



Pakistan: Contingent Liabilities from Public Private Partnerships

July 2010

Final Report



Australian Government
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Final Report

Pakistan: Contingent Liabilities from PPPs

**Report to the World Bank and the
Ministry of Finance, Government of Pakistan**

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List of Acronyms, Abbreviations and Definitions

Contingent liability	A payment obligation whose timing and/or magnitude is dependent on the occurrence of some uncertain future event
Contracting authority	The government agency, department or state-owned enterprise entering into a public private partnership
DPCO	Debt Policy Coordination Office
FRDLA	Fiscal Responsibility and Debt Limitation Act of 2005
Government guarantee	A legal or contractual arrangement under which the government agrees to fulfill a financial obligation to a private party or separate government entity
IA	Implementation Agreement
IPDF	Infrastructure Project Development Facility
IPFF	Infrastructure Project Finance Facility
IPP	Independent power producer
MOF	Ministry of Finance
NHA	National Highway Authority
NTDC	National Transmission and Despatch Company
PEPCO	Pakistan Electric Power Company
PPA	Power purchase agreement
PPIB	Private Power Infrastructure Board
PPP	Public Private Partnership
PPP Task Force	A group of senior officials from Ministries and agencies of Federal and provincial governments established to advise on PPP policy
Proponent the Government	The private party entering into a public private partnership Government of Pakistan/Federal Government of the Islamic Republic of Pakistan
VGF	Viability Gap Funding
WAPDA	Water and Power Development Authority

Executive Summary

This Final Report is the fourth and final deliverable in Castalia's assignment, funded by the World Bank, to improve how contingent liabilities are managed in Pakistan. **The report presents our recommendations on how Pakistan should improve its policies and processes for issuing and managing contingent liabilities associated with public private partnerships (PPPs) in infrastructure.** Our recommendations are based on:

- An assessment of the current exposure to contingent liabilities, including the effectiveness of the existing policies and processes governing PPPs generally, and contingent liabilities specifically (we describe the assessment in a Status Quo Report presented in Appendix A of this report)
- A comparison of international experience and best practice for managing contingent liabilities.
- Feedback received from Government stakeholders during a workshop held in Islamabad on July 21, 2010 (information from the workshop is presented in Appendix B of this report)

We recommend that the Government:

- Adopt policies to include eight specific functions for managing contingent liabilities during the PPP development, approval, and implementation process:
 - **Structuring contingent liabilities and designing contractual mechanisms** according to good principles for allocating risk
 - **Analyzing** the contingent liabilities that will be accepted under a proposed project
 - Evaluating and **approving** the contingent liabilities the federal Government will be exposed to when entering into a PPP
 - Reviewing executed PPP contracts and **formally accepting** the contingent liabilities to make the contingent liabilities explicit
 - **Monitoring** those contingent liabilities while the project is being constructed and implemented
 - Regularly and publicly **disclosing** the contingent liability exposure
 - **Taking mitigating action** where necessary to reduce the likelihood or cost of the contingent liability becoming real
 - When necessary, **budgeting for and paying** for contingent liabilities that have realized.
- Allocate responsibility for performing the recommended functions to existing institutions—specifically:
 - The Ministry of Finance (MOF) as key the oversight agency responsible for approving financial commitments to PPPs
 - The Debt Policy Coordination Office (DPCO) as the division within MOF responsible for providing administrative leadership at the central level

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- Contracting authorities as the implementing agencies responsible for complying with evaluation, submission and approval requirements, monitoring, reporting to DPCO, and taking action on emerging risk
- The Infrastructure Project Development Facility (IPDF) as the agency responsible for supporting contracting authorities and DPCO.

Table 0.1 summarizes our recommendation in more detail. We then explain why we arrived at the recommendations and the next steps to finalize our assignment.

Table 0.1: Summary of Recommendations for Contingent Liability (CL) Management in Pakistan

