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POLICY BRIEF
GOVERNMENT SHARE OF PPP PROJECT COSTS AND RISKS

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ACRONYMS

ADB	Asian Development Bank
BOT	Build-Operate-Transfer
BTO	Build-to-Order
CIIP	Comprehensive and Integrated Investment Plan
CL	Contingent Liabilities
CLM	Contingent Liability Management
DBCC	Development Budget Coordination Committee
DBM	Department of Budget Management
DBO	Design-build-operate
DBP	Development Bank of the Philippines
DOF	Department of Finance
DOTC	Department of Transportation and Communications
DPWH	Department of Public Works and Highways
DTI	Department of Trade and Industry
EIRR	Economic Internal Rate of Return
EU	European Union
FIRR	Financial Internal Rate of Return
FONADIN	Fondo Nacional de Infraestructura Inicio
GAA	General Appropriations Act
GFI	Government Financial Institutions
GOCC	Government Owned and Controlled Corporation
GPH	Government of the Philippines
IA	Implementing Agency
IAs	Implementing Agencies
ICC	Investment Coordination Committee
IMF	International Monetary Fund
IRR	Implementing Rules and Regulations
LBP	Land Bank of the Philippines
LGU	Local Government Unit
LRT	Light Rail Transit
LRTA	Light Rail Transit Authority
MCA	multi-criteria analysis
MNTC	Manila North Tollways Corporation
MRT	Metro Rail Transit
MYOA	Multi-Year Obligational Authority
NBC	National Budget Circular
NEDA	National Economic Development Authority
NEP	National Economic Plan
NGA	National Government Agency
O&M	operations and maintenance
OBA	Output Based Assistance
ODA	Official Development Assistance

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OECD	Organization for Economic Co-operation and Development
PD	Presidential Decree
PDMF	Project Development and Monitoring Facility
PDP	Philippine Development Plan
PFI	Private Finance Initiative
PIP	Philippine Investment Plan
PNR	Philippine National Railways
PPA	Philippine Ports Authority or Power Purchase Agreement
PPP	Public Private Partnerships
PPPC	PPP Center
PUs	Performance Undertakings
ROWA	Right-of-Way Acquisition
SCBA	Social Cost Benefit Analysis
SLTC	South Luzon Tollway Corporation
SPV	Special Purpose Vehicle
SSF	Strategic Support Fund
STOA	Supplemental Toll Operation Agreement
SUC	State Universities and Colleges
TRB	Toll Regulatory Board
UK	United Kingdom
VfM	Value for Money
VGF	Viability Gap Funding

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1.0 OBJECTIVES AND BACKGROUND

1. Public private partnerships (PPP) can provide private capital, technology and management, for the provision of public services.

2. Under a partnership model, PPP should provide:
   i. Improved service and efficiency;
   ii. Capital (both debt and equity) that is raised independently of the government's fiscal accounts and debt stock; and
   iii. A more decentralized approach to public services.

3. Assuring achievement of these goals requires continuing government initiative in
   a. Developing an overall infrastructure/PPP plan.
   b. Setting terms for individual franchises.
   c. Providing
      i. "Affordability" subsidies in certain cases where economic and social returns, but not returns on equity, are attractive and the Government wishes to avail of private initiative. These subsidies are often referred to a "Viability Gap Funding" or VGF, a term which puts emphasis on input rather than result.
      ii. "Other support" including both financial and risk sharing as well as general assistance such as provision of security.
   d. Selection of PPP investors and continuing supervision of projects to ensure they meet their agreed goals.
   e. Adjusting terms and conditions, if appropriate, as the projects run on.

4. In aggregate, these activities shape the PPP program and make individual projects possible. The purpose of this paper is to explore the issues around government involvement, especially items 3c and 3e above. The other items are covered in various ways in other Policy Briefs as well as by existing laws and Implementing Rules & Regulations (IRR). The overall attractiveness of both the PPP program as a whole, and individual projects, will be a function of how well the Government blends the various elements at its command, including those which are listed above.

5. The objective of this Policy Brief is two-fold:
   a. To identify the generic types of Government Share (or Support) that can be extended by GPH to PPP projects through the sharing of the cost and risk of implementing and/or operating such projects, the specific instruments that should be used to effect the support and recommend those that are preferred; and
   b. To identify issues involved in the budgeting, monitoring and management of this support.

6. Within this framework, we give special emphasis to the issue of "Viability Gap Funding," or perhaps to use a term more accessible to the Philippine public, "Affordability Support," which comes into play when the overall Economic Internal Rate of Return (EIRR) of a project is attractive but the likely return to investors (FIRR) is insufficient to meet their requirements without some degree of Government subsidy.

7. As set forth in Table 1 below, the view taken in this paper is that "Government Share of Project Cost," as a component of Government Support, includes:
   a. Actual transfers of funds, rights and tangible assets to PPP projects, some components of which are often referred to as "Viability Gap Funding" as well as "hybrid" projects; and
   b. Contingent commitments to PPP projects ("Contingent Liabilities") which have an economic although not necessarily an actual financial cost, the value of which can be estimated statistically.

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8. A recent development has been that GPH itself is entering in its own name (actually through GPH Departments) to "Availability PPP Projects," where the PPP project itself makes investments in order to provide services to the government or on its behalf which are reimbursed under PPP-style contracts This is similar to the UK's PFI (Private Finance Initiative) program which has been running for many years. The obligations under these GPH Availability PPP contracts are analogous but not the same as the Contingent Commitments created where the GPH is not itself a party to the underlying transaction.

9. Our understanding is that the GPH, in principle, recognizes that while support in the form of grants or assumption of contingent commitments may be necessary to some degree to facilitate PPPs, GPH wants to control its financial exposure and risk levels in the context of fiscal stability. From this perspective, GPH faces several related issues:
    a. Setting forth guidelines for structuring of PPP deals, so as to calibrate Government Share of PPP project cost while "getting the deal done";
    b. Determining actual types, terms and levels of GPH costs to be provided and structuring their extension in ways that are consistent with Congressional appropriations authority. This may include subsequently altering terms to deal with emerging problems or opportunities without increasing actual "Government Share" payments or risk exposures;
    c. Providing the requisite level of comfort to investors interested in bidding for, and implementing, GPH PPP projects; and
    d. Defining management processes for Government Share.

10. The paper is organized as follows:
    i. Objectives and background (this Section 1)
    ii. Policy Matters concerning the substance and legal form of Government Share
        - Current Practices and Issues (general) – Section 2
        - Background and issues relative to VGF – Section 3
        - Recommendations as to VGF – Section 4
        - Recommendations as to other Government Share/Support issues – Section 5
    iii. Process Matters for managing Government Share over time
    iv. Summary of Recommendations – Section 7
    v. Appendices:
        I – Alternate Table 1 showing which types of PPPs use which Government Support Instruments
        II – Notes on International Practice – Government Share
        III – Notes on International Experience – Viability Gap Funding
        IV – Extracts from GPH's 2012 Fiscal Risk Report
        V – PPP Nomenclature: Assessment and Specific Recommendations
        VI – Definitions

2.0 POLICY MATTERS – CURRENT PRACTICES AND ISSUES

11. In its existing PPP program, GPH has provided Government Share by way of accepting a number of Contingent Liabilities arising from the terms and conditions in the project agreements. It has also, on a project-by-project basis, extended grants to some projects with the objective of reducing investment costs for the PPP sponsor, covering revenue deficiencies thereby inducing lower, more affordable, tariff levels while at the same time, permitting the private party equity a reasonable rate of return on its investment and reducing revenue uncertainty by assuming market risk. There is no formal policy framework for authorising and managing grants and subsidies for PPP projects, except that land is normally provided by government through a ROWA provision.

12. Each existing and prospective PPP project costing up to PHP 300 million for national projects and PHP 200 million for local government unit (LGU) projects is approved for tender by the NEDA/ICC, using requirements defined in the ICC Guidelines and the IRR. Projects in excess of these limits must be approved by the NEDA Board upon ICC recommendation. Each involves a package of direct terms and conditions as well as Government Share, as needed. GPH may be willing reluctantly to assume full, or partial, Operating Risks in Concession PPPs. (PPP best practice is to assign the risk to the party best able to bear it.) GPH may also be asked to backstop commitments under Availability PPPs undertaken by Government Owned and Controlled Corporations (GOCC's).

13. Table 1 below identifies a variety of economic and financial instruments that can be used to support PPPs and whether they are in current use in the Philippines. Note that the terms "Performance Undertaking" and "Credit Enhancement" under Sections 13.3(b) and (e) of the Revised BOT Law's IRR are overlapping and also are often (misleadingly) called "contingent liabilities." In the table, we use "Performance Undertaking" and suggest a clarification of nomenclature in Section 7, paragraph 82 of the IRR. Table 1 excludes "Performance Undertakings" and other forms of guarantee in which one level of government provides the PPP investors the assurance on behalf of another level of government which normally has an independent charter and Board of Directors (or a GOCC). However, it is included if the offering level of government creates an additional obligation of its own in favour of the PPP investors. We do not believe that a GPH Performance Undertaking or similar instrument issued to support other levels of government (or a GOCC) in itself increases project risk on the simple argument that Governments will in all likelihood support, unless it has clearly stated otherwise, the operations of their agencies, corporations and the like.

14. Broadly, Government Share of project cost, as set forth in the table below, is made up of four components: (a) Viability Gap Funding (VGF although the term is not yet formally used in the Philippines), (b) Coverage of Contingent or Direct Liabilities documented as GPH PUs; (c) Incentives; and (d) certain types of credit enhancements. Incentives are not of immediate interest in this paper because they can apply to projects other than PPP. Although we think they make sense, we will not include Incentives as part of Government Share and, for the purpose of this paper, will generally disregard items (e) and (j) in Table 1 below. The term "Hybrid" has been put in quotation marks since that name, and indeed the full evaluation of the underlying ideas, remain under discussion. See the definitions in Appendix 5 as well as paragraph 69k below. It should also be noted that GPH can provide benefits which are the functional equivalent of what it provides directly as Government Share by altering the terms of the Concessions and Availability contracts subsequent to the launching of the PPP. Amongst the possibilities is re-extension of concession tenors which can provide additional net revenue either to make up, for example, for losses caused by political *force majeure*, or to provide funding for additional Investments in the short term which are remunerated by longer-term earnings. Finally we note that GPH itself is making use of "Availability PPPs" that sell services or provide them to third parties against payment by GPH itself under long-term contracts.

Table 1
Government Support Instruments for PPPs

OBJECTIVE/INSTRUMENT (at GPH Level)	**DIRECT COST** *Can be budgeted although with some degree of uncertainty in some cases*	**CONTINGENT or INDIRECT COST** *Can be statistically valued but estimates are much less useful for budgeting*	**PHILIPPINE CURRENT USE/IRR Reference**
Ensure Revenue Contractual Certainty			
(a) Contractual Agreements or Performance Undertakings – *Force Majeure* -			
• Relief and Compensation from Uninsured Natural *Force Majeure,*	No	Yes	13.3b/e
• Compensation for Political *Force Majeure,*	No	Yes	13.3b/e
(b) Other Contractual Agreements or Per-fomance Undertakings to support			
• Take or Pay Arrangements	Yes	Yes	13.3b/e
• Leases, capacity payments	Yes	Yes	13.3b/e
• O & M Contracts	Yes	Yes	13.3b/e
• MYOA	Yes	No	Not a" real" or legally binding assurance
Lower Implementation Costs			
(c) VGF – (Capital Investment Subsidies)	Yes	No	13.3a
(d) ROWA Provision	Yes	No, although final cost uncertain	13.3a/c
(e) Import Tax Waivers	Yes	No	Yes
(f) Security assistance during Construction	Yes	No	13.3g
Minimize Operating Uncertainties			
(g) VGF, Other Operating Subsidies	Yes	No	13.3c
(h) Output Based Assistance (OBA)	Yes	No	No
(i) Other Performance Undertakings	No	Yes	13.3b/e
• Formal Revenue Deficiency Guarantees	No	Yes	Regulatory act-ion assurances
• Shadow Tolls	No	Yes	No
(j) Tax Holidays	Yes	No	Yes
Mobilization of Capital			
(k) "Hybrid" Projects incl. GFI Loans	No	Yes	13.3a
(l) Government Equity	Yes	No	Only if through GOCCs invest-ting in PPPs
Other			
(m) Support of PPP development through PDMF	Yes	No	Yes

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a. VGF tools can be said to include Capital Investment Subsidies (item c), Operating Subsidies (items, (g), (h) and (i) which include revenue deficiency guarantees, shadow tolls and other similar support, Output Based Assistance (item h), "Hybrid" project arrangements where GPH makes assets available to a project under various legal structures (in lieu of other forms of subsidy) to the extent that they are concessionary (item k). We do not include Project Preparation Support through PDMF (item m) because this is to be reimbursed by the first ranked bidder. We also exclude Security Arrangements (item f), as this type of support is generally not regarded as optional and appears to be a standard form of support from one country to the next; ROWA (Right-of-way or more broadly, site acquisition) is provided to all projects. It is considered part of the 50% limit on capital grants.

b. As mentioned in the table, Contingent Liabilities (item a) include relief and compensation from *political force majeure* and natural *force majeure*, when insurance is unavailable or exorbitantly priced. GPH's exposure to such events must, of course, be negotiated (See below). The remedy may be as extreme as a Government Termination Payment. Contingent liabilities also arise from the functional equivalents of contingent Operating Subsidies, such as the revenue deficiency guarantee, ridership guarantees and hydrology risks.

c. Certain instruments are used for Availability or Concession PPPs only; others may be used for both.

d. In respect of Government Share for Unsolicited Projects, the only credit enhancement currently allowed is for Take-or-Pay or similar agreements extended to Availability PPPs (where the project is supplying the Government or one of its agencies or GOCCs).

15. To date, GPH has provided on a case-by-case basis, Operating Subsidies mainly to toll roads, hydroelectric power plants and the EDSA MRT line. In the sections below as to VGF, GHD has recommended (with the exception of projects with low capital and high operating costs such as the Orthopaedic Hospital), discontinuance of Operating Subsidies such as revenue deficiency guarantees. Instead, GHD suggests that GPH should focus on the use of VGF in the form of capital grants in those cases where VGF is employed as a form of Government Share. When structured in this manner, operating risk is better apportioned between the public and private parties.

16. All of these items have cash values which can either be projected or measured statistically and aggregated, i.e. the "portfolio" of Government Share, can be measured and managed just like any other portfolio. It is important to look at all these items together, not only in terms of "what the Government is doing for PPPs," but also because all items have impacts (at different levels of predictability) on the GPH's fiscal position. The aggregated view may suggest risk mitigation strategies such as high-attachment-point insurance, extra physical backup, emergency planning, etc.

