contingent Liability Management Methods Employed by the Private Sector

The private sector, specifically corporations, commercial banks and insurance companies, has made substantial progress in dealing with contingent liabilities in the past decade. Along this line, Schick (2000) suggests that since the business sector has more advanced statistical tools and hedging strategies for risk assessment, measurement and management, there is no reason for governments not to adapt relevant commercial practices to their fiscal risk analysis and supervision. In this respect, two examples of contingent liability management and determination of capital adequacy in commercial banking that could be illustrative to the public sector are offered: Basle Agreement Capital Adequacy Ratio and Value at Risk VAR.

More details on contingent liability management are provided in Almayda and Hinojosa (2001):



Revision of State-of-the-Art Contingent Liability Management. Almeyda and Hinojosa. 2001.