Function	Why is it important	How it should be performed?	Who should do it?	Next Steps: What legal and procedural changes are needed?
Structuring CLs and designing contractual mechanisms by which the Government bears risks under a PPP contract	Because it is important that projects are developed according to sound principles for risk allocation and PPP structuring, which are essential to providing value for money—current principles and guidance are incomplete	<ul style="list-style-type: none"> ▪ Develop and apply risk allocation principles when structuring PPPs ▪ Develop and use draft contractual mechanisms for structuring CLs 	<ul style="list-style-type: none"> ▪ Contracting authorities should develop and apply principles that are approved by MOF ▪ IPDF should support contracting authority, as needed 	<ul style="list-style-type: none"> ▪ Draft policy (and revise PPP Bill) to include a check for compliance with MOF-approved guidelines when reviewing and approving CLs ▪ Provide capacity building support to IPDF and contracting authorities to develop and use structuring guidelines and contractual mechanisms (beginning with pilot projects)
Analyzing the CLs that will be accepted under a proposed project	Because the Government has implemented PPPs without making the cost or risk associated with its financial commitment through CLs clear—for example, obligations in the energy sector	Use various qualitative and quantitative methods to evaluate the potential cost to Government of accepting the CL	<ul style="list-style-type: none"> ▪ Contracting authorities should analyze CLs, following valuation guidelines developed and approved by MOF ▪ IPDF should support contracting authority, as needed 	<ul style="list-style-type: none"> ▪ MOF to develop and issue guidelines for analyzing CLs ▪ Provide capacity building support to IPDF, DPCO, and contracting authorities on how to analyze CLs (beginning with pilot projects)
Approving those CLs, found to be consistent with structuring principles and good fiscal management	Because there is a need to strengthen the centralized process being followed by which the Government can evaluate if the CLs are consistent with good fiscal management and approve the financial commitments from CLs	Include CLs evaluation and approval in the PPP approval process: <ul style="list-style-type: none"> ▪ Check CL structure ▪ Assess the results of the analysis of CLs ▪ Introduce rules to limit overall fiscal impact of CLs (such as ceilings or defined budgeting requirements). 	MOF should provide the final approval based on certification of compliance from DPCO	<ul style="list-style-type: none"> ▪ Draft the policy (and revise PPP Bill) to include specific submission requirement for contracting authorities to follow (with support from IPDF as needed) ▪ Develop evaluation tools for DPCO to certify compliance ▪ Ensure DPCO has the resources and capacity to evaluate submissions

Function	Why is it important	How it should be performed?	Who should do it?	Next Steps: What legal and procedural changes are needed?
<p>Formally accepting the CLs defined in executed PPP contracts</p>	<p>Because the Government’s commitment to CLs should be explicit and include a process for checking that executed contracts are consistent with approval terms</p>	<ul style="list-style-type: none"> ▪ Create a distinct legal agreement acknowledging the Government’s CL commitments and/or review final PPP contracts before signing 	<p>MOF should sign an “agreement letter” after the CLs are analyzed, final PPP contracts are checked, and DPCO has certified compliance with relevant policies (FRDLA and PPP Policy)</p>	<ul style="list-style-type: none"> ▪ Determine legal restrictions for state-owned enterprises versus agencies ▪ Develop and issue a draft “agreement letter” ▪ Include the process for formally accepting CLs through an “agreement letter” in the revised approval process specified in the PPP policy (and Bill)
<p>Monitoring those CLs while the project is being constructed and implemented</p>	<p>Because the Government does not have a central database of what PPPs it has implemented, what CLs they contain, and what risks are associated with the CLs; and monitoring this information will keep officials informed of exposure and emerging risks</p>	<ul style="list-style-type: none"> ▪ Systematically collect project and other information ▪ Periodically re-evaluate CLs ▪ Maintain a central database 	<ul style="list-style-type: none"> ▪ Contracting authority should include reporting requirements in draft contracts ▪ Contracting authority should develop and follow monitoring plans, gather data for analyzing and re-valuing exposure, and report exposure to DPCO ▪ IPDF should support contracting authority, as needed. 	<ul style="list-style-type: none"> ▪ Require reporting requirements to be included in PPP contracts and in “agreement letter” ▪ Develop template monitoring plans for executed PPP projects, and include the plan in the submission requirements when approving projects ▪ Provide capacity building support to IPDF, DPCO, and contracting authorities (beginning with pilot projects).
<p>Regularly and publicly disclosing the CL exposure</p>	<p>Because it will strengthen the Government’s existing disclosure policies and principles and disclosing can improve accountability and increase transparency of the Government’s commitments to third parties (such as credit agencies and lenders)</p>	<p>Regularly publish information on CLs from PPPs as a part of other public debt and fiscal policy documents</p>	<p>DPCO should include CLs from PPPs in the annual Debt Policy Statement. Information for completing the report should be collected through the monitoring function (see above)</p>	<ul style="list-style-type: none"> ▪ Develop an outline for a section in the Debt Policy Statement on CLs from PPPs following international principles for reporting CLs ▪ Ensure DPCO has the capacity to produce the report ▪ Include CL section in next report