17. The "Government Share Risk Portfolio" at present is generally implemented under authority of the BOT Law through the issuance of Performance Undertakings ("PUs"), which may be considered to be "Credit Enhancements* (IRR 13.3b) as well as actual "Performance Undertakings" (IRR 13,3e). It should be noted that actual budget commitments, e.g. for MRT 3 or other projects receiving subsidies, were not counted as "contingent" or "potential" liabilities in the Castalia study. We have recommendations below concerning Department Contracts, DOF PUs and the management of GPH's overall PPP financial/risk exposure in Section 6.

18. Our understanding is that GPH has taken some measures to value the various Government Share items for fiscal planning purposes and, per the 2012 Fiscal Risk Report (Paragraphs 23, 25, 52, 54, 55, reprinted in Appendix IV), stress the need to upgrade the GPH's approach to managing these items. The only actual valuation of fiscal risks attached to the PPP program of which we are aware was conducted by Castalia Strategic Advisers in respect of the position at the end of 2008. The Castalia project was based on general international fiscal management best practice but reflected particular concerns, expressed in various press articles and

academic studies as to apparently ballooning liabilities arising from the 1990s' electric power developments. Castalia found that, for the projects it could value, mainly electricity and water, there was a:

i. Gross potential exposure of PHP 225 billion;
ii. A net exposure of PHP 61 billion which took account that the required termination payments meant that the GPH achieved control of the underlying project assets in return; and
iii. An Expected Value (based on a Monte Carlo probability analysis) of PHP 18 billion.

19. The valuation:

    a. Excluded much of the electricity liability on the grounds that the "Universal Charge" for stranded assets would cover much of that cost;

    b. Could not account for GPH contingent liabilities in most toll road projects since the Toll Regulatory Board (TRB) refused to furnish needed documentation. (The problem in this case arises if the TRB declines at some future date to approve tolls in line with the parametric pricing agreements embedded in the concession documents thereby leaving GPH to make up the difference); and

    c. Assumed that the Government would not otherwise interfere with the projects ("political *force majeure")* and thereby trigger Buyout Payments under the PPP agreements.

20. On the basis of what seemed to be a modest exposure in comparison to the national budget, Castalia recommended and, according to our understanding GPH agreed, that a relatively modest monitoring and management program under DOF would be sufficient at the time to manage PPP-related fiscal risks.

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21. Government Share tools are deployed in the context of fiscal and other legal standards. Pertinent characteristics of the Philippines' budget process are as set forth in Paragraphs 22-34.

22. Appropriations by Congress for infrastructure generally run for two years' maximum. During that term, the appropriation must be obligated and disbursed. PPPs are long term (i.e., across several Administrations in the Philippines). They depend on stable contract relationships with the official franchise grantors ("Concession PPPs) and stable long-term services and other contracts with off-takers ("Availability PPP's), including GPH entities. In principle, GPH could assure these conditions by way of comprehensive, enforceable Project Agreements, setting out terms and conditions, and (where GPH is not the direct contracting party) by issuance of GPH Performance Undertakings to assure investors of the proper discharge of the actual Agreements ("Terms of Contracts" Per Appendix V). The Philippine Constitution is clear that any funds to be disbursed, either under contracts with franchisees or to entities selling goods and services to the Government, are subject to prior appropriation by Congress. This condition is not unique to the GPH, as discussed further below, and other jurisdictions generally have the same appropriation requirement for the payment of money out of the treasury. To date, the GPH has fulfilled its contractual obligations and the GPH Congress has appropriated funds.

23. Relative to budget issues as mentioned above, GPH makes use of "Funds," such as the PPP Strategic Support Fund (SSF), which may have appropriations approved by Congress, with actual cash funding thereof by the Department of Budget and Management (DBM) subject to approved project requirements, budgetary exigencies and cash management. Currently the SSF must be committed within one year of Congressional appropriation and must disburse appropriations over a two-year period or they disappear. Funds are also set up for specific Departments. (In paragraph 49 and 58 below, GHD suggests that this availability period is insufficient for PPP projects requiring VGF, which may require periods of up to five years to prepare, tender, arrive at financial close and disburse for construction).

24. Although GOCC's and other sub-national entities can freely enter into long-term contracts, Departments of the Executive Branch face constraints from doing so by the short-term nature of the appropriations process as

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established by the DBM and Congress. For example, Departments have relied on MYOA certificates issued by the DBM as a legal basis for execution of long-term contracts in order to enter into an Availability PPP, (under the terms of the PPP, an obligation is imposed on the Department to make deferred payments for goods and services under a take-or-pay instrument [or its equivalent], the expiry of which may extend many years into the future). The MYOA, which contains an annual breakdown of the full project cost, obligates the Department and the DBM to prioritize in their budget proposals for the ensuing years the amount programmed for payment under the long-term contract but it is NOT a firm assurance of payment (i.e. that Congress would appropriate money) even assuming the contract terms are fulfilled by the private party, as the Supreme Court ruling explained in the following paragraphs confirms.

25. In the *Francisco v. TRB* case, the Supreme Court held that the following provisions violated Presidential Decree (PD) No. 1112 and were also unconstitutional:

    a. MNTC Supplemental Toll Operation Agreement or STOA, Section 11.7: To insure the viability and integrity of the Project, the Parties recognize the necessity for adjustments of the AUTHORIZED TOLL RATE …. In the event that said adjustment are not effected as provided under this Agreement for reasons not attributable to MNTC, the GRANTOR [TRB] warrants and so undertakes to compensate, on a monthly basis, the resulting loss of revenue due to the difference between the AUTHORIZED TOLL RATE actually collected and the AUTHORIZED TOLL RATE which MNTC would have been able to collect had the … adjustments been implemented" (MNTC Supplemental Toll Operation Agreement); and

    b. SLTC STOA, Section 8.08: In the event the Authorized Toll Rate and adjustments thereto are not implemented or made effective in accordance with the provisions of this Agreement, for reasons not attributable to the fault of the Investor and/or the Operator, including the reversal by the TRB or by any competent court or authority of any such adjustment in the Authorized Toll Rate previously approved by the TRB, except where such reversal is by reason of a determination of the misapplication of the Authorized Toll Rates, the Grantor shall compensate the Operator, on a monthly basis and within thirty (30) days of submission by the Operator of a notice thereof, without interest, for the resulting loss of revenue computed as the difference between:

        i. the actual traffic volume for the month in question multiplied by the Current Authorized Toll Rate as escalated and/or adjusted, that should be in effect; and

        ii. the Gross Toll Revenue for the month in question.

    "The obligation of the Grantor to compensate the Operator shall continue until the applicable Current Authorized Toll Rate is implemented."

26. According to the Supreme Court, PD 1112 expressly prohibits the guarantee of security of the financing of a toll operator in connection with its undertaking under the Toll Operation Certificate, making these clauses illegal. The Supreme Court added the TRB, by warranting to compensate MNTC [and SLTC] with the loss of revenue resulting from the non-implementation of the periodic and interim toll fee adjustments, violated the constitutionally guaranteed power of the Legislature, to **exclusively** appropriate money for public purpose from the General Funds of the Government**.** The TRB was viewed as having taken exclusive authority granted to Congress to appropriate money that comes from the General Funds, by making a warranty to compensate a revenue loss under Clause 11.7 of the MNTC STOA [and Clause 8.08 of the SLTC STOA]. The Supreme Court referred to Article VI, Section 29 of the Constitution, which states that no money shall be paid out of the Treasury except in pursuance of an appropriation made by law.

27. *Francisco* can be understood to support the extreme view that without prior appropriation, Government cannot even enter into a contract in which it is obligated to pay money out of the National Treasury (as shown in the separate opinion of Justice Antonio Carpio in the case of *Suplico v. NEDA*). This view may be derived from the

Supreme Court's reference to the Radstock case and the provisions of the Government Auditing Code. However, a contrary view may be taken, that is, the provisions of the two STOAs were considered unconstitutional by *Francisco* primarily because they operated as usurpation by the Executive of the Legislative prerogative to appropriate funds. The ruling does not apply to all forms of contracts or obligations, including BOTs. In an earlier case, pertaining to the counterpart provision in the 1935 Constitution, the Supreme Court said that appropriation must be made only on amounts immediately demandable. <u>It is also worth considering that with regard to PPPs, there is explicit authorization under the BOT Law for government to enter into the PPP contract variants</u> -

> "SEC. 3. Private Initiative in Infrastructure - All government infrastructure agencies, including government-owned and controlled corporations (GOCC) and local government units (LGUs) are hereby authorized to enter into contract with any duly pre-qualified project proponent for the financing, construction, operation and maintenance of any financially viable infrastructure or development facility through any of the projects authorized in this Act. Said agencies, when entering into such contracts, are enjoined to solicit the expertise of individuals, groups, or corporations in the private sector who have extensive experience in undertaking infrastructure or development projects."

28. This provision requires prior Congressional authority for the Government to enter into these contracts obviating the danger in Francisco of the Executive intruding upon the Legislative prerogative. In the Daang Hari SLEX Link Road contract, the Executive Department, through the Department of Public Works and Highways (DPWH), expressly recognizes the Legislative authority by stating that payment of shall be subject to prior Congressional appropriation.

29. If the long-term contracting that is typical of BOTs is not an issue, how does one perfect the legal status of the obligations typically incurred in these contracts by Departments of the Executive Branch, or the accompanying PUs? By law, GPH is able to provide supporting PUs in the case of GOCCs, GFIs, and other agencies without an appropriation. This is not the case for Departments of the Executive Branch. For Departments of the Executive Branch, or for any supporting PU issued on their behalf, there is a requirement for an appropriation before any amounts are paid, whether they be direct or contingent obligations. The summary below represents the current situation:

For Departments of the Executive Branch:

Entering into Availability PPP	MYOA required before the contract is signed, and annual appropriations must be secured to meet periodic payments under the purchase agreements, either under take-or-pay, lease or equivalent payment mechanisms. Since no PU is required, the Francisco case does not apply.
For GOCCs, GFIs, SUCs and Departments	
Entering into Availability PPP or Concession PPP	Appropriations required to meet potentially large, contractual lump sum, contingent liabilities which could crystallize as a result unforeseen events, e.g. - Examples include Payments arising from uninsurable natural Force Majeure or political Force Majeure events which provide the sponsor with the rights to terminate.
Entering into Concession PPP	Appropriation required to pay out under the periodic obligations that would be incurred under tariff path guarantees issued in the case of MNTC, leading up to the Francisco case discussed earlier.

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30. Except for Departments which are the equivalent of the central government and do not require PUs, such instrument issued by the central government, or its agent (DOF), for any of the above payments would require appropriation prior to any actual payment.

31. While the situation is not ideal, the above issues have existed for many years in respect of government procurement contracts (which are analogous to Availability PPPs in this respect) but have not been a problem to date, for several reasons:

    a. There have been no instances of early terminations or, at least, not large enough to create a fiscal (and corresponding, appropriations) issue;

    b. In those cases where payments have had to be made under Availability PPPs, of which there are been a few, appropriations are routinely secured for the annual payments;

    c. Neighboring countries, particularly, and, indeed, many developing countries have the same appropriation issues as does the Philippines. (It is for this reason that the PU has become such a popular instrument globally as it provides comfort to the investor that the central government's commitment lies behind the PPP obligations that are to be incurred, even though it is generally recognized that an act of the legislature lies between the "promise" and the "payment"); and

    d. GPH does not have a record of ever defaulting on any of its debts, whether arising from international loans, or from PPP obligations.

32. While it is clear that the appropriations issue does not currently appear to be a problem with longer term purchase contacts, it is unclear how long it will take before it becomes a constraint, particularly with foreign investors and all lenders. The issue, as and when it becomes a problem in the future, could be resolved in one of two ways:

    a. All long-term purchase and other obligations under Department PPPs will be treated as government debt, to be deemed appropriated as and when payments become due; and/or

    b. A special fund to be created with periodic annual appropriations from Congress, to be held in reserve by DBM to meet PPP obligations, particularly Contingent Liabilities. This would be similar to the fund created in Brazil for this purpose, *Fondo Nacional de Infraestructura Inicio* (FONADIN).

33. Both solutions require legislative acts. The solution in (a) is more relevant for Departmental Availability PPPs with long-term explicitly defined obligations in Take-or-Pay contracts, or leases, as these can be argued to be the equivalent of debt and/or the purchase of assets through an instrument equivalent to a conditional sale agreement. The International Monetary Fund, it is believed, has been considering how to tighten the accounting rules around PPPs but it is not known how far they have progressed.

34. It appears that the concept in (b) is already being considered in a House Bill 04151, the concept of which is:

    > "Section 6, Special Fund: A special fund is hereby created to defray the cost of compensation to project proponents which enter into BOT contracts, concession agreements, or other contractual agreements with any national government agency, or GOCC, pursuant to the provisions of Republic Act No. 6975, as amended, in the event that the government agency or GOCC fails to comply, or is prevented from complying, with its obligations under the aforementioned contracts or agreements as a result of any act of government agency or branch of government; provided that no compensation shall be paid out of the Special Fund if the contract or agreement has been determined to be unlawful or unconstitutional by a final judgment of a court of competent jurisdiction."

35. House Bill 04151 appears to be in the form of a budgetary construct, rather than a true standalone fund with its own management. It appears to be designed to handle all obligations, including contingent liabilities. As a budgetary construct, GHD believes this is a good idea.

3.0 POLICY MATTERS – BACKGROUND AND ISSUES RELATIVE TO VGF

Objectives of VGF

36. The purpose of this section is to explore in more detail current practices in the Philippines in the use of Viability Gap Funding (VGF) of nationally declared priority projects that are to be implemented as PPP projects, identify the issues in light of international practice and recommend updated process and implementation guidelines for the use of this tool.

37. **Viability Gap Funding** refers to a non-remunerated grant made by GPH to a PPP project so that the project can charge affordable tariffs to the public while producing a satisfactory financial return for the investor. VGF can take several forms, amongst them:

    a. Outright extension of funds to cost-share implementation of a PPP project, capital costs or operating subsidies of a PPP project. It should be noted that ROWA grants have a similar effect, although GHD agrees with the observations that emanated from recent Stakeholder Consultation that ROWA could be excluded from the 50% ceiling;

    b. "Hybrid" arrangements by which the GPH may provide financing for equipment/other assets for use by PPPs, such as the rail cars in LRT 1 South Extension project. Note that in some cases, the grant element can be determined precisely only after the tender, depending on its terms and what proponents offer to do; and

    c. Any contribution of real property (under various legal structures) to a project, over which usufruct rights to the proponent has been granted.

38. The level of VGF support and its terms and conditions, of course, would be a bid parameter in future projects.

39. VGF is a part of Government Share/Government Support. VGF may be viewed as a subsidy determined in accordance with an algorithm that focuses on user affordability in relation to PPP Sponsor returns. The above examples of direct and indirect government undertakings are believed to be consistent with the Revised (Build-Operate-Transfer) BOT Law IRR, Section 13.3, but go beyond the latter's scope in defining the processes and implementation guidelines to be used.

