

This PDF is a selection from a published volume from the
National Bureau of Economic Research

Volume Title: Fiscal Policy and Management in East Asia,
NBER-EASE, Volume 16

Volume Author/Editor: Takatoshi Ito and Andrew K. Rose,
editors

Volume Publisher: University of Chicago Press

Volume ISBN: 978-0-226-38681-2

Volume URL: http://www.nber.org/books/ito_07-1

Conference Date: June 23-25, 2005

Publication Date: October 2007

Title: Dealing with Contingent Liabilities: The Philippines

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URL: <http://www.nber.org/chapters/c0894>

Dealing with Contingent Liabilities The Philippines

Gilberto M. Llanto

8.1 Introduction

In recognition of the significant role the private sector can play in the provision, financing, and implementation of infrastructure projects, the Philippine government has adopted specific measures to encourage private-sector participation in infrastructure. The acute budgetary constraints facing the Philippine government motivated the entry of the private sector in the provision of certain infrastructure services, which can be priced accordingly, thus making it possible to exclude nonpayers from the service. Through user charges, the private investors can recover their investments and generate profits.

The passage of Republic Act 6957 or the Build-Operate-Transfer (BOT) Law in 1990, as amended by Republic Act 7718, provides the avenue for tapping private-sector expertise and resources in infrastructure.¹ The BOT law provides the legal framework governing financing, construction, and operation of an infrastructure project that the government delegates to a private proponent. The amended BOT law has increased the scope of private-sector participation, providing for direct negotiation of contracts and investment incentives in certain cases, and addressing the problem of unsolicited proposals.² Executive Order No. 215, issued in 1987, allowed the private sector to invest in power generation. The Electric Power Indus-

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1. The amended BOT law allows for various modes of private participation: build-operate-transfer, build-run-and-operate, build-transfer, build-lease-and-transfer, contract-add-operate, develop-operate-transfer, rehabilitate-operate-transfer, and rehabilitate-own-operate.

2. The local government units have also entered into BOT-type arrangements with private proponents for providing infrastructure in the local areas.

try Reform Act (EPIRA) enacted in 2002, paved the way for greater private-sector participation in the electric power industry. It laid down the basis for competition in power generation and supply segments of the industry. Distribution and transmission of electricity have continued to be monopolies. A newly created Energy Regulatory Commission was created to regulate the price of transmission and distribution of electricity. The law also created a National Transmission Company that will be initially set up as a state monopoly but that will eventually be privatized.

Thus, the creation of a new infrastructure policy environment has been rewarded by a surge in private investor interest and investments in various infrastructure projects. In 1998 President Ramos reported that the BOT law enabled government to enforce power projects on scale and speed that was unprecedented worldwide. In one year alone (1996), the government added 1,000 megawatts of capacity through BOT power plants. By the end of 1993, the ten-hour power outage affecting many metropolitan areas and manufacturing establishments in 1990 to 1992 was eliminated.

To encourage private-sector participation in infrastructure, the Philippine government has invariably provided state guarantees. This chapter draws the attention of policymakers and legislators to the fiscal risk brought by contingent liabilities arising from government guarantees given to privately driven infrastructure projects. The unmitigated provision of government guarantees has given rise to large amounts of contingent liabilities that has created a serious fiscal risk for the government. The chapter discusses the current attempt of the Philippine government to address this outstanding issue. Drawing from existing literature (Lewis and Mody 1997, Mody and Patro 1996, Irwin et al. 1997, Mody 2000) the chapter sketches how the Philippine government may organize a management framework for contingent liabilities. It concludes by pointing out the need for the government to develop credible regulatory and competition policy frameworks to minimize the demand for guarantees in the future.

8.2 Demand for State Guarantees

Private proponents faced the daunting problem of entering highly regulated and distorted markets for infrastructure, where political patronage and intervention present grave constraints to efficient operation. Confronted with the problem of providing services in a highly politically charged environment, private providers seek state guarantees on a wide variety of perceived risks. Economic and political uncertainties increase the cost of investing in a country. Mody (2000) explains the provision of government guarantees as a necessary step in view of the fact that the transition from government infrastructure monopoly to multiple private infrastructure providers would require significant investments in regulatory

capacity and since such capacity cannot be built overnight, contractually specified public-private partnerships are necessary intermediate steps in a rapid infrastructure development strategy. Government guarantees serve as second-best instruments in the absence of a stable political environment, effective regulatory bodies, independent judicial systems, and an overall competitive climate.³ Thus, a crucial condition of an effective public-private partnership in infrastructure projects is the provision of state guarantees.

The fiscally challenged Philippine government realizes it has a duty to provide its citizens adequate and better infrastructure services. It has turned to the private sector to fill the huge gap in infrastructure services that the government felt impossible to address given a debilitating fiscal deficit. To encourage private investments in infrastructure services, private proponents or investors should be able to recover costs and generate normal profits from the endeavor. It would be critical to allow the private investor the freedom to set tariffs or user charges that would adequately cover costs as well as generate profits. Since they were bringing risk capital to the project, the private investors wanted an assurance of adequate return to their investments and recovery of invested capital. Awareness of the difficulty of charging cost-recovering tariffs or user charges in heavily politicized environments, unfamiliarity with the Philippines and weaknesses in the regulatory framework only whetted their appetite for government guarantees.

Government guarantees create contingent liabilities that could spell financial trouble for the government if not properly managed. In the drive to motivate private-sector participation in infrastructure, especially in the energy sector, the Philippine government provided guarantees that covered a wide variety of project-specific and general risks (Llanto and Soriano 1997). The expectation was that high Philippine economic growth could be sustained in the future, which would somehow avert guarantee calls.

8.3 Experience with Government Guarantees to BOT Projects

The BOT scheme is a contractual arrangement between the government and the private proponent that obligates the latter to finance and construct an infrastructure project for the government, and operate and maintain the facility during the cooperation period established in a contract. During the cooperation period, the proponent can charge rent, user charges, and toll fees to recover his or her investment outlay and generate a reasonable return to investment. The private sector brings not only financing for the project but also cost efficiencies together with operating know-how and

3. See Ashoka Mody 2000.

technical advantage.⁴ Thus, the government used the BOT schemes to address the power crisis and, more recently, to move other infrastructure, such as the Manila Skyway Project, the light railway system along Metro Manila's main highway (EDSA MRT III), and others, from the drawing tables to the project-implementation stage.