Function	Why is it important	How it should be performed?	Who should do it?	Next Steps: What legal and procedural changes are needed?
<p>Taking mitigating action where necessary on emerging CL risks</p>	<p>Because the Government may be able to avoid some costs associated with problems in the past if risks are identified and action was taken to reduce the likelihood or cost of liabilities realizing—for example, by notifying officials of the costs associated with keeping tariffs low or delaying the issuance of permits and increasing incentives for good decisions</p>	<p>Identify risks and take coordinated action based on monitoring information, identify—for example, action by the contracting authority with support from the Ministry of Finance or IPDF</p>	<ul style="list-style-type: none"> ▪ Contracting authority should take any action to manage the Government’s exposure ▪ DPCO should ensure the contracting authority is taking actions where necessary, and to provide support when appropriate ▪ IPDF should support contracting authority, as needed 	<ul style="list-style-type: none"> ▪ Include identifying risks and taking mitigating action in the template monitoring plans (see above) ▪ Assign a “project officer” from the contracting authority or IPDF to liaise with oversight and regulatory bodies.
<p>When necessary, budgeting for and paying for CLs that have realized</p>	<p>To ensure resources are available to make payments promptly when required—improving credibility and clarity as to how costs of CLs will be borne, and mitigating the fiscal impact</p>	<p>Options should be evaluated, including</p> <ul style="list-style-type: none"> ▪ Setting aside funds in advance towards possible future payments ▪ Budgeting for expected upcoming payments ▪ Creating budget flexibility to accommodate payments when needed. 	<p>Contracting authorities should have budgetary accountability for CLs to provide better incentives to accept the right CLs, and to manage those CLs well</p>	<ul style="list-style-type: none"> ▪ Evaluate the options (during a pilot-test) and determine the preference of MOF to budget and pay for CLs ▪ Include a clause in the Bill stating the policy ▪ Ensure that draft PPP contracts explicitly comply with the requirements for CLs

Why enhance the roles of existing institutions?

We believe the Government is best served by adopting an institutional framework for managing contingent liability that enhances the roles and responsibilities of existing institutions, as outlined above. This option has the advantages of:

- Being consistent with the existing mandates of each agency and the basic policy and regulatory framework laid out in the 2010 PPP Policy and draft PPP Bill
- Being appropriate for the size of the problem—Pakistan has limited experience with PPPs outside of the energy sector, and therefore has limited exposure to contingent liabilities outside of that sector. The main problem the Government needs to address is the weak and unclear policies and processes that are currently in place
- Not being overly onerous or costly to implement—more complex and sweeping reforms would likely be less flexible, take longer to implement, and the benefits would be more uncertain. Establishing sound policies and practices, and building strong capacity among existing agencies more quickly, is also more likely to create an environment that is attractive to private and multilateral investors.

In selecting this preferred institutional option, we also analyzed the option of establishing an independent Guarantee Fund as a Government-owned company that issues and manages financial guarantees to PPPs, which create contingent liabilities. To date, there is limited international experience in developing Guarantee Funds, and the possible advantages have for the most part not been tested. Therefore, the practical benefits of establishing a Guarantee Fund are far from certain. Moreover, the cost of establishing such a complex institution is unlikely to be justified based on the Government's existing exposure to contingent liabilities, which is concentrated in the energy sector.

What are the next steps to implementing the recommendations?

The next steps required to begin implementing the recommendations are to:

- Pilot-test the contingent liability management recommendations on at least one live PPP project that is in the early development or feasibility stage. A pilot-test will provide an opportunity to evaluate and refine the recommendations. It will also offer the opportunity to train staff in contracting authorities, IPDF and DPCO, and provide valuable hands-on experience and guidance in closing a high-priority PPP transaction
- Evaluate and revise the proposed contingent liability management framework based on the results of pilot-testing
- Amend and update the PPP Policy (or secondary legislation) and the enabling PPP Bill to enforce and implement the recommendations
- Revise, if necessary, and adopt the Draft Procedures Manual Castalia prepared for agencies to use when performing their responsibilities
- Provide ongoing training and capacity building, and ensure each agency—particularly DPCO—has the resources to carry out its role in the contingent liability management framework.

1 Introduction

The Government of Pakistan (the Government) wants to strengthen the institutional framework for managing contingent liabilities associated with public private partnerships (PPPs) in infrastructure. **Castalia has been asked to make recommendations on how to improve the policies and processes for issuing and managing contingent liabilities associated with public private partnerships in infrastructure—this includes identifying what functions should be adopted to ensure the benefits of good management of contingent liabilities and the appropriate institutional framework for carrying out those functions.** This report is the fourth and final deliverable for the assignment, which is funded by the World Bank.

The purpose of this report is to answer the following questions:

- **Why is it important to manage contingent liabilities in Pakistan?** The answer to this question draws from Castalia’s work assessing the status quo for managing contingent liabilities in Pakistan (see Appendix A), and provides the evidence necessary to develop recommendations that are best suited for Pakistan
- **How can Pakistan improve how contingent liabilities are managed?** In answering this question, we recommend the specific functions that Pakistan should adopt. We also explain how the functions we recommend could be performed to provide the most benefit
- **Who should be responsible for managing contingent liabilities?** The answer to this question provides the basis for decision makers to determine the best institutional arrangement for carrying out the recommended functions and achieving the benefits of sound management of contingent liabilities within the existing context.