Rationale for VGF

40. Some types of infrastructure projects have high economic benefits but an unattractive commercial rate of return at user pricing that is affordable to the public. These projects are generally characterized by substantial investments, long gestation periods, lumpy cash flows, slow ramp-up in revenues, and risk-reward requirements that make the projects unacceptable to private investors without a VGF instrument. A capital grant (or indeed operating cost subsidies, used wisely), as stated earlier, can meet the objective of making socially viable projects become commercially viable through an efficient and transparent public resource allocation process.

41. Providing VGF grants to make economically essential projects commercially viable would obviate the need for full Government funding for such projects and allow private sector participation, thus facilitating potential private sector efficiencies in infrastructure development. A VGF grant for capital spending, as proposed herein must not by law exceed fifty percent (50%) of the true implementation cost of the project. (For ease of reference the applicable provision of the Revised BOT Law IRR 13.3 states that "the Implementing Agency (IA) may bear a portion of capital expenses associated with the establishment of an infrastructure development facility, such as

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the provision of access infrastructure, right-of-way, transfer of ownership over, or usufruct, or possession of land, building or any other real or personal property and/or any partial financing of the project or components thereof, provided that such shall not exceed fifty percent (50%) of the Project Cost." Notwithstanding, and as indicated earlier, GHD supports the possibility of excluding ROWA from the ceiling applicable to VGF. Since land and related site costs can vary considerably from one project type to the next, elimination of ROWA from the VGF ceiling tends to put all projects on an equal footing in terms of the percentage of project costs they can be awarded within the ceiling.

42. Section 13.3 of the IRR also permits operating subsidies (which in general we do not propose and certainly not without setting a finite cap, because it would be too difficult to arrive at fully predictable outcomes with regard to Value for Money analysis) and, more fundamentally to forecast potential fiscal impact over time.

43. VGF grants can be provided in cash or by way of Hybrid Projects. The concept here is to improve project-oriented financial terms with the project reimbursing the government over time. An important caveat in this respect is that valuing the actual cost of such support to Hybrids is quite complex, as discussed in some detail in Paragraph 69k. We assume that for purposes of BOT Law IRR Section 13a, the valuation is the initial cost of the assets injected into the project – such support not taking account of how the GPH finances the acquisition of such assets. Importantly however, this simplifies the issue of how to value Hybrid support. Accordingly, GHD has provided further comment with regard to this approach as set forth below.

44. Examples of what other countries do (precisely for the above VGF-oriented reason) include:

    a. **Heavy Rail** – Normally**,** government invests in ROWA and installs the rail network; while the PPP Project Company invests in rolling stock, signalling equipment and stations;

    b. **Mass Transit** – government invests in ROWA, which may include valuable pieces of urban property which can be used for commercial purposes and the rail network; while the PPP Project Company invests in rolling stock and commuter stations;

    c. **Ports** – government invests in ROWA and the breakwater; while the PPP Project Company builds port infrastructure; and

    d. **Airports** – government invests in ROWA, runways and apron, while the private sector provides the terminals.

45. Further details of international practice are summarized in Appendix III.

Issues needing to be addressed currently:

46. VGF grants globally have been made for both capital and operating costs. This paper makes a recommendation as to that resolution which is appropriate for the Philippines.

47. GPH is providing operating subsidies for some projects where the future call on the budget is not easily known. If the subsidies are uncapped and, as appears to be the case, not always subject to systematic, prior analysis they defeat the purpose of **whole of life costing** and **value for money** analysis and create fiscal risk.

48. With regard to Hybrids, care should be taken to manage financing the VGF with ODA loans in a different currency, as this makes it difficult to estimate for decision purposes the actual subsidy that is being assumed by GPH. However, ODA and comparable Government borrowing may be of use in such projects". See paragraph 69k below. If instead of making a grant, GPH insists on full or partial repayment of what is initially a VGF capital subsidy, the calculation becomes more complex.

49. VGF estimates are necessary for the budget process. To the extent that projects gestate during the budgeting period in the second half of the year, accelerated estimation will be necessary to assure that appropriate amounts "make it" into the budget proposals.

50. As mentioned before, the General Appropriations Act (GAA) is approved of every year in the Philippines. Monies that are appropriated for infrastructure for the following fiscal year must be obligated within one year and disbursed within two years. See, for example, DBM National Budget Circular 535, applicable to FY 2011 and 2012. This imposes unrealistic limitations on the disbursement of funds for infrastructure facilities, generally, and for PPP projects, specifically. This has not been an issue in the past, but would arise if VGF capital grants are to be made which, in all likelihood, would be payable in part after the currently allowable two year period. GHD would suggest a review of this DBM policy implied by this Circular and consider an exception for PPP projects, as it often takes a full year to prepare a project for tender; the better part of a year to tender the project; and, in most cases up to three years to disburse funds for its construction.

51. Process and Implementation Guidelines need to be put in place to effectively manage and maximize the use of the VGF tool, as is discussed further below.

4.0 RECOMMENDATIONS RELATIVE TO VGF

Whether to Offer VGF and in What Form

52. In principle, VGF is a sound way for the Government to promote the creation of infrastructure projects which charge affordable prices to users whilst being attractive to private sponsors. It is allowed by law provided it is appropriated and disbursed within specified limits. The underlying rationale, affordability, is a powerful one especially when supported by highly professional analysis during the PPP development process.

53. However, VGF should be confined to Grants to pay for a portion of project capital expenditures excluding construction period interest, and subject to the 50% limit (and in GHD view) exclusive of ROWA. This is much easier to control than operating subsidies and is disbursed within a relatively short period, lessening fiscal uncertainties.

54. We nonetheless acknowledge the argument that VGF might better be deployed during operations as output based aid (OBA), that is, payments for meeting actual defined performance targets, of a socio-economic nature. For example, in power or water projects, OBA is usually structured in the form of a contract between government and the project company, wherein the former makes payments to the latter up to defined annual targets for electricity or water connections made into a peri-urban area. The level of annual connections and corresponding payments for meeting these levels would be capped; hence the level of support is defined and known from the outset. This is in contrast to GPH agreeing to a minimum revenue guarantee in a toll road, or a ridership guarantee in a rail project. In the latter cases, the level of budgetary support is unknown from the onset. Hence, OBA is to be preferred to all other types of operating guarantees because it enables value for money analysis, a form of analysis which GHD considers to be important in justifying a project for PPP implementation.

55. We maintain our preference for capital grants which are inherently close-ended and limit the GPH's financial risks since the PPP proponents remain responsible for overall construction cost risk. Capital grants force the parties to work out detailed agreements on expectations and do not leave open the possibility of increasing subsidies in the future. If output based subsidies seem necessary, they should, as we remark below, be subject to annual and cumulative caps.

56. Another means to support projects is the "hybrid" structure which we cover in Paragraph 69k below, rates and availability periods involved not only in the actual project structure but in terms of viable alternatives. An example of the above technique is the LRT 1 Extension project.

57. There must also be some valid exceptions to the VGF policy guidelines as currently stated in this brief, for example in respect of projects with low capital costs and high operating costs, e.g. the Orthopaedic Center, a project where a capital subsidy alone will not "do the job." Operating subsidies must be carefully planned so as to create reasonable incentives for proponents. Such subsidies are normally best tied to tangible/measurable outputs. They should expire after a fixed term and amount, so as to allow renegotiation if appropriate. If the percentage of costs being covered by the subsidy is projected to rise to a very high level, consideration should be given to keeping the activity "public," possibly through long term supply contracts that put the Government in full, but high level, control of activities.

58. Infrastructure is expensive and the VGF requirements for the country are likely to be large and must be considered carefully. Amounts to be recommended for VGF appropriation will thus be carefully deliberated by the Administration before being budgeted and carefully managed by the Administration when disbursed.

59. A VGF program will need to consider an exception to the limitation on the 2-year obligation and disbursement requirement, imposed by DBM in its National Budget Circular. GHD recommends issuance of a new Circular by DBM for 2013 that exempts PPPs from this general requirement and allows disbursement of public funds for PPP projects up to 5-years from appropriation. Note that the National Budget Circular 535 refers to budgets for 2011 and 2012. Any special provision for the 2013 budget should be relayed immediately so that it can still be included in the budget notes of the 2013 National Expenditure Plan (NEP) – and eventually the 2013 General Appropriations Act (GAA).

60. GHD recommends deferral of payment of VGF subsidies until all of the private sector equity has been invested or at least acceptable guaranties provided to assure that it will. This is to reduce government risk and to spread out the financial burden. Draws of government support would be made in accordance with a tightly written agreement specifying the preconditions of each such drawdown, their relation to drawdowns of project equity and debt financing, tight adherence to the construction "S-curve" schedule of progress as vetted by an independent consultant, and other matters. The government share is deferred, and there may be concerns on the part of both equity investors and (especially) debt financiers. It may therefore have to provide credible assurances and guarantees of prompt payment itself in accordance with contract terms. We regard this as an acceptable *quid pro quo*. Adequate legal/budgetary arrangements, recommended elsewhere in this paper, are an important element in providing such assurances; these matters are, we would add, subject to negotiation; and agreement. Note that in the event of "Hybrid" projects where GPH provides assets rather than money, the timing of the provision will have to conform to the construction schedule, in which case adequate investment assurances from the PPP investors would also be needed.

61. All projects receiving VGF should be considered for a "Clawback" provision (referred to as "Revenue Sharing" further below) arrangements so that GPH has the option of recovering some amount of its VGF Grant if the project IRR is above a certain threshold. Whether or not a Revenue Sharing provision is employed can be decided on a case by case basis prior to the tender. There will be intricate trade-offs between affordable tariffs and other conditions, VGF and Revenue Sharing. In any case, Revenue Sharing should generally be for only a portion of any "excess" returns, (e.g. 50% of returns above ["x" IRR]) and will have to be judged according to perceived investor interest in the first place.

62. Where complex projects are handled as one unit, some elements of some projects may be deserving of VGF whereas it is not pertinent to others. For decision purposes, at least, project elements should be disaggregated so that VGF is directed to the right places in the right way.

63. Recommended VGF eligibility criteria, implementation issues, oversight roles and responsibilities and process guidelines are touched upon in this paragraph.

VGF Eligibility Guidelines

a. Any and all Concession PPP projects are eligible for VGF;

b. VGF grants will cover construction costs only excluding interest costs;

c. VGF projects **must be publicly solicited;** unsolicited proposals shall not be eligible for VGF;

d. VGF project equity must be 51%, or more, owned by private sector;

e. Structure of the project shall be concession-based, with pre-determined tariff and actual grant identified on the results of bidding; among other variables, bidders will request the level of VGF they think they need to achieve the project's commercial objectives;

f. Purpose of the grant should be to improve affordability, generally, but in some cases to accelerate the development of critical infrastructure. Hybrid projects may be exceptions, and indeed there may not be any value gaps but rather the aim may be that of making the project especially attractive to investors and consumers through the infusion of government-based special financing facilities;

g. EIRR must be greater than 15%, or as determined by NEDA;

h. Subsidy should be drawn during construction period only and shall not exceed 50% of project costs; ROWA is currently included for the purpose of establishing limits, but may be excluded over the longer term so as to set all projects on an equal footing with regard to the access to VGF within the 50% limit; and

i. Will cover capital investment costs of the project as budgeted but excluding interest costs during construction. "Soft" costs will be carefully reviewed for reasonableness.

Implementation Guidelines

Examples of implementation guidelines include:

a. How is the grant infused into the project? Who receives payment and with what restrictions? In some countries, the grant is infused *pari passu* with debt, through provisions found in the accounts control agreement delivered to the agent bank; after the sponsors' equity has been fully disbursed. This is a conservative position and should be considered by GPH even though it will increase the tariff.

b. What are other key elements of the transaction structure e.g. guidance related to equity as a percent of total capitalization [is the capitalization a minimum of 30% of project cost or 20%?], size of the performance bond [between 15 and 20 percent?], longstop date [180 or 270 days?] joint and several guarantees? Standby equity or guarantee of completion? Dividend restrictions, Refinancing gains, other?

c. Where VGF is involved, it is especially important for decision-makers to look at ALL elements of Government Support going into a PPP project as well as other terms and conditions in order to ensure that the package as a whole makes sense in terms of the objective to serve the public while permitting a satisfactory profit to investors.

Overview of Institutional Roles in VGF

a. DOF will be working with IAs on VGF analysis - calculation methods are summarized in Chapter 2.11 of the NGA Manual.

b. For programming purposes, the Development Budget Coordination Committee (DBCC) of the NEDA Board should ensure that amounts requested for appropriation by Congress for the SSF should position the fund to meet pre-set, maximum, VGF requirements for the following fiscal year. We note that this is not a project approval but rather budget availability.

c. During the budgeting cycle from November to July of each year, and even before the cycle commences, PPPC should be responsible for assisting IAs in selecting candidate PPP projects for implementation in the year subsequent to the following year, using tools such as multi-criteria analysis (MCA), preliminary social cost benefit analysis (SCBA) and prefeasibility studies. This level of documentation will be needed to, in a more sure-footed way, select those candidate projects which can be implemented as PPP, and for tentatively identifying/estimating the amounts of VGF needed by those projects. It should be understood that the VGF amounts are not firmed up until each project requiring such assistance is approved for tender by ICC. Even then, however, the VGF amount may not be determined until the tender is completed and the award is made.

d. PPPC and DBCC shall preliminarily review and clear for budget purposes only those projects deemed to require VGF as well as be in conformity with the reasonableness of the amount estimated to be required.

e. After the General Appropriations Act is passed by both houses of Congress and is signed into law by the President, PPPC working closely with the IAs should further assist the IAs in completing each project's preparation. By extending funding through the PDMF, PPPC can assist IAs in preparing feasibility studies to validate the original (pre-GAA) selection of candidate projects as PPPs. A VFM analysis will also be completed as part of the feasibility study, to ratify the decision to use the PPP format for the project.

f. ICC is responsible for reviewing and approving the actual VGF requirements of specific projects and endorsing recommendations to DBM to ensure that cash requirements are prioritized. The endorsement to DBM is on the assumption that the current SSF budget allocation mechanism is used. Later, if a centrally administered special fund is established, the endorsement will be submitted to the fund administrator.

Detailed Process Guidelines

a. During each year's budget exercise, projects that are adjudged by PPPC and IA to be suitable for PPP, but requiring VGF, should be identified with an estimate of the amount required. PPPC should compile the complete list of all candidate PPP projects, including those requiring VGF, and submit the list to the DBCC for clearance. The latter will then determine if the aggregate amount for the VGF is based on its budget prioritization parameters.

b. No PPP project should be proposed for VGF support unless it is clear from its preliminary economic analysis that it is likely to meet SCBA minimum required EIRR threshold established by NEDA.

c. Only candidate PPP projects, including those requiring VGF, that are cleared by DBCC will be subjected to further analysis, including feasibility studies.

d. PDMF will be used, when appropriate, to fund the prefeasibility, or feasibility study, requirements of PPP projects, including those requiring VGF.

e. During budget implementation, PPPC will ensure that the feasibility study for projects requiring VGF is complete and will indicate the rationale and reasonable level of the VGF required.