8.3.1 Private Power Generation

The government has privatized power generation in a bid to provide greater efficiency in the power sector after the government realized the inadequacies of state provision of power and the regulatory and clearance procedures in that sector. The first successful project was the 200 megawatt (MW) Hopewell Navotas I, which began operation and was synchronized with the National Power Corporation (NPC) grid in 1991. The Ramos government extensively used BOT arrangements to lick the power crisis, believing that private-sector participation was the best way to increase power generation capacity in the shortest possible time. The government and NPC launched a *fast track* program with some 10 suppliers for additional power-generation capacity of about 1,000 MW within 18 months. By the end of 1993, the power crisis was history after the private sector responded positively to its new-found role. Between 1992 and mid-1994, the government and NPC had about 24 more BOT contracts. Initially, the arrangements were done on a transaction by transaction basis with individual project sponsors because of the urgency of the situation and the lack of experience with BOT schemes in the country. The resultant contractual agreements called for the implementation of those projects on a cost plus or a minimum rate of return basis. As the economy recovered and private capital regained confidence in the country, the government awarded more recent contracts on a competitive basis.

As of 1994, more than 35 power plants accounting for some 5,000 MW were either already in production or under active development/construction with a total cost of U.S. \$5 billion. According to the Department of Energy, except for hydro and geothermal power, all future power-generation capacity will be with the private sector.

Because the power crisis was the single most important constraint to economic recovery and growth in the early 1990s, the government accepted the installation of *peak-load* power plants that provided the much needed power but at a relatively higher cost to the consumer. After the power crisis eased up, the government sought less expensive power projects.

During the *fast track* period of installing more power capacity through

4. Private power projects were completed at lower costs and used 25 percent to 30 percent less time than public projects. In Argentina, Chile, Malaysia, and Macau, private concessionaires of water supply projects have reduced unaccounted water from 50 percent to 60 percent of the total to 15 percent to 25 percent and staffing costs by 30 percent to 50 percent (Kohli 1995).

the BOT schemes, independent power producers (IPPs) required comprehensive government guarantees to cover sovereign, foreign exchange convertibility, market, and credit risks. The private proponents required comprehensive guarantee coverage in exchange for a commitment to install in the shortest possible time much-needed generation capability. In view of its inability to finance and install the required generation capability because of severe budgetary constraints and very limited access to the capital markets, the government had no choice but to grant guarantees sought by private proponents, including guarantees for National Power Corporation's (NPC) obligations, *take or pay* undertakings. The government through NPC and the private proponents agreed to have Purchased Power Agreements (PPAs), which required the government to pay for the building of capacity or power plants needed to ensure there is adequate supply of electricity, and reserve electricity in case a few power plants bog down.

Ideally, the government should have provided guarantees only to *fundamental* risks, such as sovereign and political risks. Subsequent BOT projects seemed to indicate the country's progress in attaining an improved credit standing in the international capital markets, which enabled government to provide less comprehensive risk coverage. This is seen in BOT arrangements in toll road construction and in urban mass transit system.

8.3.2 Tollways Construction

The project was the construction of a 25.5 kilometer toll road costing U.S. \$500 million connecting Metro Manila to Cavite province.⁵ The government awarded a 35-year BOT concession to a joint venture between a private-sector consortium and the government's Public Estates Authority. The government's guarantee cover was limited to political and sovereign risks, including right of way, force majeure during construction and operation, and cost escalation arising from variations in design. A guarantee on the adjustment of toll rates assured the proponents compensation for any shortfall in toll revenues arising from the nonimplementation of an agreed-upon parametric adjustment of toll rates. While the government took the tariff risks, all other commercial and market risks (e.g., the volume of traffic that will actually use the toll road) were absorbed by the private investors and lenders.

8.3.3 Light Railway System

This involved the construction of a 17-kilometer light railway system traversing Epifanio de los Santos Avenue (EDSA). The U.S. \$650 million project was awarded to the private sector on a 25-year build-lease-transfer

5. Drawn from the speech of Secretary of Finance, Roberto de Ocampo, in the High Level Conference on Frontiers of the Public-Private Interface in East Asia's Infrastructure, Jakarta, Indonesia, September 3, 1996.

arrangement. The original plan was to finance the project from commercial borrowing from foreign capital markets with the government providing only fundamental guarantees. However, government, through the Department of Transportation and Communication (DOTC) and the Department of Finance (DOF), took the initiative of helping the private-sector consortium negotiate for lower financing costs with the senior lenders of the projects. The government guaranteed the lease payments of DOTC to the proponents with confirmation from DOF that the obligations carry the full faith and credit of the Republic of the Philippines. With this performance undertaking, the interest rate to investors was brought down from 20 percent to 15 percent. The project was also made more commercially attractive to the private-sector consortium by awarding them the right to commercial development in the depot and stations. The private-sector consortium would have to pay lease to the government. Thus, the fare revenues will be supplemented by revenues from commercial developments.

8.4 Contingent Liabilities in Infrastructure Projects

In the Philippines, Llanto and Soriano (1997) first raised the problem of the fiscal risk of contingent liabilities arising from the provision of government guarantees to infrastructure projects. The provision of comprehensive guarantees to infrastructure projects has generated huge contingent liabilities that must be managed well; otherwise the government will be exposed to substantial payment burdens once a guarantee call is triggered. Subsequent studies (Llanto et al. 1999; Bernardo et al. 2004) confirmed this as a potentially very serious fiscal problem if not properly managed by the government. Table 8.1 shows project-specific risks in certain sectors that impelled private proponents to ask for government guarantees.

8.5 Risks Most Commonly Shouldered by Government

The most often shouldered risks by the national government in BOT-type projects are the following:

- *Site availability.* The government guarantees right-of-way for the project. This involves purchasing the site for the project as well as relocating people who will be affected by the project;
- *Market risk.* If the buyer of the service is a government entity, the government typically agrees to minimum off-take contract purchases and prices (take or pay arrangements). These have the effect of guaranteeing a market for the output of the proponent (e.g., power, water);
- *Payment risk.* If the buyer of the service is a government entity, the government guarantees contractual performance;