The following sections of this report present analysis to answer each of these questions. The remainder of this introduction provides background on the assignment (Section 1.1) and describes the content of the report (Section 1.2).

1.1 Background on the Assignment

The Government has identified public private partnerships as an important option for delivering infrastructure services and closing the financing gap in infrastructure investment in Pakistan. PPP contracts have been entered into in the past—particularly, in energy, roads, and ports and shipping sectors—and the Government intends to use PPPs more widely and increase the number of PPPs going forward in infrastructure.

A well-designed PPP will often include Government guarantees or will allocate some risks to the Government to make sure the transaction can be completed, and to reduce the total upfront project costs by retaining some risk that it is more practical or more efficient for the public sector to manage. Retaining risk and issuing guarantees create contingent liabilities. The Government has some contingent liabilities from existing PPPs, and as the Government’s stock of PPPs grows, so will its exposure to underlying risk associated with these obligations. However, there are costs associated with the provision of contingent liabilities.

Contingent liabilities create the possibility that the Government may be obligated to make unexpected and substantial payments. **These uncertain payment obligations expose the Government to fiscal risk that can create budgetary uncertainty and put the public debt on an unsustainable path.** Therefore, effective PPP policy will include a sound framework for deciding when to issue guarantees and managing the fiscal risk arising from guarantees. Improving how contingent liabilities associated with infrastructure PPPs are managed can encourage better decision making, enhance fiscal stability, improve sovereign credit ratings, and lower the cost of borrowing.

This assignment aims to develop policies, procedural guidelines, and implementation plans for managing contingent liabilities through four primary tasks:

- **Task 1: Inception**—Identify the scope of the assignment and prioritize the objectives of an institutional framework for managing contingent liabilities
- **Task 2: Assess Current Framework and Exposure**—Preliminarily assess the Government’s existing exposure to fiscal risk arising from contingent liabilities; identify and assess the current institutional framework governing contingent liabilities in Pakistan; and determine the gaps that should be addressed to strengthen the policies and processes for managing contingent liabilities from PPPs
- **Task 3: Identify and Analyze Options**—Identify and analyze options that address the key gaps in the institutional framework from Task 2 will help achieve the benefits of good management of contingent liabilities in Pakistan
- **Task 4: Develop Final Recommendations**—Develop a final set of policy recommendations, guidelines, and tools needed to implement the preferred institutional framework for managing contingent liabilities from Task 3.

The assignment is a continuation of a previous assignment completed by Castalia in 2008. For that work, Castalia submitted a report on *Advice for Fiscal Management of Infrastructure PPPs in Pakistan*. Since 2008, the Government has announced an interest in continuing to pursue PPPs to develop new infrastructure and approved a new PPP Policy in January 2010. The Debt Policy Coordination Office (DPCO) in the Ministry of Finance (MOF) is expected to be the key beneficiary of Castalia’s work under this assignment.

1.2 Content of the Report

The contents of this report are organized as follows:

- Section 2 explains why it is important for Pakistan to establish sound policies for managing contingent liabilities, based on the Government’s existing exposure and gaps in the policies and processes that are currently in place. The Status Quo Report presented in Appendix A provides an assessment of the Government’s exposure to contingent liabilities and the existing policies and processes that are in place
- Section 3 explains how Pakistan can better manage contingent liabilities by presenting our recommendations to eight specific functions that will strengthen existing PPP policies

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- Section 4 analyzes options for who should perform the functions for managing contingent liabilities, and explains why we recommend empowering existing institutions in the preferred institutional framework
- Section 5 presents the steps we suggest that the Government follows to implement these recommendations and operationalize an effective contingent liabilities management framework
- Finally, Section 6 presents our assessment of international experience and good practice in managing contingent liabilities to provide additional context for our recommendations in Pakistan.
- Appendix A includes the Status Quo Report from the first stage of this assignment
- Appendix B includes a summary of the stakeholder consultation workshop conducted in Islamabad on July 21 to receive feedback on the draft recommendations for this assignment

2 Why it is Important to Manage Contingent Liabilities

To develop appropriate policies and processes for managing contingent liabilities in Pakistan, it is important first to understand what the current problem is and what benefits can be achieved by improving how contingent liabilities from PPPs are managed. Castalia has worked to identify the existing PPPs and the associated contingent liabilities in Pakistan. We have also assessed the effectiveness of the policies and processes governing PPPs generally, and contingent liabilities specifically, to identify where there are opportunities to improve how contingent liabilities are managed in the future. In our assessment, we found that:

- The Government is exposed to contingent liabilities in the energy sector—although in practice the liabilities have realized—through its obligations to Independent Power Producers (IPPs) and Rental Power Plants (RPPs)
- Outside of the energy sector, there is limited exposure to existing contingent liabilities due to the few PPP projects that have been implemented
- Policies and processes in place are not adequate to facilitate good decision making when structuring PPPs, accepting contingent liabilities, and managing risks.