5.0 RECOMMENDATIONS ON OTHER ISSUES

64. Turning from the specific issue of VGF to the other instruments cited in Table 1, we have the following further recommendations. As implied above, it would seem prudent to set forth guidelines and constraints on the use of these instruments (including VGF) that are part of Government Share. GHD summary recommendations regarding the use of instruments in Table 1 are as follows.

65. **Operating and business risk, as much as possible, should be assigned to the private proponents save for ROWA, which we do see as "operational," and for which GPH is better suited to manage and bear**. An important principle in PPPs is that private management is better at managing operating risks than the GPH and

the transfer of this risk should be optimized within limits of manageability. Terms of a PPP must be such that a well-managed PPP enterprise can earn a profit that matches the private sector's hurdle rates for various types of activities.

66. There will be exceptions to this general proposition. Certain risks, referred to in this brief as "*Force Majeure* Contingent Liabilities," are usual for governments to undertake, including uninsured natural, as well as several components of risk that fall under the concept of political, *force majeure*. This said, as noted previously, detailed terms relative to these obligations must be negotiated. Also, we do not believe GPH has really looked at its various natural *force majeure* exposures on PPP projects in aggregate sense, and thus **it may want to consider whether some form of broadly spread, high attachment point catastrophe cover might make sense** even though individual PPP projects all require adequate insurance which should be carefully monitored by GPH IAs.

67. If GPH exceptionally decides to take operating and business risks, it should certainly ensure that it is properly paid for doing so, whether in the form of specified adjustments in terms from PPP owners, fees or incentive compensation arrangements or all three.

68. **Availability PPPs set up by Government Departments or Agencies, which feature take-or-pay instruments, in GHD's view, are "business as usual" transactions and do not imply incremental exposure related to Government Share**. On the contrary, GPH needs the inputs (and, thereby, assumes the business risks) for carrying out its activities but may be able to farm out components of this risk to the PPP Proponent. We would note, however, that entering into long-term contracts does reduce Government's flexibility since they cannot in all probability be cancelled without penalty and this risk should be noted for fiscal risk purposes. We would also comment that Performance Undertakings issued in respect of GOCC's take-or-pay or other contractual obligations do not actually increase risk to GPH on the assumption (which should be qualified if it is not the case) that it will stand behind its GOCC's. The level of government support for government-owned corporations has been a subject of major misunderstanding around the world between lenders and governments, and there is no substitute here for clarity – bankers tend to assume that "the government will be there" unless the government says it will not.

69. **The combination of a renewed PPP program and the addition of a potential large subsidy input (through VGF) suggests that, in the context of fiscal risk management, GPH should review and value periodically its position on (not) provisioning for Performance Undertakings and/or paying out on future disbursement requirements of VGF.** We cover this point in greater detail in the Sections 6 and 7 below on Process Issues. However, the Expected Value of the current allowable Performance Undertakings is fairly low, and provisioning would be a management decision to call attention to these rather than a real economic and accounting assessment.

70. Recommendations with regard to contingent liabilities are as follows:

    a. **GPH assumption, by way of Performance Undertakings or direct contractual agreements*, of Force majeure-related* Contingent Liabilities**, as defined herein are basic market requirements. GPH should have a set of "preferred" or even "mandatory" written model PU terms and conditions for such clauses, which are generally unavoidable in some form at least with international investors and lenders. However, there are specific matters about these *force majeure*-related PUs which are subject to negotiation, including Termination Payments and to some degree actual risk sharing in respect of Natural Force Majeure issues, hydrology risk and other types of operating risks. **In this case, GPH should assume risk only up to the level required to service debt, beyond that, proponents should be at risk**.

    b. In some cases concerning Availability PPPs, sub-government agencies and GOCC's enter into leases and Take-or-Pay contracts that require GPH support. The principal user of this requirement has been the

National Power Corporation, which is now being privatized. Nonetheless, this type of Performance Undertaking will remain necessary and appropriate in some cases.

c. In paragraphs 24-34, we set forth an extensive discussion in respect of the *direct* long-term purchase obligations arising from Departmental Availability PPPs, and/or PUs issued by the DOF to support *indirect* contractual obligations of GOCCs, GFIs and SUCs. Obligations under Departmental PPPs are subject to annual appropriation, and the PUs supporting the contractual obligations of other agencies are subject to Congressional appropriation. Ideally, these solutions must be "legally perfect:" GHD does not have an immediate recommendation on this matter as it is not a problem currently. Over time consideration could be given to resolution of these issues through measure that are described in paragraphs 31-34, above.

d. The ideal solution for PUs is a law change that puts the PU equivalent to the financial guarantee GPH provides to its Departments when the latter borrow from donors, an activity currently authorized by law.

e. As to Availability PPPs, the standard model is probably the UK PFI program which provides for long-term contracts within the normal expenditure process.

f. As mentioned in paragraphs 24-34, GPH in the past has had DOF issue PPP-related performance guaranties supporting the obligations of Departments of the national Government, which is redundant – but was perhaps necessary to satisfy lenders, or investors, who are more comfortable with a DOF undertaking. With the country's significant increase in creditworthiness, it should be possible to eliminate this burdensome "market" requirement. However, we would suggest this be done through positive negotiations rather than by fiat unless bankers cannot be persuaded to be reasonable. The negotiation should be supported by a strong opinion from the Department of Justice, written in consultation with the leading local law firms which advise international PPP investors, laying out the legal position that a DOF written guarantee or assurance in respect of another GPH Department is unnecessary. DOF should be willing orally to confirm to lenders that it is quite aware of its sister department's activities, being the approving authority of PPP contracts with national government undertakings, and may wish to point out that (when it implements the Castalia recommendations [as per Section 7 below]) the DOF is at the center of monitoring and managing all GPH commitments.

g. With the build-up of PPPs and further commitments for VGF, the issue of provisioning for Performance Undertakings should be reviewed to the extent budgetary plans involve actual significant legal exposures under contracts; this goes with the consideration of solutions for the *Francisco* ruling.

h. "Hybrid" PPP projects – These projects include (in the Philippines) the provision of GPH-provided assets (other than ROWA, which every projects gets), or of GFI-provided financing, into a PPP project. An example of a Hybrid project is the LRT 1 Extension, a BTO project where the GPH will provide rail cars (financed by a Japanese Government loan that would not be directly available to the PPP project). In return, the PPP project is expected to offer lower fares as the GPH financing arrangement with Japan will lower capital costs. In other countries, the term "hybrid" has other meanings but is generally associated with variants of project structure from the common archetypes used in worldwide PPP parlance.

i. There are many complexities in Hybrid deals and GPH must be careful to work out all the terms so that the deal "works" in a physical and financial sense, and there is a clear understanding of the advantages, risks and costs involved both by GPH and the project owners.

j. Hybrid deals are most likely to be used for Concession PPPs in order to lower costs and facilitate lower user charges. A provision of capital assets for which GPH does not expect reimbursement (or only partial reimbursement) is the functional equivalent of a VGF Capital Grant (or following our recommended terminology, an "Affordability Grant)." It is possible to conceive of VGF type of grants for other purposes, with the PPP proponents reciprocating with benefits to the government or the public, but we here maintain the focus on VGF itself. For whatever purpose, the Grants involve Cost Sharing under IRR 13.3a. In

principle, Hybrids are all subject to the same contractual configuration as a cash grant, with additional provisions to account for the fact that the Grant is in terms of financing rather than cash.

k. GPH might also provide ongoing services to the PPP project, which would be a Direct Government Subsidy in lieu of cash. We are not aware such transactions have been effected but may be logical if the assets in questions are already in existence and under GPH management. . We are generally averse to operating subsidies, and in this case the more so, on the premise that the private operator is assumed likely to do a better job.

l. A variant on the Hybrid formula is when an international institution provides ODA which GPH uses in lieu (on whole or in part) of a VGF subsidy.

m. There are basic issues involved in Hybrid projects. They are decidedly not simple." Considerable calculation and judgment needs to be applied:

   i. Procurement Issues --- Construction management is a significant issue, equally procurement has to respect GPH regulations but mesh with the PPP sponsor needs (including delivery timing, specifications and policies). The assets provided have to be suitable as well as compatible with the infrastructure that is built by the PPP sponsor, and there must be agreement as to clear responsibility for the effects of any operational problems in the project related to the assets furnished. The BTO agreement, in the case of the LRT 1 extension can, of course, take this into account. With procurement goes financing, and there may be complexities in terms of ensuring that the overall project financing plan accommodates the Hybrid aspects of the project. We noted issues in connection with Hybrid used for VGF grants.

   ii. Structure of Project Terms – Government provision of substantial capital assets will perhaps change the dynamics of the bidding process in the sense there will be fewer parts of the contract on which to compete. Indeed bidders may try to influence these matters. In many cases, it would probably be wise to develop alternative feasibility studies with and without the Hybrid formula to test the worth of "going Hybrid." Obviously the financial terms of different solutions will be different, and will often influence the outcome comparison as well.

   iii. Appraising, Valuing and Pricing the Assets --- GPH and the PPP proponents must agree on the valuation of assets. Where assets will be purchased by GPH for injection into the project, there must be agreement on the pricing and purchase terms for such assets. It is not necessarily the case that assets provided under government-to-government loans are more cost effective than assets purchased in the open market by the PPP Project Company or the government's own funds. Similarly, when ODA is involved, it is not necessarily obvious that the asset injection would be the best use of the ODA, if GPH could use the ODA loan or grant for other purposes.

   iv. Financing the Asset Injection --- Most often, the Hybrid Project is an effective way of infusing a benefit into a PPP project because GPH can borrow money to purchase the assets on terms better than those of the PPP project company. In principle, these benefits are passed on to the project as part of its terms and conditions. The government bears the cost and risk of servicing the loans above and beyond whatever (if anything) the project is required to pay for the use of the assets. Government financial management is separate from Hybrids, but must be viewed in the context of the transaction as a whole. There may be considerable currency exchange risk; both in a basic sense of foreign borrowing and in the specific sense of borrowing in currencies other than the USD which is the base reserve holding of GPH. Usually the interest rates underlying Hybrid transactions are quite low, but the foreign exchange (FX) risk is an offset. Under commonly accepted PPP doctrine, arguably, the government is in the best place to bear FX risks since few PPP projects produce foreign currency earnings. We do not take a position on financing other than to say it needs to be thoroughly analysed as part of a government's overall borrowing plan as well as in relation to the Hybrid PPP. We note that the Philippines own

international financial position has improved very substantially in recent years and GPH can therefore be more selective in respect of offers of export financing and tied ODA from supplier countries.

v. Value for Money Issues --- The assets injected into a Hybrid PPP may be valued for purposes of IRR 13.3a at the price at which they are obtained. However, the cost of providing such assets needs to be estimated and budgeted. If new loans or ODA are obtained for the Hybrid, the cost of provision is the cost of this borrowing less any front end, or ongoing, fees and reimbursements paid to GPH by the project company. In the case of assets already owned by the GPH or developed without specific loans, there is still a cost of government borrowing to be applied (assume to be amortized over the project life). The gross and present value costs of the Hybrid can thus be estimated once the tender is completed but, of course, the actual cost will only be known when the underlying financing is paid off. This equally applies to assets financed by PHP domestically. In terms of the negotiation with the PPP proponents, of course, the government needs to be conscious of the value of what it is providing which is determined by what the proponents would have to pay to borrow and buy without the Hybrid feature. GPH should be sure to get full value for its contribution, which may be in the form of lower user charges than actual reimbursement.

vi. If a procurement situation is especially fraught, or there are questions about terms favouring one bidder or another, it would also be possible to offer a tender containing a particularly Hybrid option as well as a cash option.

vii. In summary we understand that certain Hybrid transactions may well be attractive but caution that they are intrinsically complicated and have long-term budgetary implications in many cases above and beyond the provision of assets *per se*. Both GPH and the private proponents have to work hard to ensure that value is realized for the benefit of users and the country as a whole.

n. Government Equity – The point of PPPs is to attract private equity. The GPH should, we believe, avoid this activity. There are conflicts of interest in the GPH investing in something it likely regulates or from which it purchases goods and services. GOCC's, based on joint ventures, may be creating PPPs which could be appropriate since they are commercial corporations. However, any effort to support the equity commitments of a GOCC should be accessed through the normal ICC process and not given a special pass.

o. Use of the Project Development and Monitoring Fund -- This covers the GPH's own costs of launching a PPP, which it aims to recover from the winning proponent. It perhaps is a form of government support, but in our opinion, it would not classify as Government Share (for the fiscal year beginning the following January) since the work is part of the Government's process for approving a PPP.

p. Guaranty Fund – This is discussed in Paragraph 31b and 33, but we give further comment here as this issue is often raised. Funds, which are used in other countries, may either assume or guarantee the obligations of GPH under Performance Undertakings and other Credit Enhancements. In Indonesia, the Guarantee Fund is set up as an independent, standalone fund, with its own management; while in other countries, the fund is simply a budgetary construct, a way of provisioning for unanticipated calls on the budget. The objectives of the Indonesian fund, which is to guarantee all obligations of the government, impacts its size and scope. GHD would suggest the budgetary construct model to start with.

6.0 PROCESS ISSUES – CURRENT PRACTICES AND ISSUES

71. Budgeting practice, including the submission of the National Expenditure Plan to Congress in July for the fiscal year beginning the following January, places a large stress on PPP budgeting during the first year of any new Administration which has to set forth a Philippine Development Plan (PDP) and a Philippine Investment Plan (PIP) to guide IAs in planning and budgeting for PPP-related expenditure. PDMF is a revolving fund and, in time, should not require fresh appropriations but the SSF will need to gain longer term appropriations, as discussed earlier, than currently available.

72. Funding for Government Share has to be closely linked with the annual budget cycle, a topic which is addressed by DBM National Budget Circular 538, March 22, 2012, which sets forth general guidelines for appropriating funds to meet VGF requirements for those PPP projects which are to be implemented the following year. In this respect, procedures for identifying, selecting and prioritizing candidate PPP projects with the assistance of MCA screens, pre-feasibility studies and social cost benefit analyses must be timed to fit into the budget cycle, a task which will be addressed in more detail in the ICC Guidelines. An overall process for determining Government Share on individual projects, as well as the overall portfolio of Government Share, has not been formalized over the years. It is certainly true that the prospect of linking Government Share, including VGF, is more acute in the first year of a President's administration. However, with defined systems in place, it becomes progressively easier later, when IAs have much more time to screen, pre-select and validate projects for PPP implementation.

73. The GPH's total exposure to future PPP direct and indirect Government Share exposure can raise serious forward budget issues and needs to be well planned through the PPP budget cycle process, which is regulated by NEDA and DBM under ICC Guidelines which have yet to be developed. At present, the fiscal risks would appear to be low but if the PPP program is successful, they will certainly increase both on a nominal and expected value basis.

74. Related to risk reporting is the need to coordinate and prioritize PPP projects with other domestic and international financing operations of the GPH, since most overseas lenders have "sovereign risk limits" by country and large financings can impact one another if not well timed.