Table 8.1 Selected project-specific risks and sectoral examples

Type of project-specific risks	Sectoral examples
Project-performance risks High cost of service Bad/inefficient service	<p>Power—Power purchase agreements refer to minimum power plan performance criteria that the proponent has to satisfy.</p> <p>Water—MWSS concession agreement states the minimum criteria for project performance to be satisfied by the proponent. The concessionaires would bear the risk of poor project performance if they are penalized by the MWSS Regulatory Office.</p> <p>Transport—Most toll road concession agreements state the minimum criteria for project performance to be satisfied by the proponent.</p>
Project-completion risks Delays Cost overruns Site availability	<p>Power—NPC normally guarantees right-of-way and site availability for power projects.</p> <p>Water—The MWSS concession agreement stipulates that cost overruns in projects may be passed onto consumers provided they are covered in grounds for extraordinary price adjustments (EPAs). Otherwise, such costs are borne by the concessionaires.</p> <p>Transport—Responsibility for constructing access and feeder roads necessary for ensuring the viability of many toll roads are assumed by the government.</p>
Fuel and other inputs risk Fuel availability Skilled labor	<p>Power—In many instances, power purchase agreements include commitments by National Power Corporation (also the off-taker) to guarantee the supply of fuel inputs for independent power producers.</p> <p>Water—The MWSS concession agreement transfers input risk to the concessionaire, unless there are grounds for extraordinary price adjustments.</p> <p>Transport—Inputs for road and bridge construction are usually carried by the contractor.</p>
Market risk User demand for services	<p>Power—At the height of the power crisis, the government agreed to bear significant market risks by adopting minimum off-take contracts with independent power producers.</p> <p>Water—The MWSS concession agreement transfers market risk to the concessionaire. However, a number of bulk water service contracts with pending approvals have minimum off-take provisions with government-owned off-takers.</p> <p>Transport—The MRT-3 contract includes a stipulation of minimum ridership levels, below which government must compensate the contractor.</p>
Payment risk Creditworthiness of buyers of output	<p>Power—All power purchase agreements stipulate that NPC's commitments carry a full government guarantee for minimum off-take amounts. Thus, the relevant credit risk is that of NPC and government.</p> <p>All PPAs carry a buyout clause the IPP may invoke in case NPC commits a breach of contract or fails to make required payments to IPPs.</p> <p>Water—Many proposed service contracts between bulk water providers and off-takers, usually municipal water districts, carry \ guarantees of payment from the latter. Thus, the relevant credit risk is of the municipal water districts or the municipal government.</p> <p>Transport—There is no off-taker in most transport projects.</p>

(continued)

Table 8.1 (continued)

Type of project-specific risks	Sectoral examples
Financial risk Debt service coverage Security On-going compliance	<p>Power—All PPAs carry a buyout clause the IPP may invoke in case there is a change in circumstance that materially reduces or prejudices the IPP return and the parties are unable to agree to a change in the contract after a defined period (guaranteed rate of return risk). In addition, most capacity payments are tailored to cover the project sponsor's debt services plus a fair rate of return.</p> <p>Water—In the MWSS Concession Agreement, the government does not assume financial risk. This is instead passed onto the concessionaires.</p> <p>Transport—Debt service coverage is a risk assumed by private operators in the case of toll roads.</p>
Country environment risk Expropriation Regulatory interference Concession revoked Legal framework Environmental approval Foreign exchange	<p>Power—All PPAs carry a buyout clause the IPP may invoke in case there is a change in law or regulations, and if compliance with such laws results in:</p> <ol style="list-style-type: none"> 1. The power station being unable to operate; or 2. The interest of the operator in the project and the operator's expectation of its return on investment being materially and adversely affected, <p>and the parties are unable to agree to an amendment of the PPA after the defined period of negotiation (legal framework risk).</p> <p>All PPAs carry a buyout clause the IPP may invoke in case there is a force majeure event that is within the reasonable control of the government or NPC that lasts for a defined period and the parties are unable to agree to a contract revision. In a few cases, this applies to all force majeure events (force majeure risk).</p> <p>Many PPAs carry a buyout clause the IPP may invoke in case the NPC is privatized and this effectively results in a real or purported assignment of rights or assumption of obligations under this agreement or materially and adversely changes its net assets, projected profits, projected net cash flow from operations, or otherwise would prompt a reasonable person to conclude that the ability of NPC or its successor entity to duly perform its obligations under the PPA on a timely basis has been materially and adversely affected.</p> <p>Water—In setting the concession fee equivalent to the annual debt amortization payments of MWSS, the MWSS concession agreement effectively transfers the responsibility for paying MWSS loans to the concessionaires. Since these loans have been contracted in foreign currency, the concessionaires bear the risk. However, the concessionaires have cited the devaluation of the peso in their latest petition for EPA before the MWSS Appeals Board. There are no automatic adjustment mechanisms for passing these risks to consumers.</p> <p>Transport—In toll road agreements, most of the country environment risks are assumed by the government.</p>

Source: Llanto et al. (1999).

Note: The Philippines no longer guarantees foreign exchange rates at the time of conversion. What is more prevalent is a guarantee of convertibility of domestic currency into foreign exchange.

- *Change in law risk.* The government assures proponents that changes in the legal framework will not affect contractual agreements;
- *Foreign exchange risk.* The government/central bank agrees to provide forward cover for the proponent. This will entail either: (a) ensuring that foreign exchange is made available for the project; or that (b) foreign exchange may be purchased through a forward contract for delivery at a later date. A common problem is the currency mismatch where project revenues are peso-denominated while debt repayments are in foreign currency. The failure to have cost-recovering tariffs will prevent raising the necessary peso amounts to cover a foreign-currency denominated debt; and
- *Regulatory and political risk.* Regulatory risk concerns the implementation of regulation that would have adverse impact on the financial viability of the project. For example, in toll road projects, the government through the Toll Regulatory Board guarantees that toll adjustment shall be in accordance with a parametric formula determined for the project. Political risks may include changes in law, war, hostilities, belligerence, revolution, insurrection, riot, public disorders, or terrorist acts.

Of the previous risks mentioned, the provision of guarantees to cover market risks and buyouts in the event of project termination contribute the greatest share to increases in the contingent liabilities of government (table 8.2). The amount of uncertainty inherent in the transition period—from a state of direct government provision to a state of privatization and the long gestation period of infrastructure projects—implies that when such guarantees are provided, the government shoulders a larger proportion of the

Table 8.2 Largest sources of contingent liabilities

Item guaranteed	Cost
<i>Power sector</i>	
1. Buyout clause or termination	Buyout or termination price
2. Force Majeure	Buyout or termination price
<i>Transport sector</i>	
1. Toll changes; automatic toll adjustment formula	Costs of inability to implement toll adjustments
<i>Water sector (MWSS)</i>	
1. MWSS to assume loans being paid by concessionaire	Cost of principal and interest on old MWSS loans
2. MWSS to pay early termination fee	Early termination amount
3. Lower of appeal to pay total cost of appeal process for both parties	Cost of appeals process
4. Force Majeure	Early termination amount

risk of insufficient market demand, adverse exchange rate fluctuations, and other negative shocks.

8.6 Contingent Liabilities of the Philippine Government

Total estimated contingent liabilities as of 2003 was P1,672 billion (U.S. \$30.4 billion; see table 8.3).⁶ Accounting for liabilities that have become actual, total liabilities amount to P1,455 billion. The total estimated value, however, does not include exposures from unfunded liabilities of the social security institutions and implicit contingent liabilities that may arise from defaults on nonguaranteed debts and collapse due to capital outflows. A 2003 report of the Commission on Audit on the Government Service Insurance System (GSIS) reported the institution's actuarial reserve deficiency at P5.24 billion. On the other hand, the Social Security System (SSS) valuation report in 1999 revealed that a portion of its assets would be used for benefit payments by 2008 and the fund would last until 2015 assuming there would be no across-the-board increases in benefits. If there would be annual across-the-board increases, assets would be used starting 2004 and the fund would last till 2012. SSS is currently updating its actuarial valuations.