These findings suggest there is an opportunity to adopt an institutional framework that will facilitate the development of better PPPs, create more value for money for the Government when entering into PPPs, and managing the fiscal risk associated with those PPPs once they are operational.

In the remainder of this section, we characterize the existing exposure to contingent liabilities from PPPs (Section 2.1) and then describe where there are opportunities to improve existing policies and processes.

2.1 Exposure to Contingent Liabilities from PPPs

The definition of PPP has been clarified in Pakistan’s 2010 PPP Policy to include any arrangement involving the financing, development, operation, and maintenance of infrastructure by the private sector which would otherwise have been provided by the public sector. Instead of the public sector procuring a capital asset and providing a public service, the private sector develops the asset and delivers a service in return for payment that is linked to performance.

By this definition, the current PPPs in Pakistan that we are aware of include:

- Thirty IPPs and at least nine RPPs contracted by the Private Power Infrastructure Board (PPIB), totaling approximately 8,500 MW of electricity generation capacity
- Three concession agreements that the National Highway Authority (NHA) is party to
- At least 11 concession agreements for terminal facilities contracted by Pakistan’s port authorities and one dry port railway terminal.

Pakistan has limited experience developing PPPs in other sectors. The Infrastructure Project Development Facility (IPDF)—created within the Ministry of Finance (MOF) to develop

and implement PPPs—has several projects in various stages of development, but to date IPDF has not completed a transaction.

The Government's stock of contingent liabilities associated with existing PPPs is mainly in the energy sector. Within the energy sector, contingent liabilities arise in the 30 implementation agreements signed between IPPs and PPIB on behalf of the Government, and in at least nine rental power agreements signed with RPPs. These contingent liabilities include primarily the financial obligations of the power purchaser and termination payments in the event of default or force majeure. The contingent liability associated with the guarantee of the power purchaser has effectively been realized—in 2008, for example, the Central Power Purchasing Authority failed to pay about 51 billion Rupees owed to IPPs.¹

While the contingent liabilities in the energy sector are known, assessing the full magnitude of the liabilities and the associated fiscal risk is complicated by the current energy crisis in Pakistan, which has created a large, ongoing fiscal burden. In the past, the Government has negotiated solutions to some of these fiscal challenges, and we understand there are current efforts to address the energy crisis that go well beyond the scope of this assignment.²

Outside of this sector, the Government has limited exposure to contingent liabilities. Concession agreements for national highway services include the following obligations that create the primary contingent liabilities for the Government:

- Termination payment clauses in the event of default by the company or the Government, or a force majeure event
- A guarantee on the regulated toll rate for Lakpass Tunnel
- Commercial risk the Government has retained on Shahdara Flyover.

In the case of Lakpass Tunnel, the concession includes a toll rate of 13 Rupees per trip; however, the NHA only allowed tolls of 10 Rupees per trip during the first year of operations. Under the terms of the concession agreement, the NHA is obligated to pay the proponent the revenue difference generated by the three Rupee deviation from the contracted toll rate.

Concessions on shipping terminals also include termination payment clauses, but there is not enough information available to determine the extent of the contingent liabilities under those agreements. Moreover, it is unclear whether the Government intends to include port authorities in the efforts to strengthen the policies and processes for PPPs and contingent liability management.

2.2 Existing Policies and Processes are Incomplete

As explained above, existing exposure contingent liabilities is concentrated in the energy sector. Outside of the energy sector, there are no examples of major problems created by poor management of contingent liabilities. However, our assessment shows that the existing policies and processes are largely incomplete and likely to be ineffective. Failure to improve these policies could exacerbate the problem in the energy sector, create significant problems

¹ 2009 WAPDA Annual Report. The estimated amount includes only the unmet obligations associated with power purchased 2008, not the cumulative amount in past due.

² See Appendix A for additional background.

in other sectors and, if left un-addressed, risk derailing Pakistan's PPP program development efforts.

The current lack of effective policies has fostered an environment where decision makers are not well informed of the costs of contingent liabilities and the magnitude of the risks they are accepting when approving PPPs. Moreover, there is no policy in place for the Government to centrally process contingent liabilities, monitor projects, and respond to realized contingent liabilities or take action to mitigate emerging risks.

To manage the fiscal risk that the Government is currently exposed to and ensure that contingent liabilities are justified and managed effectively in the future, we think it is important that the Government adopt a series of proven functions for managing contingent liabilities throughout the PPP lifecycle. These functions include:

- **Structuring contingent liabilities and designing contractual mechanisms** according to good principles for allocating risk in PPP projects and contract design
- **Analyzing** the contingent liabilities to be accepted under a proposed project
- Evaluating and **approving** the contingent liabilities the federal Government will be exposed to when entering into a PPP
- Reviewing executed PPP contracts and **formally accepting** the contingent liabilities to make the contingent liabilities explicit
- **Monitoring** those contingent liabilities while the project is being constructed and implemented
- Regularly and publicly **disclosing** the contingent liability exposure
- **Taking mitigating action** where necessary to reduce the likelihood or cost of the contingent liability becoming real
- When necessary, **budgeting for and paying** for realized contingent liabilities.