75. DOF has the leadership in monitoring Contingent Liabilities (CL). It has received a detailed recommendation on monitoring/ managing of its Contingent Liabilities from Castalia Strategic Advisers and is moving to implement the recommendations, which were as follows:

Castalia Recommendation *This summarizes briefly the Castalia report which should be respected and implemented subject to our broadening comments*
▪ CL assessment is part of preparing a PPP project proposal by IA;
▪ NEDA to check contracts to ensure they reflect approved terms of Government Share prior to sending them to DOF for issuance of any undertakings;
▪ DOF responsible for monitoring CLs within policy framework;
▪ DOF to produce an annual report on CL exposure. This calls attention to exposures but in a mild form in that the exposures are actually quite low and intended to stay that way;
▪ IAs to budget for any crystallized CL payments.

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7.0 RECOMMENDATIONS FOR ADMINISTRATIVE PROCESSES

76. The following are key recommendations related to the administrative processes involved with GPH Share of project cost. Please also refer to Section 5 above.

77. **Determining and Managing Government Share:** This is critical from a financial and a political viewpoint since potentially large amounts of GPH funds will be spent, and other support given with risks taken that could lead to further expense. As shown in Table 3 following, we recommend the broadest view of GPH financial/risk exposures be taken in respect of PPP projects. It is important that risk management activity, including the monitoring and evaluation of this risk, be done regularly and transparently for fiscal reasons and because there may be large transfers to private parties. In our PPP process work, GHD will be making recommendations on setting and negotiating terms for PPP projects, including but not limited to Government Share, that will balance the objective of protecting the Government itself and the public in general with that of providing an appropriate incentive for the private sector to invest in the project?

78. Risk management activity will involve precise reporting and close cooperation between DOF, DBM, the IAs and the PPP Center as well as procedures designed to keep the process orderly and effective.

79. **Financial Forecasting of PPP Implications for Budget --** The project evaluation process under the ICC Guidelines should be strengthened. **GHD will propose improvements when it addresses the re-draft of the ICC Guidelines.** There is no good solution to the "first year" problem when a new Administration comes in and has to do a long-term plan which includes developing a PDP, PIP, Comprehensive and Integrated Investment Plan (CIIP) and from these outputs, preparing an initial budget. However, if the PPP program evolves as is hoped, the PPP Center will have gained the experience to make needed estimates of direct and indirect liabilities for budgetary purposes with far more understanding than at present, when there has been a dearth of projects and, therefore, experience. GHD considers that stronger requirements for PPP Government Share should be built into the ICC/NEDA Guidelines. **Our recommendation below for the monitoring of PPP financial exposures, would build a base for forecasting.**

80. As discussed in Paragraph 31, **the GPH should consider reconfiguring the SSF** which, as mentioned, is a budgetary construct and not a true fund. An international example would be the Canada P3 Fund, which, while possessing the same technical structure as the SSF, has built up an organization to make VGF grants to PPPs of sub-national agencies. Over time, as the PPP program gathers strength, GPH should consider creating a similar "fund" for provision of VGF to national and sub-national agencies and establishing the PPP Center, DBM or DOF as its Manager. As in Canada, the SSF – re-branded with perhaps a more "politically acceptable" corporate name such as the "Affordability Fund" – would continue to function as a budgetary device (Canada funds only when grants are made) but might extend a more popular thrust to the activity, the more so as it involves giving subsidies to private capitalists notwithstanding that the program would be carefully implemented. It should be noted that the Canada P3 fund either approves its own grants on a "merit" basis, or has to process them through the Minister of Finance. Parliament only approves the general estimate for the monies required. Under Canada's Westminster system, of course, the Government can always get its business done, so the issue of specific Parliamentary prior vetting of grants would not arise.

81. **Policy Statement – It would be useful, for placement in the ICC Guidelines which are intended to elucidate the whole PPP process and its objectives, to have a general policy statement on Government Share of project cost, level of support, risk taking and means by which this support is executed.** We understand that Contingent Liability Guidelines are being prepared; we endorse this and suggest that they be broadened to cover all of Government Share once all the policies have been formulated and promulgated.

82. **Nomenclature --** As the Philippine PPP effort has evolved, and international practices have advanced, PPP language appears to have developed some inconsistencies and often tends not to reflect "natural" speech of the informed lay person. **In Appendix V, we have set out some suggestions for linguistic reform that aims to simplify and make more consistent the PPP vocabulary.** This reflects that PPP is a public policy matter in the Philippines subject to Congressional supervision and public approbation. Change in the IRR/BOT Law would be indicated. On specific words:

    i. We particularly draw attention to the possibility to use the word "Affordability" in respect of VGF since it puts emphasis on what is being received, not what is being given.
    ii. The term "Performance Undertaking" in IRR 13.3e has a different meaning than the more common usage of this term which refers to a document issued by the GPH as a "Credit Enhancement" to assure third parties that a GPH entity will do as it has promised in the contract between them.
    iii. There is also some conflation of the expressions Credit Enhancement and Performance Undertaking, as employed in the IRR, and between these words and "contingent liabilities".
    iv. "Equipment-Financed Grant might be a better term for what are now called "Hybrid" transactions, a term which has a meaning understood to those directly involved in PPPs but not to others.

83. In Appendix V, we make some suggestions to deal with these terminological issues. We appreciate that IRR modification cannot be undertaken for seemingly trivial reasons, but since acceptance of the overall GHD recommendations will almost certainly require IRR revisions, nomenclature questions can be taken up as part of this, also of course if the BOT Law requires amendment. (A set of BOT Law amendments is in fact in Congressional circulation).

84. **Building the Government Share Monitoring and Management Process –** DOF has the overall GPH responsibility for monitoring Government Share and especially the risk of any contingent liabilities or long-term commitments. This includes:

    - review of individual transactions, where analysis may be prepared by individual IAs or the PPP Center in its Feasibility Study work;
    - combining all the individual information into a coherent portfolio database which can then be managed on a portfolio basis, which may suggest strategies, such as insurance coverage, back-up capabilities and other ideas to reduce overall risk at the national level;
    - Actively monitoring developments to ensure that untoward developments are prevented from occurring, or are prepared for Monitoring by DOF in particular;
    - possible actions by Government entities and regulatory authorities not under the control of the Administration, and
    - potential natural catastrophes.
    - Both of the above categories of events are subject to some degree of government risk taking under standard PPP Termination/Buyout clauses.

85. **GHD suggests that the Castalia-recommended process for Contingent Liabilities be broadened to include surveillance of all Government Share of project cost and then implemented promptly.** Procedures for cash disbursements at the IA, PPP Center and DBM level should be detailed as well as guidelines related to the dimensioning, monitoring and evaluation of these direct and indirect liabilities. The DOF, assisted by the PPP Center, should have a central role in respect to, not only to monitoring Contingent Liabilities, but also VGF and long term-GPH contracts and MYOAs (if issued). The table below summarizes Castalia's recommendations and GHD's additions.

Table 2
GHD Risk Reporting and Management Recommendations
Alongside Original Castalia Recommendations

Castalia	GHD Recommendations
CL assessment is part of preparing a PPP project proposal by IA, in line with DoF instructions as input to DoF's overall management of CL risk	• Include all Government Share components of PPP project cost. These include: ○ All types of PUs ○ Commitments for ROWA (distinguishing between land which the GPH already owns and what it must purchase) ○ Commitments for VGF through the SSF ○ Commitments for VGF operating subsidies if any ○ MYOA's and long-term Departmental procurement contracts ○ GOCC commitments not covered by PUs (as a memorandum item since GPH has not assumed formal legal responsibility to back up through a PU) • Take both a "factor sensitivity" and a financial viewpoint on assessing the risks. "Factor sensitivities" are related to the independent risk factors, e.g., weather, hydrology, volcanic, social, market, demographic and other factors that may generate problems that have financial consequences. (In this sense, most "financial" risks are derivative of "real" risks since PPP projects are primarily "physical" or "business" in nature and cannot be managed completely in financial terms.) • Include a more pointed estimation of Government Share when selecting the project as a candidate PPP during Stage 1, after the completion of the prefeasibility study which validates the project as a PPP. • Do a full calculation of Government Share when preparing the feasibility study including setting terms and conditions for the tender? • Each PPP approval package should contain a risk analysis, as required by NEDA and as outlined in NGA Manual, Part I, Chapter 2-10, and a risk management plan for each candidate PPP project detailing risks and what needs to be done to manage them. • Government Share proposals should attempt to limit VGF to capital subsidies, as much as possible. Operating subsidies should only be used for projects with very high EIRR that have low implementation costs.
NEDA to ensure contracts reflect approved terms prior to execution	• DOF to ensure PPP projects reflect Government Share terms originally approved by NEDA/ICC prior to execution.
DOF responsible for monitoring	• IA, to be responsible for Contract Administration; PPPC, to be responsible for overall monitoring and evaluation activities; as per Executive Order 8 [2010]

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Castalia	GHD Recommendations
	and the Revised PPP BOT Law IRR; DOF, to approve contract terms and any changes in the project agreement or the Financial Model during the concession period working hand-in-hand with the IA. .
DOF to produce an annual report on CL exposure. This is to call attention to exposures but in a mild form in that the exposures are actually quite low and intended to stay that way	• Report to be broadened to include all actual Government Share, comparing that to what was originally approved. This supports Government transparency in terms of risks and actual payments. This should be coordinated with fiscal risks statements. Report categories to include: o Projections of any operational subsidy payments o Projections of VGF capital grants o Estimated cash cost of ROWA (to the extent possible) o Long-term contract obligations (including but not limited to Take-or-Pay contracts) entered into by the GPH with PPPs o MYOA's in respect of PPP projects o Gross, net and expected value of Contingent Liabilities • These numbers cannot be added together as they have different bases.
IAs to budget for any crystallized CL payments	• IAs and DOF, DBM to agree on specific budget numbers each year for Government Share.

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8.0 GENERAL SUMMARY OF ALL RECOMMENDATIONS

86. Table 3 summaries the most important recommendations made in this paper. These touch on policy as well as process.

Table 3
Summary of Key Recommendations

Category	Recommendation	Rationale
Policy	Adopt the Viability (or "Affordability") Gap approach to subsidies for PPPs, and with the exception of OBA, limit the application of subsidies to capital grants. Cash injections should follow sponsor equity. Allow for Revenue Sharing in selected cases if results are much better than forecasted. Specific procedures have been recommended for using VGF to assist in increasing affordability of a PPP project to the public whilst allowing for adequate returns to investors.	• Reconcile Affordability with Investor Return requirements. • Limits on fiscal exposure. • Maintain focus on operations once project is built.
	Continue to curtail acceptance of operating risks and manage any exceptions carefully. N.B, ROWA is an appropriate cost for GPH but should be excluded from the 50% VGF ceiling	• Point of PPPs is in part to apportion risk to the private sector which generally can manage it more effectively. • Any operating risks should be tied to Output Based Aid contracts. • Avoid uncertain fiscal risks as much as possible.
	Manage all Performance Undertakings carefully. Accept that certain undertakings are industry general practice and usually necessary, but set out model terms, limitations on risk, e.g. on hydraulic risk, do not incur exposure beyond needed cash flow cover, for debt service and fixed operating cost requirements. All PUs to be issued by DOF	Same as above.
	Treat Hybrid transactions with utmost care due to their inherent complexities.	• Manage equipment acquisition, construction etc. with PPP sponsor. • Set terms with the cognizance that structure of the Hybrid is bound to influence the overall shape of the Tender, possibly favouring some and not other bidders. • Take account of financing costs in valuing the Hybrid, but keep financing of the assets separate from the project itself as an ongoing cost of GPH. • Do a VFM analysis of the project with and without

Category	Recommendation	Rationale
		the Hybrid aspects to ensure the Hybrid formula makes sense.
Process	Expand exposure monitoring process recommended by Castalia to include all cash exposures including VGF grants, long-term procurement contracts/MYOA and other items and actually implement the process.	Although Expected Value of contingent exposures may be low, the risk levels and fiscal exposures are important to the budget and must be measured and managed.
	Give the SSF some identity beyond its use as a budget artifice.	We noted that the Canada P3 Fund, although legally congruent with the SSF, has a management and public image that actually provides grants to sub-Federal level PPP projects and generally promotes the PPP concept across Canada.
	Issue a general policy statement on Government Share, PPP and Infrastructure.	Communicate objectives to all the stakeholders, including the public, and government servants to build consistency across a complex organization, and create investor predictability.
	Review the technical and legal language used for the PPP program.	The public must support PPP and discussing it in accessible, natural language will facilitate public support.

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APPENDICES

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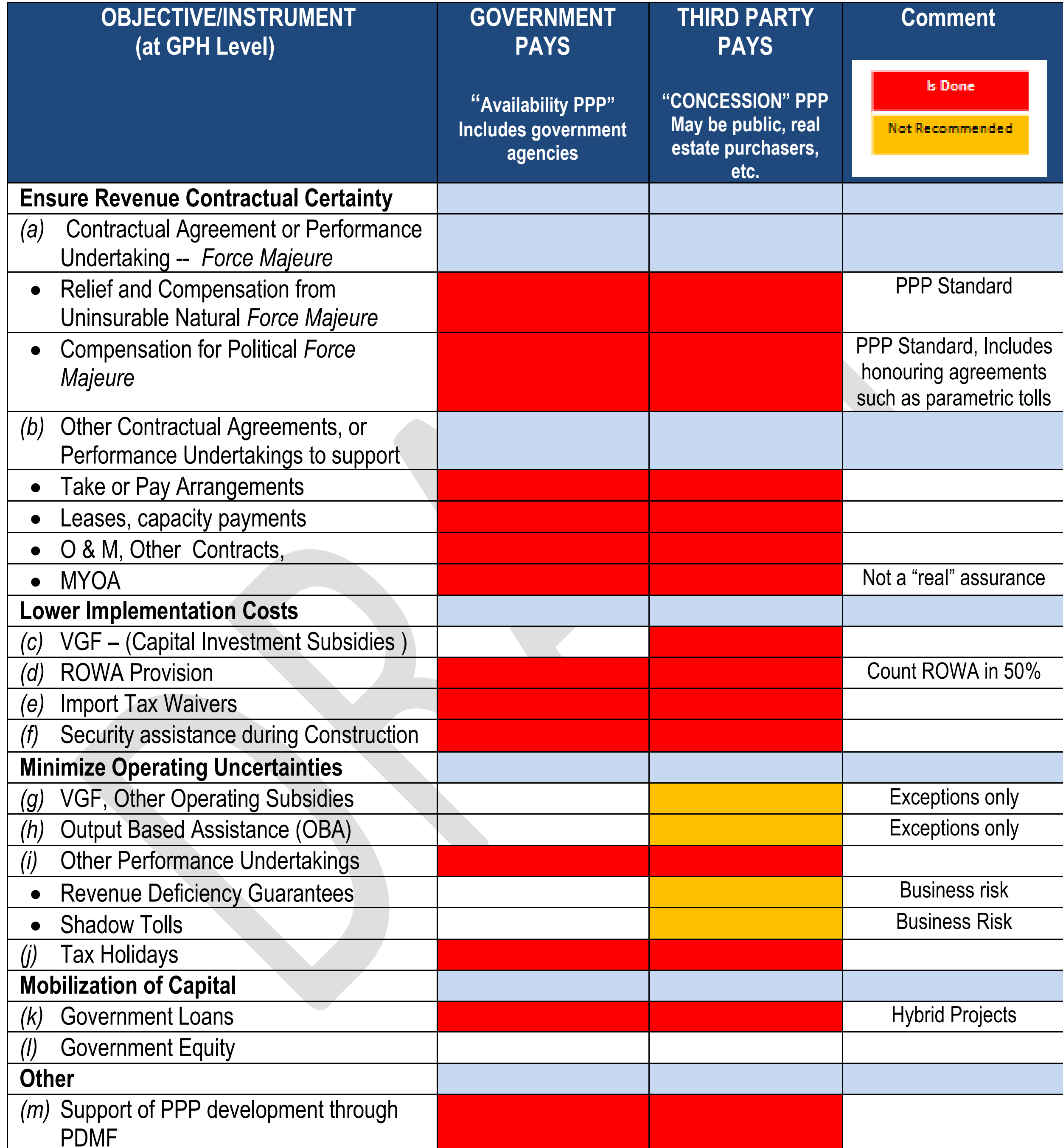
APPENDIX I