The contingent liabilities of the infrastructure sector comprised 54 percent of total contingent liabilities estimated by the Department of Finance. BOT projects had a share of 18.5 percent while buy-out costs of independent power producers (IPPs) made up 35 percent. Guarantees on projects and activities of government-owned-and-controlled corporations (GOCCs) and government financial institutions (GFI) loans were 43 percent of the total estimate. Guarantee institutions had 3 percent of the total estimate.

Table 8.4 lists the government corporations and financial institutions that have provided government guarantees. The charters of some of those government corporations allow them to issue sovereign guarantee. Once the guarantee is called upon by the private investor, the national government becomes liable for payment. The table also rates the likelihood of these guarantees to be called, with the Light Rail Transit Authority, National Food Authority, and Philippine National Railways having the highest likelihood of being called. Guarantees on the National Power Corporation (NPC) and Technology Livelihood Resource Center equivalent to P200 billion and P0.32 billion, respectively, are already to be assumed by the national government. Among the GOCCs, NPC presents the highest

6. The estimates for contingent liabilities were based on reports of several key government agencies and external consultants. The report was compiled from the monitoring activities of the Department of Finance (DOF) on the cash flows of GOCCs as well as IPP reports from the National Power Corporation (NPC). Consultants were contracted in 2003 to quantify the contingent liabilities in BOT projects. As the central finance management office, DOF maintains information and annually updates the financial positions of GOCCs.

Table 8.3 Estimated contingent liabilities as of December 31, 2003

Types of contingent liabilities	Amount Php billion	Amount U.S.\$ billion
Guarantee on GOCC/GFI loans ^a	723.90	13.16
Guarantee Institutions ^b	51.50	0.94
Guarantee on PSP (BOT) projects	308.85	5.62
Buyout of IPPs ^c	587.140	10.68
Total	1,671.65	30.40

Source: DOF.

^aExcludes NG loans relent to GOCCs amounting to U.S.\$2,05 billion or Php112.77 billion. Pertains to outstanding principal balance only.

^bGuarantees on deposit insurance was not included because there are no provisions in the PDIC Charter that provides for NG guarantee on its obligations.

^cBeginning January 2005.

^dExcludes potential NG exposure for the social security institutions.

^eExchange rate Php55 = U.S.\$1.

risk both in likelihood and cost. The government should review the contracts entered upon by those GOCCs and monitor the guarantees and the concomitant contingent liabilities arising from those contracts. Off-budget obligations such as guarantees provided by GOCC may give rise to a fiscal shock unless monitored and budgeted by the national government.

Republic Act 4860 sets a ceiling of U.S. \$7.5 million on outstanding guarantees of foreign loans of GOCCs. However, some corporations have been exempted from the guarantee ceiling: Light Rail Transit Authority, Metropolitan Waterworks and Sewerage System, National Development Corporation, National Electrification Administration, National Irrigation Administration, Philippine National Oil Company, and Philippine National Railways. The national government charges a fixed annual guarantee fee of 1 percent regardless of the risk profile of the guaranteed loan or the institution. However, because the accounting system is still cash based, the fees collected are treated as part of the general revenues and are not kept in separate accounts to fund potential guarantee calls.⁷

Table 8.5 shows the maximum estimated exposure from independent power producers (IPPs). Liability exposures from private-sector participation in infrastructure projects are itemized in table 8.6. As of year-end 2003, the national government has made payments of P11,572 million and P5,258 million on behalf of MRT3 Project and Casecanan, respectively, for a total of P16,831 million. In this case, the contingent liabilities have become actual liabilities.

7. See Bernardo and Tang 2001.

Philippine Export Zone Authority	RA 4860	102.27	1.86	102.27	1.86	2,229.07	40.53	2,331.34	42.39	LL		
Philippine Fisheries Development Authority						91.19	1.66	91.19	1.66	LL		
Philippine National Oil Company w/ECD ^a	Charter	34,381.10	625.11	34,381.10	625.11	3,988.48	72.52	38,369.58	697.63	LL		
Philippine National Railways	RA 4860	2,069.62	37.63	2,069.62	37.63	3,952.00	71.85	6,021.62	109.48 ^k	AC		
Philippine Ports Authority	RA 4860	3,597.13	65.40	3,597.13	65.40	3,724.06	67.71	7,321.19	133.11	LL		
Philippine Tourism Authority	RA 4860	693.45	12.61	693.45	12.61			693.45	12.61	LL		
Subic Bay Metropolitan Authority	RA 4860	3,732.30	67.86	3,732.30	67.86			3,732.30	67.86	LL		
Technology & Livelihood Research Center	RA 4860					2,155.42	39.19	2,155.42	39.19 ^l	AC		
Trade & Investment Development Corp.	Charter	5,063.85	92.07	5,063.85	92.07			5,063.85	92.07	LL		
Total		662,852.25	12,051.85	61,047.47	1,109.96	723,899.72	13,161.81	109,048.75	1,982.70	832,948.47	15,144.52	3,642.27

Source: DOF.

Note: LL = least likely; ML = most likely; AC = almost certain; NB = no basis.

^aTotal bond flotation as of end-December 2003 is P5.58 B; the rest is the P5.0 B DBP yen loan.

^bIncludes debentures and zero coupon bonds used as payment for calls on its guaranty.

^cNDC includes exposure in FCCC.

^dRepresents projected advances of NG for 2003 considering that PSALM has cashflow difficulties for 2003. Starting 2004, PSALM shall shoulder repayment of NEA loans.

^eBecause of the negative performance of NFA, a call on the NG guarantee would be forthcoming.

^fNG guarantees 22% of the drawdowns of NHMFC from funders (SSS, GSIS, and HDMF) under the Unified Home Lending Program.

^gPaying directly to creditors.

^hAssumed that NPC repays all advances made by NG with the exception of the US\$40 M paid to Sa Roque which will be repaid upon drawdown from JBIC loan.

ⁱEquivalent to P200 B of NPC loans to be assumed by NG under the EPIRA law.

^jRepresents ROW of Manila-Cavite Toll Expressway project. Under MOA between PEA and TRB/DPWH, latter will reimburse PEA expenses paid for ROW and include the same in TRB annual budget for years 1999–2004. TRB has not remitted any amount to PEA. Total loans shall be paid on October 3, 2003.

^kNot paying because of cashflow difficulties.

^lTo be proposed for conversion into subsidy.

^mNG relent to LBP which the latter lent to its subsidiary the PCFC.

ⁿPNOC figures represents Citibank US\$175 M and a portion of IBRD 2181PH Coal Exploration.