If effectively implemented, these functions could significantly strengthen Pakistan's PPP program and help to manage fiscal risk by:

- **Improving incentives to make good decisions**, to help ensure:
 - The Government accepts risks and approves contingent liabilities that provide value for money
 - Decision makers manage existing risks well.
- **Improving credibility** by:
 - Making the Government's exposure transparent and signaling a commitment to managing risk, thereby decreasing the likelihood that credit rating agencies and others assessing Pakistan's sovereign risk overestimate risk exposure
 - Implementing a systematic process that defines how payments will be made reduces uncertainty, thereby increasing investors' confidence, attracting greater investment, and lowering the cost of borrowing.

- **Reducing adverse fiscal impact** by implementing a systematic process that reduces the uncertainty of payment obligations, minimizes the cost of realized contingent liabilities, and limits the impact of payments on the fiscal deficit, debt levels, and budget priorities.

The next section of this report focuses on explaining why each of the eight functions listed above is needed and how they can be performed in practice.

3 How to Improve the Management of Contingent Liabilities

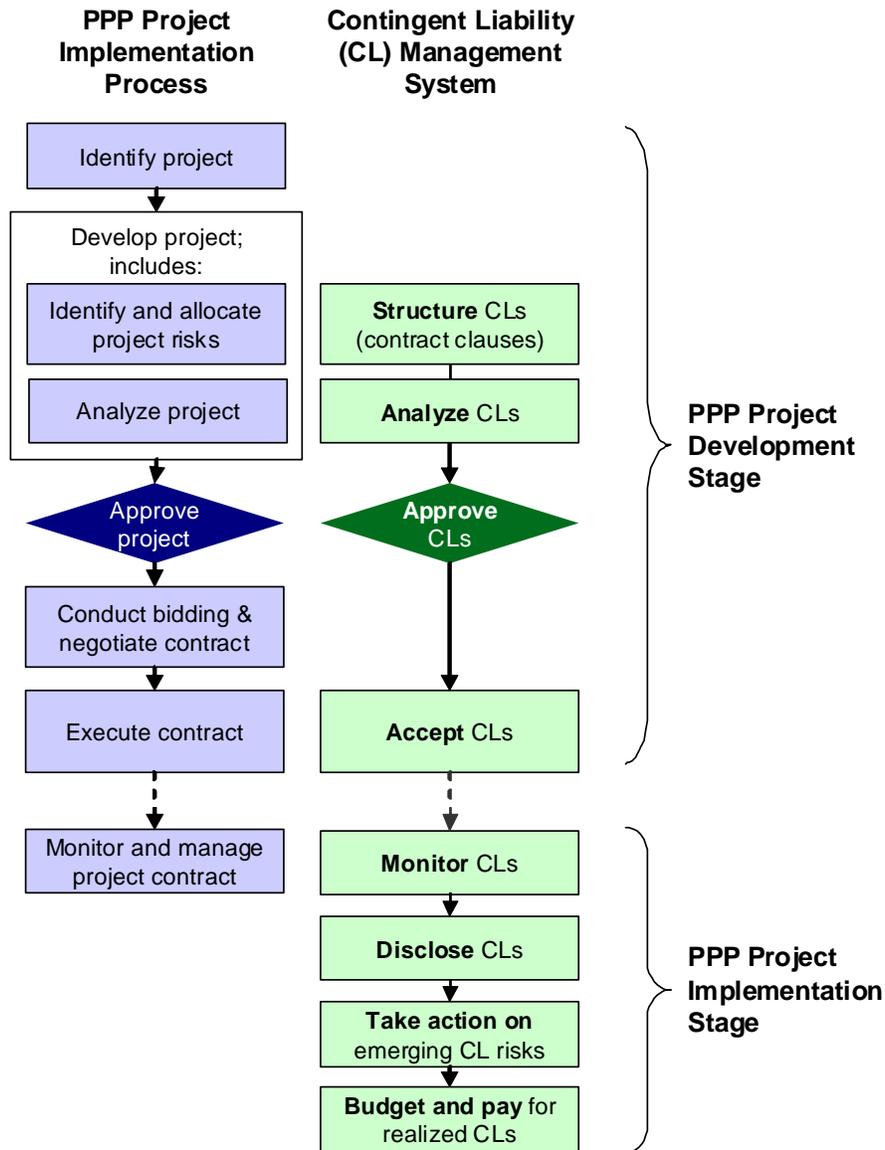
In this section we describe the functions we recommend the Government include in a system for managing contingent liabilities from PPP projects, and describe options for how these functions could be carried out. While the functions described in this section apply specifically to the management of the contingent liabilities, we have developed recommendations that apply generally and can strengthen the entire PPP development process and the process by which the Government prepares and approves the terms of a PPP contracts, and the associated financial commitments, and monitors and manages PPPs once they are implemented.