ALTERNATIVE TO TABLE 1 – WHICH PPPs USE WHICH GOVERNMENT SUPPORT INSTRUMENTS



OBJECTIVE/INSTRUMENT (at GPH Level)	GOVERNMENT PAYS "Availability PPP" Includes government agencies	THIRD PARTY PAYS "CONCESSION" PPP May be public, real estate purchasers, etc.	Comment Is Done (red) / Not Recommended (yellow)
Ensure Revenue Contractual Certainty			
(a) Contractual Agreement or Performance Undertaking -- *Force Majeure*			
• Relief and Compensation from Uninsurable Natural *Force Majeure*	Is Done	Is Done	PPP Standard
• Compensation for Political *Force Majeure*	Is Done	Is Done	PPP Standard, Includes honouring agreements such as parametric tolls
(b) Other Contractual Agreements, or Performance Undertakings to support			
• Take or Pay Arrangements	Is Done	Is Done	
• Leases, capacity payments	Is Done	Is Done	
• O & M, Other Contracts,	Is Done	Is Done	
• MYOA	Is Done	Is Done	Not a "real" assurance
Lower Implementation Costs			
(c) VGF – (Capital Investment Subsidies)		Is Done	
(d) ROWA Provision	Is Done	Is Done	Count ROWA in 50%
(e) Import Tax Waivers	Is Done	Is Done	
(f) Security assistance during Construction	Is Done	Is Done	
Minimize Operating Uncertainties			
(g) VGF, Other Operating Subsidies		Not Recommended	Exceptions only
(h) Output Based Assistance (OBA)		Not Recommended	Exceptions only
(i) Other Performance Undertakings	Is Done	Is Done	
• Revenue Deficiency Guarantees		Not Recommended	Business risk
• Shadow Tolls		Not Recommended	Business Risk
(j) Tax Holidays	Is Done	Is Done	
Mobilization of Capital			
(k) Government Loans	Is Done	Is Done	Hybrid Projects
(l) Government Equity			
Other			
(m) Support of PPP development through PDMF	Is Done	Is Done	

Note that certain large projects such as MRT 7 may contain elements of both Availability and Concession PPPs. Individual components should be assessed separately for policy purposes as well as a whole. Also, obligations of Government Agencies/GOCCs may be guaranteed by the Government. This is not covered by the above chart. Payment under certain guarantees is subject to prior appropriation according to *Francisco.*

APPENDIX II
NOTES ON INTERNATIONAL PRACTICE – Government Share

VGF and other subsidies have been covered in the section on VGF and in Appendix III.

The budgetary aspects of subsidies do concern us here. The World Bank recently issued a paper *("Best Practices in Public-Private Partnerships Financing in Latin America – the role of subsidy mechanisms,* World Bank Institute 2012) dealing with programs analogous to VGF in India (which is covered in our VGF paper), Brazil, Colombia and Mexico. We also looked at PPP Canada and the United Kingdom. Budgeting is obviously a worldwide government activity and we mean here only to give some indications of practice; we believe the DBM is well aware of the pertinent problems, as per their February 4-5, 2010 presentation "Budget in the Philippines" at the Meeting of OECD Asian Senior Budgeting Officials by Mr. Jon Ragnar Blondel, Deputy Head, Budgeting and Public Expenditures.

Government Share for Availability PPP's is provided in the UK by way of long term services contracts set out in great detail and covering the period of the project. See also www.hm-treasury.gov.uk/ppp_standardised_contracts.htn. (The UK is currently examining all aspects of its Private Finance Initiative (PFI) notwithstanding it has been generally considered to be successful. See www.hm-treasury.gov.uk/d/condoc_pfi_call_for_evidence,pdf).

PPP Canada (www.p3canada.ca) might be described as a PPP Center with its own money. It supports all types of PPPs within its criteria list, Availability or Concession. It acts as a PPP promoter and manages the P3Canada Fund which disburses financing on a "merit basis" to public PPP projects to cover a portion (up to 25%) of construction costs. The emphasis is on stimulating private sector involvement in public activities and the criterion is a VfM approach. The Fund is supported by Federal Government appropriations, and investments must be approved by the government. The activity is accountable to Parliament through the Minister of Finance. Canada, of course, is highly decentralized in a political sense, and the Fund is, in effect, Federal assistance for local initiatives rather than the implementation of a comprehensive national infrastructure plan, as would be the case in the Philippines for National Government projects. The "Fund" is actually not funded with cash until it requires money for disbursement. It has a very promotional emphasis in its documents and in many ways would seem to want to function as a sort of merchant bank, albeit getting its returns in PPP success as opposed to dividends. The Strategic Support Fund could carry some of the same accoutrements at P3Canada, but in the Philippine context, it is probably better for the Government to develop a successful infrastructure record first before opening the window for what are in Canada the equivalent of Unsolicited Project Proposals.

The World Bank Institute Report on "Best Practices in Public-Private Partnership Financing in Latin America": the Role of Subsidy Mechanisms" report on Brazil, Mexico, Colombia and India drew several generalized conclusions that bear on budget issues. We therefore summarize the actual arrangements in each country briefly and turn to those lessons.

India (not a Latin American country but included) has a VGF Fund, as we elsewhere report in more detail, which focuses on highway development and is funded by way of annual appropriations. It provides one-off capital subsidies.

Brazil and Federal States (Sao Paulo is the World Bank's illustration since the Republic has not actually disbursed any PPP-related subsidies) provide operating subsidies which are bid out. The States have annual appropriations (which seem to work) and the national Government classifies subsidies (although it has yet to pay any) as "interest" for government accounting purposes and therefore not subject to appropriations under Brazilian Law;

Colombia, which mainly subsidizes construction and early stage operations for the early years of the road, as well as issuing traffic guarantees which projects pay for, has a special procedure for future appropriations (Colombia does not have a formal PPP program nor the VGF concept but rather a highway procurement program through the Transport Ministry.) Future appropriations must be routed through a special council at the Ministry of Finance (Transport handles the actual transactions) there are two types of future appropriations:

- Ordinary appropriations which last the life of the current Administration, or
- Exceptional appropriations which go beyond the current Administration term. These appropriations must be declared of "strategic importance" by a second Council which is actually chaired by the President and consists of the senior economic and central bank officials. (Similar to the ICC.) Given the length of construction, most subsidies are "exceptional".

Mexico has a fund, "FONADIN" which is a real fund with independent assets (injected from two previous highway-related funds) in the nominal value of more than USD 3 billion equivalent. It does not receive appropriations. It has a broad business charter, including funding and guarantee activity as well as paying out subsidies. The Mexican PPP program is weak, and many of the project applications are highly politicized. There is a reform program for both the PPP program and FONADIN. This program is worth monitoring to see how it develops over time, though currently it is not a best practices model.

All of the above Funds have a conventional inter-departmental administrative and approval process for handling applications. All provide subsidies by way of tenders – the lowest qualified applicant gets what it asks for. Monitoring is by the IA. None of the processes seem quite as coherent as that of P3Canada. Colombia's program appears to have been the most successful. India, in also emphasizing transportation, is following in its footsteps.

The World Bank's "lessons learned" include:

a. The Fund vehicle appears to concentrate attention and effectiveness. We might add that any Fund, whether a real (i.e., actually funded-in-advance) fund or just a budgetary construct, needs rules, targets, a public image and management by a specific agency, even if only part-time staffed, such as could be effected by the PPP Center.

b. Funds need processes and knowledge sharing, just as in general we recommend for the PPP Center.

c. Fund rules should provide clear performance monitoring and measurement – a comment which applies to any type of subsidy and not just ones provided by funds which, however, are a good nexus for consolidation of this approach.

d. It is suggested that management of subsidies should be kept separate from management of other Government Share although of course the Government has to be aware of the total fiscal exposure to a given project. The paper believes there is a conflict between a subsidy agency and, for example, a loan guarantee providing agency. Clearly it is necessary to avoid subsidizing another part of a government, but there is also value in taking a broad approach to individual PPP's as well.

e. There were a variety of approaches to monitoring, although it is important in all jurisdictions.

f. The funds should be quite open and transparent, both for probity reasons and to encourage activity.

We note that the UK and Colombia has processes for longer term appropriations, whether for specific subsidies to PPPs as in Colombia (and presumably other expenditures) or for supply contracts in general by Government Departments as in the UK, which support PFI (PPP) Availability PPPs.

Contingent liabilities are a major concern of most world governments. The World Bank and IMF have provided extensive papers on this subject, and the Philippine Government is fully aware of the issues. This was covered at length by Castalia and the issues are very familiar to the Government. The Foundation document is the World Bank 1999 study cited in the Definitions (Appendix VI).

APPENDIX III
NOTES ON INTERNATIONAL EXPERIENCE – Viability Gap Funding

1. **Experience of EU [now numbering 27 countries][1] with all abiding by common rules in respect of public private partnerships**

A) **Key conditions related to EU grant eligibility** requirements for PPPs and determining the maximum permitted amount for a specific PPP project:

a. The EU grant can cover up to 85% of eligible expenditures for any project. Co-financing by the member government (at least 15%) is always required;

b. Generally, the grant is applied preferably to construction expenditure, but operating subsidies are also permitted. However, the preference is to cover construction expenditure first as evidenced by the following statement taken from an EU directive: "If the PPP generates revenue from user charges, the 'eligible expenditure' for purposes of determining the size of the EU grant is reduced by the net contribution (i.e. after covering operating and maintenance costs) that such user-charge revenue makes to funding capital expenditures, as determined on a discounted basis"[2];

c. The direct beneficiary of the grant must be the IA responsible for the PPP, rather than the lenders [through the accounts control agreement] or, more directly, the project company.

Comparison India: Key conditions related to Indian grant eligibility requirements for PPP and determining the maximum permitted amount for specific PPP projects:

a. The Central Government will cover up to 20% of project cost, and the State where the project is located can co-finance another 20% of project cost from its own revenue base;

b. The project must be 51% owned by private sector and the grant can only be used during the construction;

c. The direct beneficiary of the grant is the project but its disbursement can only be made to the Security Trustee under the terms of the accounts control agreement.

B) **Procedures for formalizing the size of the grant.**

EU – the grant and its approval can be determined before or after tender, as set forth below:

a. Approval of the grant occurs before bidding for the PPP project takes place. In many ways, this is the preferred solution. The grant conditions can be thoroughly vetted and planned with estimates specified in advance. Tariffs may be set first and bidders may be asked to participate in the tender by competing with each other for the lowest grant. This requires detailed structuring of the PPP project before going to the market, but this is the best approach regardless of the presence of any grant funding;

b. Approval of the grant occurs after the preferred bidder has been selected. Although it is well understood at an earlier stage how an EU grant is to be incorporated into the PPP project, the approval of the grant is not obtained until after the preferred bidder has been selected. This approach is advantageous where the results of the PPP bidding process need to be clarified in order to enable key elements of the grant application to be filled in (e.g., for example, if there would be significant uncertainty about the size of grant required);

[1] See, for example, further guidance in EU support for PPP through grants in eib.org/epec/g2g/annex/3-struct-coh-ppp/index.htm
[2] Ibid

c. **Comparison India:** Approval of the grant occurs before bidding for the PPP takes place. As in the case of the EU, grant conditions are thoroughly vetted and planned with estimates specified in advance. Tariffs are set first and bidders are asked to participate in the tender by competing with each other for the lowest grant. However, Indian projects must meet certain requirements to the satisfaction of the approving authority: the IA must demonstrate that (a) it cannot eliminate the viability gap through the use of the tariff (for reasons of affordability); and (b) that an increase in project term will not resolve the problem.

C) **Application of the Grants**

EU

a. Parallel co-financing of capital expenditure (capital grant), based on the existence of two construction contracts: one commissioned by government; one commissioned by the private sector. With this method, a distinct component of capital expenditure is financed by the private sector and another by the EU grant and government funds;

b. Blended co-financing of capital expenditure (capital expenditure subsidy, capital grant). This is the most common model. The EU grant and government funds are used jointly with the financing mobilized by the private partner to make parri passu[3] payments during the construction period under a single prime construction contract. The disbursement schedule is agreed in advance and disbursements are made into an account controlled by the Security Trustee appointed by the lenders;

c. Design-build-operate (DBO) contract. This is an extreme form of the above approach in which private financing has been entirely replaced with EU grant and government funds, but there is just one prime contract covering both the construction and operating phases;

d. Partial grant funding of service fee. In this option, grant funds could be used during the operating period as full or partial availability payments, that is, time-based payments made by the IA. It is not clear whether the commitment is fully funded on a multi-year term basis;

Comparison India: PPP equity must be disbursed entirely first, before VGF is disbursed. Subsequently, VGF is disbursed proportionately to the release of debt. Obviously, the intent here is to maintain as much of the construction risk transfer as possible to the PPP project company.

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[3] Equally divided

APPENDIX IV
EXTRACTS FROM GPH 2012 FISCAL RISK REPORT

Appendix D Extract for RP 1012 Fiscal Risk Report.

D. PUBLIC-PRIVATE PARTNERSHIPS (PPPs) AND CONTINGENT LIABILITIES

23. **PPP arrangements expose the country to a diverse, complex and often large array of fiscal risks.** Performance undertakings or acknowledgments of Government obligations are issued for projects undertaken by line agencies through PPPs. Fiscal risks stemming from these projects include risks related to right-of-way, political/regulatory risk, change in law, currency convertibility, events of termination, events of force majeure, and take-or-pay arrangements, among others. Some of these eventualities translate to actual liabilities and should be included in the government's budget when they do. The contingent obligations associated with the performance undertakings arise in case of delay or default on the part of Government in executing its deliverables and have varying probabilities of becoming real and having an impact on the budget.

substantial obligations over a short period of time and could lead to a severe strain on its fiscal resources. Given that the impact of guarantees come due only if triggered by a particular event or economic shock, a constrained ability to respond on the part of fiscal authorities could worsen fiscal and macroeconomic vulnerabilities. Provisioning for such contingencies needs to be reflected in the annual budget and clear mechanisms to cover them in case such guarantees are called need to be established (e.g., the government could explore reserve-type, insurance-type, and other mechanisms).