Table 8.5 Estimated contingent liabilities on IPPs beginning January 2005

Project name	Buyout price at 4% CIRR			Cooperation period	Remaining project life
	Amount in US\$ M	Basis other than buyout price			
2 × 350 Pagbilao Coal Fired Plant (Units I and II)	2,927.15			Oct. 1995–Oct. 2025	19 yrs 9 mos
2 × 100 Mindanao Diesel Power Barge	13.30	2 yrs capacity fees + value of all equipment		July 1994–July 2009	5 yrs 6 mos
300 MW Limay Bataan CC, Block A	6.43	6 months worth of capacity fees		Oct. 1994–Oct. 2009	4 yrs 9 mos
100 MW Navotas Gas Turbine 4 Power Station 2	2.01			Apr. 1993–Apr. 2005	4 mos
300 MW Limay Bataan CC, Block B	6.83	6 months worth of capacity fees		Mar. 1993–Mar. 2007	2 yrs 3 mos
Ilijan City Diesel Plant II (Mindanao NMPC Unit 2)	5.53			Sept. 1993–Sept. 2005	9 mos
108 MW Subic Zambales Diesel Plant/I Enron I	104.04			Feb. 1994–Feb. 2009	4 yrs 1 mo
215 MW Bauang Diesel Power Plant	171.36			Feb. 1995–Feb. 2010	5 yrs 2 mos
63 MW Cavite EPZA Diesel Plant	6.07			Dec. 1995–Dec. 2005	12 mos
203 MW Naga Thermal Power Complex	83.20			May 1994–Feb. 2012	7 yrs 4 mos
2 × 500 Sual Coal Fired Thermal Power Plant	2,327.80			Oct. 1999–Sept. 2024	19 yrs 9 mos
650 MW Malaya Thermal Power Plant (Unit 1)	164.69			Sept. 1995–Sept. 2010	5 yrs 8 mos
100 MW Zamboanga Diesel Plant Project	53.04			Dec. 1997–Dec. 2015	10 yrs 11 mos
50 MW General Santos Diesel Power	27.67			Mar. 1998–Mar. 2016	11 yrs 2 mos

70 MW Bakun A/B & C Hydro Power	181.40	assignment fee w/c also serve as termination	Feb. 2001–Feb. 2026	21 yrs 1 mo
304 MW San Pascual Cogeneration Power Plant	8.00	fee for SPCC development costs	25 years	preconstruction stage
200 MW Mindanao Coal Fired Thermal Power Plant Project I	35.00	total contractor's disbursement as of Oct. 2004	25 years	construction stage
345 MW San Roque Multi-Purpose Hydro Project	1,664.22		May 2003–May 2028	23 yrs 4 mos
1200 MW Natural Gas Fired Combined Cycle Power/Ilijan	1,314.00	at 4% CIRR—1,314; at WACC—1,049	June 2002–June 2022	17 yrs 5 mos
379.4 MW Caliraya-Botocan-Kalayaan HEP	1,573.98	at 4% CIRR—1,573.98; at WACC per contract—1,210.39	Kalayaan I Unit 1 & 2 Mar. 2002–Mar. 2027 Kalayaan II Unit 3 Nov. 2003–Nov. 2028 Unit 4 Jan. 2004–Jan. 2029 Botocan June 2003–June 2028 Caliraya Unit 1 Oct. 2002–Oct. 2027 Unit 2 Dec. 2002–Dec. 2027	21 yrs 2 mos 22 yrs 10 mos 23 yrs 22 yrs 5 mos 21 yrs 9 mos 22 yrs
Total	10,675.72			

Source: DOF.

Note: CIRR = Commercial interest reference rate; WACC = Weighted average cost of capital.

Table 8.6 Estimated potential liability exposure of NG in BOT projects (based on various parameters depending upon availability of information) as of December 31, 2003

Projects	Implementing agency	Status	Maximum potential liability exposure		Actual payments by NG	
			In Php million equivalent ^a	In U.S\$ million ^b	In Php million	In U.S\$ million
<i>Transport sector</i>						
LRTA Extension 1	Light Rail Transit Authority	Not yet operational	1,794.31	32.62 ^c		
NAIA International Passenger Terminal 3	DOTC/MIAA—NG	Completed, not yet operational	94,246.79	1,713.58 ^d		
South Luzon Expressway Extension Project	Toll Regulatory Board—NG	Completed	470.65	8.56 ^e		
Manila Cavite Expressway Project	Toll Regulatory Board—NG	Operational	51.23	0.93 ^f		
North Luzon Expressway Project	Philippine National Construction Co.	Not yet completed	13.37	0.24 ^g		
Southern tagalog Arterial Road	DPWH	Partly completed	3,303.36	60.06 ^h		
Metro Rail Transit 3	DOTC	Operational	31,265.09	568.46 ⁱ	11,572.39	210.41
Metro Manila Skyway	Toll Regulatory Board—NG	Operational	43,874.54	797.72 ^j		
<i>Information technology-related</i>						
Civil Registry System Database Infrastructure	National Statistics Office—NG	Operational	0.65	0.01 ^k		
& IT System	Land Transportation Office	Operational	1,219.90	22.18 ^l		
Machine Readable Passport and Visa	Department of Foreign Affairs	Not yet operational	560.00	10.18 ^m		
Land Titling Computerization Project	Land Registration Authority	Not yet operational	1,120.95	20.38 ⁿ		

<i>Water sector</i>					
Cascanan	National Irrigation Administration	63,805.96	1,160.11 ^o	5,258.25	95.60
MWSS East Zone Concession	Metropolitan Waterworks & Sewerage System	9,291.00	168.93 ^p		
MWSS West Zone Concession	Metropolitan Waterworks & Sewerage System	17,729.00	322.35 ^p		
Subic Water	SBMA & Olongapo City Water District	529.73	9.63 ^q		
<i>Power sector</i>					
Leyte Geothermal Project	PNOC-EDC	34,392.05	625.31 ^r		
Mindanao Geothermal Project	PNOC-EDC	5,182.10	94.22 ^r		
Total		308,850.68	5,615.47	16,830.64	306.01

Source: DOF.

^oExchange rate Php55 = US\$1.

^pMostly U.S. dollar denominated.

^qTermination payment prior to Financial Closing.

^rTotal liquidated damages payable to concessionaire.

^sFinancial obligation pertains to compensation.

^tTotal financial obligation of TRB in the event the project is terminated.

^uFinancial obligation in the event the project is terminated.

^vFinancial obligation in the event of termination after the completion of construction.

^wBuyout price if agency is in default. Market/revenue risk is based on deficiency in fee collections vis-à-vis rental payments to proponent. Actual payment by NG pertains to principal and interest payments of MRTC loans to its creditors.

^xBuyout price in the event the project is terminated.

^yFinancial obligations in the event NSO defaults.

^zTermination amount plus attendant liabilities if agency is in default.

^{aa}Liabilities assumed in the event of termination by DFA due to proponent's default.

^{ab}Termination amount plus attendant liabilities if agency is in default.

^{ac}Potential payment obligation for the post completion buyout price. Real liability includes water delivery fee and taxes.

^{ad}Early termination amount due to MWSS in the event of termination.

^{ae}Termination due to SBMA default.