The functions we recommend include:

- Structuring contingent liabilities (Section 3.1)
- Analyzing contingent liabilities (Section 3.2)
- Approving contingent liabilities (Section 3.3)
- Accepting contingent liabilities (Section 3.4)
- Monitoring contingent liabilities (Section 3.5)
- Disclosing contingent liability (Section 3.6)
- Action on emerging risk (Section 3.7)
- Budgeting for and paying for realized contingent liabilities (Section 3.8)

These functions are shown in Figure 3.1, in the context of the broader PPP project development and implementation process. **It is important to note that while these functions are shown alongside the PPP lifecycle, they are an integral part of the PPP project development process and should be embedded within the overarching PPP Policy and related guidelines.)**

Figure 3.1: Functional Components of Managing Contingent Liabilities



In the following sub-sections we discuss each of these functions in more detail, describing:

- The objective of the function
- Why the function is important
- What policies and processes related to the function are in place
- How the policies and processes should be improved.

In some cases there is more than one alternative for how the function could be carried out—for example, what rules will be applied when deciding whether to accept the contingent liabilities under a proposed project. In these cases, we describe the alternatives and recommend the approach we think makes sense for Pakistan. The workshop we will facilitate

with Government officials to discuss this report will help us refine our recommendations and identify the preferred final recommendation.

Additionally, in practice, many of these functions are inter-related. For example, the decision on how contingent liabilities will be budgeted for and paid affects the incentives contracting authorities face in structuring proposed projects. The nature of disclosing also affects the information that needs to be collected and maintained to monitor projects. We highlight these relationships at each stage.

3.1 Structuring Contingent Liabilities

The most important step in managing contingent liabilities under PPPs is deciding which contingent liabilities to accept in the first place. This can be accomplished by improving how risks are allocated and how contingent liabilities are structured when developing new PPP projects and drafting contracts. The improvements should be made in the context of the entire PPP structuring and risk allocation process. That is, contingent liabilities should be considered along with the range of financial commitments and obligations the Government makes to a PPP.

Objective when structuring contingent liabilities: To develop terms that will help complete a transaction, while ensuring that the risks the Government will bear are consistent with good risk allocation principles, borne at the lowest cost and with minimal fiscal impact.

3.1.1 Why is the function important?

Contracting authorities lack consistent principles to follow when allocating risks and structuring PPPs. This creates the possibility that projects will be developed that do not adhere to sound principles for risk allocation and PPP structuring, which are essential to providing value for money to the Government. Moreover, contracting authorities have not developed tools and contractual mechanisms—with the exception of PPIB’s template implementation agreements—to ensure PPP contract terms *consistently* adhere to stated principles.

By developing sound principles and policies to follow when structuring contingent liabilities, the Government can have more confidence that it is accepting risks and providing financial support to a PPP project in a way that provides value for money. In turn, this improves the attractiveness of PPPs to the private sector by providing more clarity and certainty on the contractual mechanisms and development procedures that will be followed.

3.1.2 What relevant policies and processes are in place?

A broad principle for allocating risk is defined in the 2010 PPP Policy, which states that:

“[each] risk will generally be borne by the party best able to manage it at minimum cost.”

This principle is in line with international good practice, and provides a basis for managing contingent liabilities. The PPP policy also states that the concession contract will specify how risks have been allocated. However, no further policy or guidance is provided and there is no direction on how contractual mechanisms should be designed to achieve the best risk allocation and to manage fiscal impact.

An example of good practice for contracting authorities is the template implementation agreement published by PPIB, which lays out the entirety of the Government’s support to

an IPP, including contingent liabilities like termination payment clauses and the guarantees of the obligation of the power purchaser. Additionally, NHA's PPP Policy and Regulatory Framework states that NHA will provide "procedures such as time extensions or termination to deal with force majeure risks, and procedures for dealing with changes in costs and losses caused by changes in law". This guarantee from NHA will create contingent liabilities. NHA has also taken the important step of drafting model concession agreements for BOT contracts. These are important steps in the structuring process and serve as an example that other contracting authorities could follow. NHA could further strengthen its existing policies by better defining and codifying its principles for applying its general policy in practice.

3.1.3 How should the policies and processes be improved?

This policies and process for structuring contingent liabilities can be performed by completing two steps:

- Developing, approving, and applying risk allocation principles when structuring PPPs
- Developing rules for structuring contingent liabilities and draft contractual mechanisms.