25. **Performance undertakings on BOT/PPP projects also explicitly expose the budget to GOCC credit risk.** ICC clearance is a precondition for projects to secure government guarantees. Nonetheless, in some cases, a project's social desirability takes precedence, despite technical concerns about a project's financial feasibility.

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52. **The Public-Private Partnership (PPP) Center of the Philippines was established and covers all PPP programs and projects including all the variants or arrangements under the BOT Law and Joint-Venture agreements.** Executive Order 8 of 2010 reorganized and renamed the BOT Center as the PPP Center and transferred its attachment from the Department of Trade and Industry (DTI) to NEDA. With a more proactive role, the main functions of the new PPP Center are: 1) facilitate implementation of PPPs, including provision of advisory and technical assistance to implementing agencies, GOCCs, and LGUs; 2) monitor and evaluate the development, approval, and implementation of PPP programs; and 3) effectively integrate PPPs into government's planning, programming and budgeting processes and policies.

54. **To better manage the Government's exposure to risks associated with GOCCs and PPPs, several initiatives can be undertaken to mitigate fiscal risks.** In addition to other NG reforms, the following are some strategic measures the Philippine Development Plan (PDP) 2011-2016 spells out to address fiscal risks arising from contingent liabilities as well as some needed improvements in the government corporate sector:

- **Strengthen Contingent Liability Management (CLM) through a joint ICC-DBCC resolution** that provides for the preparation of the CLM Plan by implementing agencies, training for value analysis/value engineering and contingent liability (CL) assessment, CL evaluation of every financing/ procurement option by DOF, and full disclosure of the required budget for CL that will become real liabilities and will thereby need funding.

- **Debt management reforms (see section on Public Debt and the newly established DRMD under DOF)** to pursue more aggressive options such as debt exchanges and swaps at the most opportune times to optimize savings. There is also a need for greater diversification of modes, instruments used, and currency mix, as well as more innovative terms and features. All types of projects funded from borrowing, whether these are government-to-government arrangements, automatically guaranteed under GOCC charters, and under BOT or PPP arrangements, should be subject to the rigid test of project viability and procurement processes and conducted with the highest standards of transparency.

55. **A stronger legal and institutional framework for project selection, approvals and contract negotiations is needed to comprehend fiscal risks involved in PPPs.** In this regard, the NEDA Board Committee on Infrastructure (Infracom) Technical Board has drafted proposed amendments to the Implementing Rules and Regulations of the BOT Law to improve the investment climate for private sector participation in public sector projects/programs through streamlined and simplified procedures/policies that are consistent and transparent. The proposed amendments are available at the NEDA website. Furthermore, a risk allocation policy for PPPs between the national government and the private sector is being formulated. The risk allocation policy will facilitate the transparent and efficient valuation as well as monitoring of associated contingent liabilities and the timely provision in the budget in the event these liabilities are triggered.

APPENDIX V
PPP Nomenclature: Assessment and Recommendations

GHD Recommendations to Modify Current IRR Name				
Current IRR Name	Principal Name	Sub name (add to principal name)	Purpose	Questions
Cost Sharing	Affordability Assistance	Capital Grant	Implement VGF	Calculation of the 50%
		"Hybrid" or another name, e.g., "endowment"	Implement VGF/Hybrid	
	Project Assistance	ROWA		Available by policy for all PPP projects. Deduct from 50% limit for VGF availability
		Capital Grant	Recommend this not be available	May be better to consider all project assistance is "affordability," although tariffs may be market and project assistance is proffered to earn a premium from bidders
		"Hybrid"	Hybrid Projects	There may be some needs that can be satisfied advantageously this way, with the PPP proponents paying for them to mutual advantage with the government.
		ROWA	For all non VGF projects – usual government risk taking	
Credit Enhancements *See note below*	Credit Enhancements		Provide assurance that sub-government units and GOCC's will meet their Performance Undertakings and pay up if not	Need to resolve Francisco Overlap in definition with Performance Undertaking.
Direct Government Subsidy	Affordability Assistance Operating Grant	Capital Grant	Implement VGF	Overlaps Cost Sharing
		Operating Grant	Implement VGF	We recommend this be limited to projects with low capital costs and high expenses. Sunsetted
	Project Assistance Operating Grant	Capital Grant		
		Operating Grant		Sunsetted. Not clear there is any limit on this

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GHD Recommendations to Modify Current IRR Name				
Current IRR Name	Principal Name	Sub name (add to principal name)	Purpose	Questions
Direct Government Equity	Project Assistance - -Direct Government Equity			GOCC equity not included here?
Performance Undertaking *See note below*	Performance Undertaking		Agreement to "do something, or "not do something" with penalties applicable	Must Resolve Francisco Case Language here overlaps Credit Enhancement language
Legal Assistance	Project Assistance – Legal			
Security Assistance	Project Assistance – Security			

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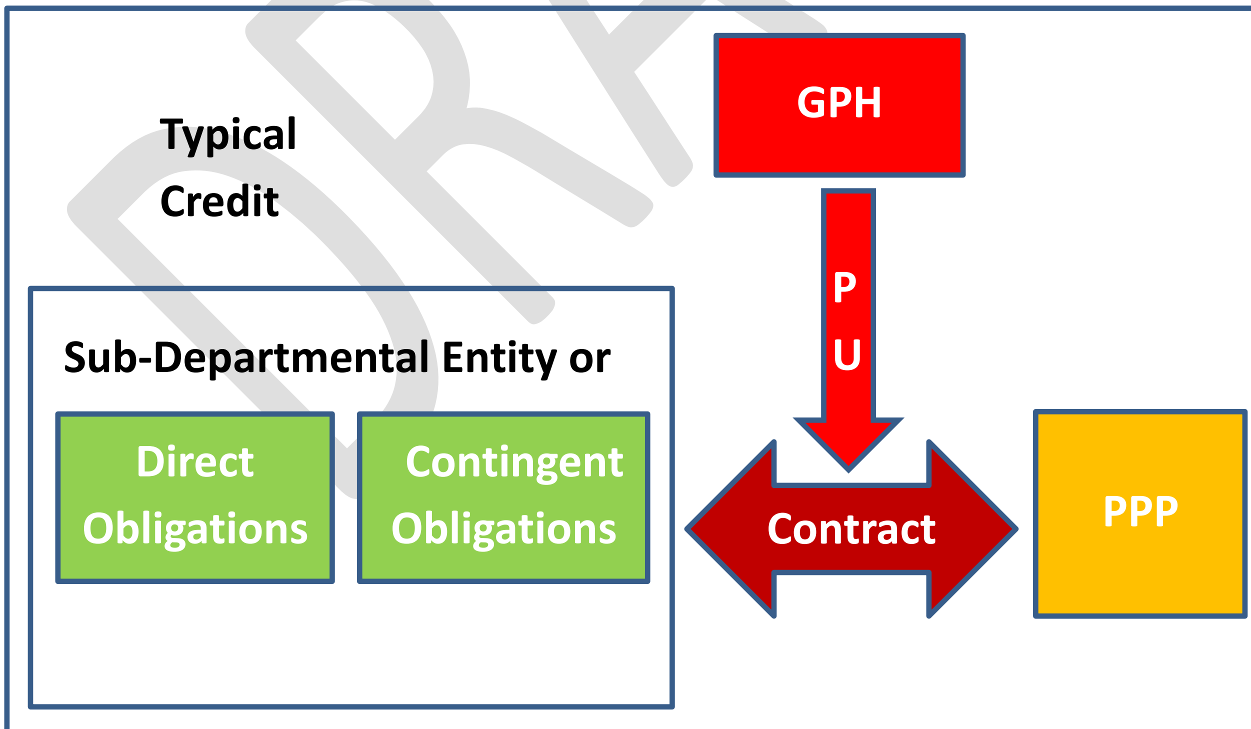
Comment on use of terms "Performance Undertaking," "Credit Enhancement," and "Contingent Liabilities"

1. The concern about the obligations that may be designated by any or all of these terms is that, at some point in the future, GPH may have to make a payment or suffer an economic loss. Therefore, they need to be properly approved and then monitored and managed.
2. We need to differentiate between the basic **terms of a deal** and the extra guarantees, assurances and other agreements that accompany them which are called "Performance Undertakings", "Credit Enhancements" or even "Contingent Liabilities." The first two names relate to instruments, whereas the term "contingent liability" represents something that might be actuated in the future by various events. .
3. **"Terms of the Deal"**__ The "basic terms of a deal" are what the parties signing the contract undertake to make it happen, for example, in a power project, the PPP project agrees to build and manage a generator station and the off taker agrees to purchase the output under a long term contract. It may also agree to certain contingent payments under defined circumstances. The long-term contract is NOT a "credit enhancement" – it is the credit itself. "Enhancement" would enter the picture when a third party, in this case GPH, guaranteed that the contract would be honoured and that, if not, it (GPH) will either pay for the electricity or make whatever penalty payment is required under the Take-or-Pay Agreement. A "Term of the Deal" is what is meant by "Performance Undertaking" in the current IRR. These terms, which may be direct or contingent, are entered into by the contracting parties.
4. A "**Credit Enhancement"** is generally understood to be some sort of guarantee or other undertaking including the placement of collateral, issued or entered into by a third party, i.e. an entity not directly involved in the actual transaction contract. The credit enhancements may not have "legal" standing, e.g. a "comfort letter". Credit Enhancements could be financial guaranties issued by entities such as the LGUGC in the Philippines, the World Bank, a corporate owner of a PPP investor or, in the case of GOCCs or (although it makes no legal sense) a GPH entity (DoF), to support another GPH entity of equal Constitutional standing.
5. **"Performance Undertaking,"** as used in the BOT IRR appears to mean an agreement to do something which is part of the "Terms of the Deal."
6. A **Performance Undertaking**, as this term is generally used, is a written third party agreement to do something in the event the primary obligor does not. It is the way a credit enhancement is generally implemented in respect of PPP projects.

7. **"Contingent Liability"** is a liability (i.e. generally an obligation either to pay or to do something) that might arise under certain circumstances. For example, an obligation to take or pay might arise if the primary obligor defaults. It also might **arise in the event of** a civil insurrection. The term, as generally used, has been applied incorrectly to both Credit Enhancements and to Performance Undertakings. Liabilities in this context are "incurred" whereas Performance Undertakings and Credit Enhancements are, broadly, "issued,"

Although subject to legal drafting and subject to further discussions, our Nomenclature recommendations are as follows:

a. "**Contractual Terms"** -- what the GPH entity involved in the PPP agrees to do. This substitutes for "Performance Undertaking" in the IRR and authorizes GPH entities to enter into PPP-related legal agreements. This would include contracts issued by Government Departments**, "hybrid"** project commitments, payments to be made in the event that a regulatory agency does not honor parametric pricing (*our assumption – the regulatory body itself is not obligated to make any payments, only the GPH*), etc. This expression, Contractual Terms, substitutes for "Performance Undertaking". The IRR can set boundaries as to what can and what cannot be contracted for.
b. **"Credit Enhancement"** – when a third party OR another GPH entity agrees to do something that will strengthen the likelihood of performance of the Contractual Terms. This is basically a form of guarantee or recourse agreement or "comfort letter," which may be subject to the legal rules on loan guarantees or to the Francisco case and whatever legislation is enacted to deal with this problem. The credit enhancement instrument could also be in the form of a **"Performance Undertaking"** or some other legal or substantive instrument; such as posting third party collateral. Credit Enhancements often create **"Contingent Liabilities**" in the sense that no GPH action will be required if the actual obligor of the Contractual Terms does what it has agreed to do. Diagrammatically:



Please also refer to our comment (paragraph 38e) that Credit Enhancements are not appropriate between Government Departments (including their agencies) which all carry the full faith and credit of the Republic. However, a Department signature is necessary to commit the full faith and credit to an agency of that Department, such as the Port Authority.

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APPENDIX VI
DEFINITIONS

Please refer to Appendix 4 for proposed changes or clarifications of the definitions of "Credit Enhancement," "Performance U undertaking" and "Contingent Liabilities." This lexicon attempts to follow current usage.

1. **AUTHORITY TO ISSUE GUARANTEES** - At the national level, this arises under Revised BOT Law IRR, which authorizes the DOF to issue guarantees and other undertakings to support contracts[4].
.
2. **CAPITAL SUBSIDY** – will refer to a VGF grant provided to a project by GPH during its construction period.

3. **CONTRACTUAL OBLIGATIONS (UNDER PPP AGREEMENTS) –** means those actual or potential obligations which may be entered into by the GPH, or its Implementing Agencies (IAs) (*See definition below),* including Government-Owned-and Controlled-Corporations (GOCCs), Government Financial Institutions (GFI), State Universities and Colleges (SUC) and Local Government Units (LGUs). In a PPP Contract, Contractual Obligations can cover both deferred direct and indirect liabilities as defined further below.

4. **CONTINGENT LIABILITIES** - means a potential but unrealized liability incurred by the GPH, or an implementing agency under a PPP Contract, that does not crystallize until some defined event occurs. If a sub-national agency incurs a direct liability, and the GPH guarantees, or issues, a Performance Undertaking to assume it or ensure its servicing, this represents a Contingent Liability at the Government level, whilst a Direct Liability at the level of the sub-national agency. We refer below to two types of Contingent Liabilities in PPPs.

   "*FORCE MAJEURE*--RELATED CONTINGENT LIABILITY COMMITMENTS" refers to those contingent liabilities invariably required by PPP investors and financiers to cover a standard set of risks on contracts at any level of government, including:

   i. *Natural Force Majeure*, **are agreed natural events which are to remain uninsured due to unavailability, or high cost, of insurance, and are beyond the control of either party** which may require sponsorship/GPH action in the event of an irreparable natural disaster and under extreme circumstances, may involve a GPH buyout of the project.

   ii. *Political Force Majeure* refers to those events that interfere with the contractual rights of the private party to a PPP, such as expropriation, nationalization, confiscation, war, national labor strikes or any change in law, the occurrence of which materially restricts the rights of the private party, or changes the conditions prevalent at the time the project agreement was executed. In extreme cases, GPH would normally have to buy out the project on terms set out in the contract.

   iii. An undertaking by the national government to neutralize regulatory or change-in-law risk is also included in this category **–** such an undertaking would obligate GPH to make up revenue shortfalls if, for example, taxes increase or the regulator prevents tariff increases in the PPP project agreement based on the parametric formula agreed in PPP contracts. However, in the *Francisco* case[5], doubts are raised concerning the GPH ability to pay out under such commitments without a Congressional budgetary appropriation.