8.7 Attempts to Manage Contingent Liabilities

The Department of Finance (DOF) is in charge of overall monitoring of contingent liabilities. Two interagency committees (namely, [a] the Development Budget Coordinating Committee (DBCC) composed of the Department of Finance, National Economic and Development Authority, the Department of Budget and Management, and other agencies; and [b] the NEDA Investment Coordinating Committee [ICC]) both work with DOF at monitoring contingent liabilities. The DBCC regularly deliberates on possible claims arising from contingent liabilities and factors these in the budget program. The national government has required all government agencies and GOCCs to seek the approval of the DOF prior to entering into negotiations for foreign loans through Administrative Order 19 in October 2002. A more recent effort was the setting up of a taskforce on Debt and Risk Management within DOF in December 2004, which will be the primary unit responsible for monitoring and managing contingent liabilities.

A contingent liability becomes an assumed liability of the national government only after getting the recommendation of DBCC to absorb the liability. When this happens, the Department of Budget and Management prepares to service the liability, using as legal basis the automatic appropriations provision under the General Appropriations Act. A recent development is the preparation by the Department of Budget and Management of a draft bill entitled the Fiscal Responsibility Act, which has been submitted and is currently being studied by the Senate. One of the salient points of the draft bill is the repeal of the automatic guarantees that certain government-owned and -controlled corporations can provide under their respective charters. This will free the national government of an obligatory financial burden arising from calls on guarantees provided by GOCCs, thus, mitigating fiscal risk. The draft also calls for greater transparency and accountability in the public sector.

The Philippines is still in the process of defining an effective strategy for managing contingent liabilities. Apart from setting a debt cap, charging a uniform 1 percent annual guarantee fee, and the automatic appropriations once the guarantee is called, the government has yet to come up with a more efficient system of budgeting for the contingent liabilities. A direction for reform suggested by Brixi and Mody (2002) is accrual-based budgeting that is built upon an accrual-based accounting platform. Under this system of budgeting, the net present fiscal cost of contingent liabilities will be included in budget documents. The government may be able to analyze the fiscal impact of contingent liabilities sooner than when they become actual liabilities. Thus, this helps the government to more effectively manage them. This would include proper accounting of all contingent liabilities in their net present values. The government will be able to include anticipated

contingent liabilities in the regular budget that is submitted for congressional appropriation.

There is now an urgent need to set up a management framework that would take into account the screening, accounting, budgeting, and provisioning of contingent liabilities.

8.8 Toward a Management Framework

This leads to several issues that the Philippine government must work on:⁸ (a) an improved framework for the grant of guarantees; (b) accounting, budgeting, monitoring, and management of contingent liabilities; (c) policies that reduce risks including the promotion of competition and developing efficient regulatory frameworks; and (d) maintaining a sound macroeconomic environment.

8.8.1 Framework for Providing Guarantees

The government should recognize that a guarantee cover is not a free resource that government can grant at will. It represents actual claims on government's fiscal resources once certain future events trigger a guarantee call. Without an efficient allocation of this resource, the government could find itself in a fiscal shock once private investors call on guarantees that have been given without regard for efficient allocation principles.

Correct pricing of the guarantee may help ensure an efficient allocation. This means that pricing the guarantee should consider market conditions and relative project risks. A first approximation may relate the guarantee fee to the market price of a long-term government security or bond in the absence of a history or pattern of guarantee calls. The guarantee cover could be seen as a form of insurance made available by the government to the project proponent, which will be paid once a guarantee trigger brings about the call. Since the insurance cover constitutes an allocation of government resources to the project, the premium or fee should be based on the opportunity cost of the allocated resource. There is also a great advantage in calibrating the guarantee fee according to the relative risks in infrastructure projects. Thus, government should identify all the possible risks that can affect the project, rank them according to their weight and likelihood of occurrence, and determine what specific risks the government is willing to cover. Risk-adjusted and market-based guarantee fee will create the proper incentives for private demand for that cover, thereby ensuring allocation efficiency.

8. The discussion on the principles and approach behind guarantee provision and management of contingent liabilities draws on Mody, Lewis, Irwin, and others. This section also draws on Gilberto M. Llanto 2004.

A nonprice-allocation mechanism for guarantee cover is the government's ranking of infrastructure projects that would be given such cover. This will require a thorough evaluation of the projects' relative social benefits and costs and of the different projects' contribution to the attainment of desired development outcomes. Reference to the Medium-Term Public Investment Program as well as the budgetary deliberations of the Development Budget Coordinating Committee could provide guidance on the relative ranking of projects. On the other hand, it is not inconceivable that political interests may influence the ranking of infrastructure projects. The reality is that decisions by policymakers are influenced by technical, economic, and political considerations. It will be very important to ensure transparency of the policy debates, the arguments given, and the ultimate choices made by policymakers.

The government should determine the amount of guarantee cover it can prudently provide in any given year. This amount should include not only those granted to infrastructure projects but also to other guarantee programs implemented by various government agencies, especially those that have the nature of sovereign guarantees. In some instances, the national government gives only an indirect guarantee, since the first recourse of the private investor is the balance sheet of the sponsoring government agency. However, this also exposes the government to contingent liabilities and thus indirect guarantees should be considered in the overall appreciation of how much guarantee the government can provide at any given time.

Contingent liabilities should compete on equal footing (e.g., in budgetary terms) with other forms of financial support, such as direct subsidies, tax exemptions, loans, and so on, so that the choice for more contingent liabilities does not lessen public finance efficiency.⁹

A vital principle is to unbundle and assign risks to the party most capable of managing them, or whose actions have a direct bearing on their outcome. Thus, a risk-sharing arrangement with private parties shall reduce demand for government guarantee and minimize government's exposure to contingent liabilities. The sharing of risks has to be reflected in the contracts to be executed between the contracting parties. One advantage of a risk-sharing arrangement is the minimization of moral hazard in implementing projects.

The provision only of a set of core guarantees to BOT projects, which should also be extended to concession arrangements, merits serious consideration. The core guarantees should cover only (a) fundamental risks, for example, uninsurable political risks; (b) fundamental rights, for example, repatriation of profits; and (c) foreign exchange convertibility. Fundamental rights bind the BOT proponent to undertake the project in full accordance with the terms of the contract. These require government to grant

9. See Currie and Velandia.

the exclusive right to the project to the BOT proponent and to guarantee against direct or indirect government takeover unless agreed upon based on a termination or buyout provision of the project contract. Foreign exchange convertibility guarantees the BOT proponent's right to (a) purchase foreign exchange in the open market; (b) transfer its foreign currency funds abroad; and (c) maintain foreign currency bank accounts in the Philippines or abroad. To be neutral, the core guarantees will be applicable to all sectors and are impartial to all types of projects.¹⁰

Related to this is the recommendation for government to adopt a selective and reasonable set of performance undertakings that are subject to a fall-away clause. More specifically, there should be no guarantee cover for commercial and market risks that appropriately belong to the private sector. The introduction of fall-away clauses in certain performance undertakings will enable the national government to minimize its contingent liability exposure. Fall-away clauses were included in the 1200-MW Ilijan Natural Gas Power Plant and San Pascual Cogeneration Power Plant project agreements. For the Ilijan plant, the performance undertaking for the availability fees shall fall away when the Philippines achieves consecutively for two years an investment grade rating for its Philippine peso debt from Standard and Poor, Moody's, or other internationally recognized rating agency of comparable standing.