[4] Revised BOT Law Implementing Rules and Regulations
[5] Francisco Vs. Toll Road Regulatory Board, GR 166910, 10 October 2010

iv. The usual remedies for violations of these conditions are buyouts, in which GPH has to take over the project at a price usually based on a pre-negotiated formula, or make payments to cover revenue losses, or cost increases, based on a formula. Whilst Standard Contingent Liabilities are fairly universal, the actual buyout formulae must be specifically negotiated and can vary substantially.

v. **OTHER CONTINGENT LIABILITY EXPOSURES** – refers to undertakings which are not common to all projects and which tend to be very specific to project typologies, for example, the assumption of hydrology risk by GPH in a hydroelectric project is very specific to certain types of power generation projects. The same can be said of GPH willingness to assume revenue risk in the case of mass transit projects, or other transport projects.

5. **CREDIT ENHANCEMENT** – refers to commitments or other measures (such as provision of collateral) undertaken by a third party to provide assurance that the obligation of a given entity will be honoured in accordance with their terms. The most usual PPP credit enhancement is a Performance Undertaking generally issued by the GPH**.**

6. **DBCC** – Development Budget Coordinating Committee consists of the key economic agencies that meet regularly to co-ordinate budget formulation and implementation activities.

   i. Its functions are, *inter alia*, to:

      1. Establish the level of annual GPH expenditure;
      2. Determine the proper allocation of expenditure;
      3. Analyse macroeconomic prospects;
      4. Assess reliability of revenue estimates; and
      5. Recommend appropriate tax or other revenue measures and the extent and type of borrowings.

   ii. The DBCC acts as a consultative forum where each of the economic agencies extends advice relative to the above functions based on its specific remit, with final action taken by the Committee based on its collective judgment.

7. **DESIGN BUILD OPERATE** – as used in the European Union (EU), a more restrictive definition than normally found elsewhere, which means one contractor undertakes the design, building and operation of an infrastructure facility. Since one of the examples mentioned below relates to European practice, the European version of this definition is used.

8. **DIRECT LIABILITY -** as used in this memorandum, arises when the Government and/or one of its IAs contractually agrees to assume or incur a defined, time-certain, financial obligation (for example, through Viability Gap Funding (VGF, see below).

9. **EXPECTED VALUE –** A probabilistic calculation which multiplies the estimated effect of an event by the probability of its occurrence. The Expected Values of events connected to PPP projects covered by Standard Contingent Liabilities is generally quite low in that although there could be major financial exposures, say from an expropriation, the probably of occurrence is quite low. Expected Values would be higher most of the time for Other Contingent Liabilities which usually involve payments in relation to ongoing operations. Expected Value is part of the range of possible values. It is important also to look at the nature of the overall statistical distribution of which the Expected Value is only the most likely value to occur.

10. **FEASIBILITY STUDY –** An analysis of the commercial sustainability of building, operating and maintaining a project successfully, taking into account technical, social, economic, financial, legal and institutional constraints. Rather than just diving into a project and hoping for the best, a feasibility study allows implementing agencies to investigate the possible negative and positive outcomes of a project before investing too much time and money. It differs from a **pre-feasibility study** in that the latter is a more preliminary and less precise measure of commercial sustainability.

11. **GOVERNMENT** – as the term is used in this paper refers to the national government, or more broadly to the Executive Branch of the GPH. In some contexts, however, the term will refer to the Department of Finance (DOF), which normally serves as Agent of the GPH for commitments under PPP Agreements**.**

12. **GOVERNMENT FINANCIAL INSTITUTION -** A financial institution organized as a GOCC under a Special Charter or the Corporation Code of the Philippines, which extends deposit gathering, lending or other financial services to the public; for example Development Bank of the Philippines (DBP) or Land Bank of the Philippines (LBP).

13. **GOVERNMENT OWNED AND CONTROLLED CORPORATION -** GOCCs are corporations owned and controlled by the Executive Branch created by special charter or law in the interest of the common good and subject to the test of commercial sustainability. GOCCs are attached to the appropriate Department, with which they have allied functions, for policy program coordination and for general supervision[6].

14. **GOVERNMENT SUPPORT -** as used in this Brief is broader than Government Share of Project Cost and refers to all of the instruments identified in Table 2 of this Policy Brief. Government Share, on the other hand, refers to direct Grants (see below), guarantees and other kinds of Contingent Liabilities. International definitions of types of Government Share are as follows:

Table 4
International Definitions for Government Share
(Specific number references are to clauses of Section 13.3e of the Implementing Rules and Regulations (IRR) of the BOT Act, RA7718

Refer to Table 1 above where these definitions are taken	**Direct** *"Obligation in any event." But may vary for reason known in advance, agreed formulae*	**Contingent** *Obligation arises if a particular event happens. It includes at Government level, performance undertakings in respect of GOCC's, sub Governments*
Explicit *Created by law or contract*	**Cost Sharing,** **Direct Government Subsidy, 4** although amount may not be predetermined **Investment incentives, 5** **Direct Government Equity, 6**	-**Credit Enhancements 1,2** -**Direct Government Subsidy** which may be contracted as contingent -**Legal, security support, 7**
Implicit "*Political" obligations re-effecting public pressures, Government need for project to "succeed"*	Generally would be implemented through **Direct Government Subsidy, 4** and create recurring fiscal draws	**Direct Government Subsidy, 3** (which may be in the form of price controls with the Government covering the resulting financial losses) **Extra-budgetary assurances of support 8**

a. (See Marko Mrsnik of the European Commission, "Managing Fiscal Risks from PPPs: Main Issues for Governments," March 7-8 2009 available on the IMF website in turn based on Hana Palackova of the World Bank, "Government Contingent Liabilities, a Hidden Risk to Fiscal Stability," undated, available on World Bank Website.)

[6] Book IV Chapter 9 of the Administrative Code of 1987

15. **GUARANTEE** – refers to any direct or indirect undertaking extended by GPH to the PPP Project Company, under the terms of the project agreement, including but not limited to, a performance undertaking.

16. **HYBRID PROJECT** – As used currently in the Philippines, a PPP to which the GPH, a GPH entity or an LGU provides assets other than ROWA or services related to those assets as part of the overall transaction. The asset provision can be in lieu of cash in a Cost Sharing Grant (IRR 13.3a). Hybrid projects often are, but not invariably arranged, to allow for the injection of concessional international financing or ODA into a structural which cannot be obtained directly by the PPP project. In other countries, the term is used more broadly to refer to a PPP transaction which does not follow the industry-standard typologies such as BTO, BOT, etc.

17. **ICC / NEDA GUIDELINES (ICC Guidelines) –** issued by the Investment Coordination Committee (ICC) (see below) to govern the process and implementation standards for PPPs.

18. **IMPLEMENTING AGENCY (IA) -** refers to any unit of GPH with the mandate and authority to identify, select, prioritize, prepare, tender, negotiate and execute a PPP project agreement with a private entity. This can be a Department (as in the case of Department of Public Works and Highways (DPWH) or Department of Transportation and Communication (DOTC), a GOCC (as in the case of PPA, LRTA or PNR), a GFI (as in the case of DBP, LBP), an SUC or an LGU.

19. **IMPLEMENTATION GUIDELINES** – the terms and conditions under which government ensures that the risk transfer to the private sector during construction and operations is optimized. As outlined in the BOT Law and its implementing rules and regulations (IRR) and ICC-Project Evaluation (ICC-PE) Guideline.

20. **INVESTMENT COORDINATION COMMITTEE (ICC) -** refers to the NEDA Investment Coordination Committee, which approves PPP infrastructure projects up to PHP300 million and endorses PPP infrastructure projects that have higher costs to NEDA Board.

21. **INDIRECT GUARANTEE** – refers to a Performance Undertaking issued in respect of any contingency liability assumed by an IA, or the government in a performance undertaking.

22. **IMPLEMENTING RULES AND REGULATIONS (IRR) -** refers to the Revised Implementing Rules & Regulations of Republic Act 7718, referred to as the BOT Law.

23. **MULTI-YEAR OBLIGATIONAL AUTHORITY –** according to Circular 01 of 2009 issued by Department of Budget and Management (DBM), a Multi-Year Obligational Authority (MYOA) is a document issued by DBM either for locally funded projects, or foreign assisted projects, that are to be built by IAs in order to authorize the latter to enter into multi-year contracts for full project cost. A MYOA, which contains an annual breakdown of the full project cost, obligates agencies to prioritize in their budget proposal for the ensuing years the amount programmed for the said year(s). A MYOA is NOT a guarantee of payment in that Congress may not appropriate the funds to service it.

24. **OUTPUT BASED ASSISTANCE (OBA) –** "Output based aid is a development aid strategy that links the delivery of public services in developing economies to targeted performance related subsidies.

25. **OVERSEAS DEVELOPMENT ASSISTANCE** (ODA) grants or loans at or near concessional terms extended to the Philippines by foreign official donors, excluding export credits which are regarded as commercial loans.

26. **OPERATING SUBSIDY --** refers to a grant, or grants, provided to a project during its operating period. This could take the form of a revenue deficiency guarantee, a ridership guarantee or a defined multi-year grant to cover defined operating expenses.

27. **PERFORMANCE UNDERTAKING –** A legally binding commitment to undertake a specific obligation on behalf of a separate party, if the latter fails to do so. See Contingent Liabilities and Indirect Guarantees.

28. **PRIVATE PUBLIC PARTNERSHIPS (PPP) -** refers to a variety of contractual arrangements under which a private party provides utility, or other "governmental" services, under a long-term contact with an IA which have the following characteristics:

    i. A long term agreement between a private party and an IA, delegating the offer and provision of infrastructure services to the former;

    ii. A focus on project outputs rather than project inputs, taking account of the whole life cycle cost implications for the project;

    iii. Transfer of certain project risks to the private sector, notably designing, building, operating and/or financing risks of the project;

    iv. Usually, the application of private financing to underpin risk transfer; and

    v. Payments to the private sector which are reflective of the costs of services to be provided. The Project Company may be paid either by users through user charges (e .g. tolls or tariffs), by the IA (Availability Payments or Shadow Tolls) or by a combination of both (e.g. user charges together with public operating subsidies). Payments may be regulated and/or be subject to parametric adjustment formulas.

    Generic types of PPPs include:

    - **AVAILABILITY PPP** means a PPP project which is structured as the sale of production capacity or actual output to a single or restricted number of buyer(s) supported by a service fee usually under a take-or-pay instrument, e.g. a bulk water treatment facility selling processed water to the water utility; or a lease, e.g. on a power plant that sells bulk power to the utility under a BOT contract in which the utility takes ownership at the end of the contract period. "Availability PPPs" are moving beyond the historical "public utility" character in the Philippines to include provision of services traditionally provided directly to the public by Government departments, such as education and health. Availability PPPs may also include leases of buildings and facilities to the Government as well as Operation and Maintenance (O & M) arrangements; and

    - **CONCESSION PPP** means a PPP project which is structured to provide defined services to multiple users (normally "the general public"), for a defined tariff, usually under the purview of a regulatory body.

29. **PROCESS GUIDELINES –** means the steps the Implementing Agency needs to take in tendering a project which incorporates VGF.

30. **PROJECT AGREEMENT –** refers to the umbrella agreement between an IA and a private party, around which all of the other legal documents revolve.

31. **PROJECT DEVELOPMENT AND MONITORING FACILITY ("PDMF") –** a Fund managed by the Private-Public Partnership Center that pays for various activities such as feasibility studies and transaction advisory engagements relative to PPP project development, negotiation and management. See Executive Order No 8s, 2010 and National Budget Circular 538, March 22, 2012.

32. **PROPONENT –** The sponsor(s) of a PPP project who are normally also the beneficial shareholder(s).

33. **RIGHT-OF-WAY AUTHORITY (ROWA) -** As used in this document means the acquisition of real property and property rights. Real property, or property rights, purchased must be for projects that are approved by the NEDA/ICC for implementation in the following year's budget.

34. **SHADOW TOLL –** a subsidy arrangement under which the government pays the PPP project company a fee for each use of a Concession PPP.

35. **SPECIAL PURPOSE VEHICLE (SPV) –** A limited liability legal entity which is often set up to own and operate a PPP project which has limited support commitments from PPP stakeholders each of which commits to defined levels of support to the project.

36. **STRATEGIC SUPPORT FUND (SSF) –** An appropriation lodged in the budget of IAs (under DBM Circular 538, March 22, 2012) to pay for the Government Share of PPP project components. Discrete components including project preparation (pre-feasibility studies, feasibility studies, legal contracts, etc.), ROWA and other forms of Viability Gap Funding (VGF) as may be defined by policy. SSF is subject to time constraints on incurring obligations and disbursing funds.

37. **TAKE-OR-PAY AGREEMENT –** An agreement between two parties where one agrees to either buy certain goods or services from the other on a certain date, or dates, or otherwise, to pay for them even if the buyer does not need them on that date. A take-or-pay agreement provides guaranteed revenue for the seller even if the buyer decides against actually purchasing the goods or services. It is common in transactions involving electric utilities and amended to modify other industries.

38. **TERMINATION PAYMENT (BUYOUT) –** a Payment that, depending on the circumstances either the Government or one of its entities or the PPP owners have to make in the event of contract termination due to defaults under the Project Agreements OR Government determination. In the event of Government default /determination and absent agreement with the owners, the Government broadly has to assume all liabilities, and purchase the owners' equity as well as paying for anticipated profits. This situation most often arises, if at all, as a result of either natural or government *force majeure*. If the project owner defaults, generally the government has to assume project debts. Precise terms of Termination Payments are established in the PPP Agreements.

39. **VIABILITY GAP FUNDING -** Grant, or the other value, component extended by GPH, or any Implementing agency in the Philippines, in any of the agreed forms for the purpose of making the tariff affordable to users while improving the commercial attractiveness and sustainability of the project.

    As indicated above, VGF grant can take several forms, amongst them:

    i. Outright extension of funds to cost-share implementation of a PPP project , including ROWA, capital costs or operating subsidies of a PPP project;

    ii. Subordinated or concessionary loan, where the monetary value of the grant is based on the difference between the present value of prevailing commercial terms for such loan and actual terms extended by GPH. (Note that in some cases, the grant element can be determined precisely only after the tender, depending on its terms and what proponents offer to do;

    iii. The commercial value of performance undertaking which has an economic value that can be calculated, but normally no identifiable "cash value" for accounting purposes; and

iv. Any contribution of real property to a project, over which usufruct rights to the proponent has been granted.

v. Subject to existing laws and implementing rules, GPH may provide any form of direct or indirect contribution or support, including ROWA, subject to the limitation that, in unsolicited proposals, there can be no government equity, subsidy or direct government guarantee (Revised BOT Law IRR, Section 13.3).

***WHAT VGF IS NOT* -** Any business as usual arrangement such as a take-or-pay agreement (otherwise referred to as a "credit enhancement"), any incentive (fiscal or otherwise) or any contingent liability excepting those arising from operating subsidies.

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