The framework for giving guarantees should include an explicit exit strategy for government guarantee. This will minimize government's risk exposure and potential burden on its fiscal position. The exit strategy will prevent perverse incentives and moral hazard in project management and implementation. For example, the government could design a contract that provides for a fall-away of government guarantee for foreign exchange convertibility once the country attains investment-grade rating in international capital markets.¹¹

The duration of the guarantee cover or the period of cooperation between the sponsoring agency/national government and the project proponent is another crucial factor in providing guarantees. IPPs' experience in the power sector seems to show that the lengthier the time period within which the guarantee call can be exercised, the more likely it will be exercised by the project proponent. Thus, a higher guarantee fee or premium could be required. The guarantee fee should also be reviewed annually by DOF, the sponsoring agency, and the project proponent to account for changes in business circumstances and, more generally, to give the department the flexibility to determine guarantee fees. The market is very dynamic and circumstances affecting the infrastructure project change. Thus,

10. Drawn from NEDA-ICC Policy Workshop on BOT and Related Policies, May 14, 1999, Tektite Building, Pasig City.

11. See Llanto and Soriano 1997.

there is a need for a regular review of project performance and a reassessment of the guarantee cover provided to the project.

In summary, the suggested framework for government guarantee has the following components:

- treatment of guarantee cover as a scarce resource that should be efficiently allocated
- determination of the annual amount of guarantee cover that government can provide
- pricing of a guarantee according to market conditions and relative risks
- risk sharing between project proponent and government
- core guarantees for selected risks
- core guarantees to be applicable to all sectors and all projects
- exit strategy or fall-away clause in guarantee contracts
- guarantee fee based on cooperation period
- annual review of project performance and required guarantee cover

8.8.2 Programming and Allocation of Guarantees

Together with monitoring, the programming and allocation of government guarantee will provide government useful information on the value of contingent liabilities and the amount of guarantee ex ante that can be reasonably provided without unduly exposing the government to unmanageable fiscal risk. In this respect, there is a need for a system of ranking or prioritizing access to the government's guarantee. At the moment, there are no internally consistent programming and allocation rules, much less provisioning for potential guarantee calls. An unanticipated call will produce a fiscal shock, forcing government to tap the debt market at a high cost in order to pay the claims of the affected party.

8.8.3 Accounting, Budgeting, Monitoring, and Management of Contingent Liabilities

The governments do not usually account for contingent liabilities because they follow cash-based budgeting. Thus, a government loan is actually recorded as an outflow but the government guarantee is not recorded because nothing has been spent during the accounting period. The cost of the guarantee is accounted for only when a guarantee call and the ensuing guarantee payment occur. This is myopic. For fiscal prudence, there is thus a need for an accounting and budgeting system that will take into consideration contingent liabilities. Lewis and Mody (1997) note that cash-based budgeting misrepresents and masks the aggregate exposure associated with loan guarantees and government insurance programs and creates perverse incentives for selecting one form of financing assistance over another. The failure to account for the true cost of guarantees leads to the expan-

sion of guarantee cover for various activities and infrastructure projects without requiring the government to reserve for future claims or losses.

The Philippine government has to introduce reforms into its budgetary system and processes and, in this case, scrutinize the budgetary impact of direct and indirect guarantees. Monitoring the cost of the guarantee claims and appropriating funds to service those claims only when those claims are submitted encourage the extension of guarantees without having to consider the costs, leaving future administrations vulnerable to huge claims. Lewis and Mody (1997) emphasize that only by enforcing budgetary control at the time the financial assistance (that is, in this case, the guarantee) is committed can the appropriate budgetary incentives be realigned to eliminate this moral hazard. A useful example of dealing with this situation is the Federal Credit Reform Act of 1990 in the United States (see table 8.7).

The contingent liabilities generated by the provision of guarantees should be carefully managed to minimize the costs of actual calls on the government. An appropriate contingent liabilities management framework could inform government's decision on providing guarantees, expectation of guarantee calls in the future, and the setting of reserves for the contingent event. The underlying rule is, first, to identify the different types of risks and, second, to determine the best way to improve their management, whether by insuring, transferring, mitigating, or retaining the risk. This approach, when adopted by the public sector, should take into account the government's budgetary processes, the legal environment, and the type of risks being evaluated.

The Philippine government has recognized the seriousness of the fiscal risk created by contingent liabilities. Thus, the Department of Budget and Management has included in the budget submitted to congress for appro-

Table 8.7 **The Federal Credit Reform Act of 1990**

A systematic accounting, monitoring, budgeting, and reporting of contingent liabilities are important to serve as early warning to the government of potential guarantee calls and the amount of government exposure. A good example of this practice is the requirement under the U.S. Federal Credit Reform Act of 1990 for the budget to reflect the outlays required to cover loan guarantees. Direct loans, guarantees, and grants are valued using a financially equivalent metric—the expected present value of future costs.

Each federal agency that administers credit programs has five accounts: a credit program account, a financing account, a liquidating account, a noncredit account, and a receipts account. There are separate financing accounts for loans and guarantees. In their annual requests for budgets, agencies have to include estimates of the subsidy costs for new loans and guarantees. If an agency exhausts its subsidy appropriations in a given year, it cannot provide further credit assistance in that year. Funding to cover the expected present value of future costs is charged against the appropriation for an agency when the direct loan or loan guarantee is issued and the government's commitment is extended. These costs or subsidies must compete for budgetary resources on the same basis as other government spending.

Source: Lewis and Mody (1997).

priation a line-item budget that is allocated for payment of contingent liabilities that have turned to be actual liabilities following certain triggering events. The Philippine government is also considering the establishment of a debt and risk management office at the Department of Finance, which shall monitor contingent liabilities and advise government on appropriate action, among other responsibilities. However, the attempt to budget and monitor is still in a rudimentary stage and the government still has to develop its capacity for management of contingent liabilities.

8.8.4 Developing Efficient Regulatory Frameworks and Promoting Competition

There is a need for policies that reduce risks and raise expected returns and can help attract private investments that do not depend on government guarantees (Irwin et al. 1997).¹² An important component of those policies is a credible regulatory and legal framework for the provision of infrastructure services. Private investors have repeatedly indicated the weak regulatory framework of the Philippines as a major factor deterring foreign investments. For instance, in the water sector, certain consumer groups such as NGOs have accused the lack of independence of the Regulatory Office as responsible for the high water tariffs. On the other hand, private business has rued their inability to charge cost-recovering tariffs because of political intervention and, thus, the tendency of private proponents is to ask for guarantees that cover this risk.

It is important to note that government risk-bearing is not necessarily required by private investments in infrastructure. Irwin and others (1997) call attention to the experience of the United Kingdom in attracting large amounts of private investments despite its policy of not bearing even regulatory risks except where they relate specifically to a project. In Chile, private investments in telecommunications, gas, and power were made without government guarantees. In Argentina, reforms in the power industry made it possible to get private investment without the government assuming major risks (Klein 1996).¹³

The most important policy measure is to expose infrastructure service to competition whenever possible. When monopolies are unavoidable, it is important for government to establish laws and regulations that protect property rights and to enforce them fairly and consistently (Irwin et al. 1997). Table 8.8 provides policies that reduce risks and increase expected returns.

Privatization, deregulation, and liberalization in the infrastructure sector do not necessarily lead to unadulterated economic benefits to the consumer. As Joskow (1998) points out, there could still be segments of the in-

12. See Irwin et al. 1997.

13. See Klein 1996.

Table 8.8 Economy-wide options to reduce risks

-
- Establish expert and independent regulatory agencies
 - Reform the constitution to impose limits on the power of the executive to act arbitrarily
 - Strengthen the independence and quality of the judiciary
 - Sign international treaties
 - Agree to be bound by international arbitration
-

Source: Irwin et al. (1997).

infrastructure sector that are natural monopolies for which continuing regulation would be needed to safeguard consumer welfare. At the same time, an effective regulatory presence is needed to ensure that potential competitors are not barred from entry into the competitive segment of infrastructure sectors. The Philippine government should recognize this as a crucial component of its overall infrastructure policy and strategy for private participation in infrastructure.

Effective regulation would be necessary to ensure consumer welfare, especially where there are segments of the infrastructure sector that are natural monopolies.¹⁴ In the case of the electric power industry, the EPIRA (RA 9136) created the Energy Regulatory Commission to promote competition; safeguard consumer welfare; ensure performance and compliance with health, safety, and environmental standards; and punish abuse of market power. Prohibition against cross-ownership between subindustries, concentration of ownership, and sourcing of power from bilateral supply contracts is provided for under the EPIRA and its Implementing Rules and Regulations.

Regulatory agencies should be independent and accountable. One of the dangers of not having an independent and accountable agency is to have pricing policies that can become highly politicized. This will prevent private investors from recovering their costs and generating profits, creating uncertainty about future income streams and magnifying the risks perceived by private investors. Accountability is another hallmark of a good regulatory agency. This will discourage arbitrariness in decision making and potential abuse of regulatory power. Campos (1998) cites the need for a judiciary environment that must be trusted by private investors and an effective and credible arrangement for appealing agency decisions to ensure accountability in a regulatory agency.¹⁵

All these point to the need to install a regulatory framework for the infrastructure sector that is clear, predictable, competent, and independent. Such a regulatory framework will help minimize uncertainty and risks faced by private investors and consumers alike and, thus, the need for gov-

14. See Joskow 1998.

15. See Campos 1998.

ernment guarantees against certain risks. Clarity of procedures for bid and award and dealing with disputes and unforeseen events in an infrastructure sector are indispensable to private participation in the infrastructure sector. Certainty about government's role in implementing commitments (e.g., tariff adjustment) gives private investors a measure of comfort and, finally, a competitive environment assures the private proponent that it will be able to charge tariffs or user charges that will enable it to recover costs and generate profits. This will also help minimize the need for guarantees against market-related risks.

8.8.5 Sharing the Risks with the Private Sector

Public infrastructure projects carry various risks that may discourage private sector financing, construction, or operation. Unless the government assumes some or all of the risks associated with the project, the economy will tend to underprovide it. The underlying rationale of the government's absorption of risks in public infrastructure projects is that the project's social return exceeds its private returns and that society will be better off having the project than doing without it. Thus, a government guarantee is given to project lenders and/or sponsors to minimize the attendant risks of an infrastructure project and thereby, encourage private-sector participation.

A practical approach in dealing with this problem of underprovision is to identify and break down the risks associated with the infrastructure project into several components and assign the component risks to the parties that should absorb them. The key activities are:

- the optimal assignment of risks to the parties that should absorb them
- the minimization of the component risks through efficient risk management

To encourage private-sector participation and performance in public infrastructure projects, the government and the private sector may agree on the assignment of the component risks and the determination of the extent of risk sharing. For instance, the government can guarantee the debt exposure of private sector investors for a limited period of time.

The critical action to take then is to determine which risks are transferable to the private sector and encourage greater private-sector share of those risks. The delineation and sharing of component risks are necessary to prevent perverse incentives that lead to project mismanagement, and to avoid moral hazard problems such as relaxing on project monitoring and concentrating on fund diversion. By taking on the full extent of the risk of defaults, the government may end up holding the proverbial empty bag as private lenders and sponsors take strategic action to capture rents at the expense of the government. The satisfactory allocation of risks between the

government and the private sector is essential to the successful implementation of infrastructure projects.

8.8.6 Maintaining a Sound Macroeconomic Environment

Macroeconomic stability characterized by low inflation and low interest rates will enable projects to have more certain cash streams and a positive rate of return on investments. This will minimize the risks of guarantee calls, especially in those instances when the government has been exposed to buy-out clauses.

To build the confidence of private investors in infrastructure, the Philippine government needs to maintain a stable macroeconomic environment and continue with economic and financial reforms that will deepen the financial and capital markets. Infrastructure projects are vulnerable to currency and maturity risks, a source of uneasiness to the private investor. The maturity structure of bank liabilities cannot simply match the long gestation of infrastructure projects. Hence there is a need to develop long-term peso debt finance. This will also take care of currency risks that arise because the infrastructure project generates revenues in pesos while the loan exposure is denominated in foreign currency.

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Comment Jason McDonald

The issue of how governments should manage their contingent liabilities is receiving increasing attention internationally (see Polackova-Brixi and Schick 2002). Dr. Llanto's chapter contributes to this burgeoning literature with a valuable examination of government-contingent liabilities in the Philippines. The chapter analyzes the fiscal risks associated with contingent liabilities, many of which are associated with private financing arrangements of public infrastructure, and proposes some possible management solutions.

This increasing attention appears to be driven by two fiscal problems associated with governments using contingent liabilities. The first is the possibility of increasing the adverse implications of macroeconomic risks. Where such risks are not transparent, investors face increased uncertainty as to the true extent of a government's fiscal liabilities. Further, the fiscal risks inherent in contingent liabilities may be systematically related—for example, guarantees over exchange rate values in different contracts can easily crystallize at the same time. Finally, contingent liabilities have no overt budgetary constraint (unlike traditional spending) that can hinder macroeconomic control.

The second fiscal problem is the potential microeconomic distortions from government's using contingent liabilities where no market failures exist. In such cases, contingent liabilities contain an implicit subsidy (equal