Developing, approving, and applying risk allocation principles

As part of developing and structuring a PPP project, the contracting authority must identify all the project risks, and decide how these should be allocated. A clear set of principles for allocating risk in PPP projects is an important part of this process, and will determine what contingent liabilities the Government will accept.

Pakistan's PPP Policy 2010 states that risks should be allocated to the party (private or government) best able to manage the risk at the lowest cost. At a minimum, the Government should ensure this broad principle is applied in practice by requiring contracting authorities to develop and follow approved principles when allocating specific risks associated with common types of PPPs. IPDF should provide support to contracting authorities in developing and applying the risk allocation principles, as needed. A central authority, such as DPCO, should review and approve the principles, and check to ensure that the principles are followed before approving individual PPP projects (see Section 3.3).

One useful tool that could be used by contracting authorities is a preferred risk allocation matrix for common projects. Table 3.1 below presents an example of a preferred risk allocation matrix that contracting authorities could use as a template.

Table 3.1: Example of a Preferred Risk Allocation Matrix

Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
Pre-contract risks					
Existing structure (refurbishment / extensions)	Risk that the procurement process will experience any of the following: (a) failure to attract sufficient qualified bidders and/or responsive offers; or (b) prolonged and expensive negotiations; or (c) collapse of negotiations.	Government	Government does not have a partner yet at this stage, so it has no option but to bear this risk.	<ul style="list-style-type: none"> ▪ Careful preparation and management of the procurement process ▪ Ensure that the agency’s procurement team is experienced and competent ▪ Establish a procurement schedule commensurate with project complexity 	Since there is no agreement yet signed with any other party, there is no specific allocation instrument, but the lack of recourse to any sort of compensation.
Site risk					
Existing structure (refurbishment / extensions)	Risk that existing structures are inadequate to support new improvements, resulting in additional construction time and cost	Private	Private sector can manage cost-effectively if proper due diligence of existing structure is conducted.	<ul style="list-style-type: none"> ▪ Private firm will pass to builder which relies on expert testing and due diligence ▪ Give private firm enough time to do site studies 	Contract clause requiring private partner to provide performance bond
Site conditions	Risk that unanticipated adverse geological conditions (geotechnical risk) are discovered which cause construction costs to increase and/or cause	Private – except when complex geological conditions are present AND project is government-solicited, private to absorb only up	<ul style="list-style-type: none"> ▪ Private sector can manage cost-effectively if site study effort is moderate and enough time is provided to bidders. 	<ul style="list-style-type: none"> ▪ Private firm will pass to builder which relies on expert testing and due diligence ▪ Give private firm enough time to do site 	Contract clause requiring private partner to provide performance bond Contract clause stipulating the conditions and mechanism to compensate

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
	construction delays	to a specific cost amount, after which government assumes	<ul style="list-style-type: none"> ▪ Complex structures on linear infrastructure (road, rail, pipeline) may require more thorough and detailed geotechnical studies (for example, long tunnels and long span bridges in unstable terrain), that may not be reasonably completed within the bidding period or may be too expensive for bidders to conduct at the bidding stage without some cost-sharing. 	<ul style="list-style-type: none"> ▪ Reimburse part of bidding cost to encourage bidders to prepare their own site studies 	private sector for agreed-upon portion of cost overruns on technically complex structures (for example, tunnel cost overrun guarantee).
Permits and approvals	Risk that necessary approvals (for example, environmental license, environmental management plan, construction permit) may not be obtained or may be obtained only subject to unanticipated conditions which have adverse cost consequences or cause prolonged delay	<p>Private if and when:</p> <ul style="list-style-type: none"> ▪ Permits and approvals have been obtained prior to the submission of proposals by potential bidders, and later modified at the request of successful bidder. <p>Government if and when:</p> <ul style="list-style-type: none"> ▪ Permits and approvals have not been obtained prior to 	<p>When Private:</p> <ul style="list-style-type: none"> ▪ Private is better informed about the rationale for its request. <p>When Government:</p> <ul style="list-style-type: none"> ▪ Government is better informed and positioned to influence the speed of the approval process, particularly in situations that are 	Government to obtain in advance of the bidder proposal submission stage the requisite permits and approvals, which would allow the private firm to achieve a measure of pre-contractual certainty and an early start to the approval process.	Contract clause stipulating the schedule to obtain permits and approval and stipulating liquidated damages payable to private partner in case of delays

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
		bidder proposal submission– private is responsible to manage the process, though.	complex or sensitive.		
Environmental liabilities existing prior to project	Risk that project site is contaminated requiring significant remediation expenses	Private, except when: <ul style="list-style-type: none"> ▪ Project was solicited by the government; and ▪ Cost and time required to conduct a full due diligence (site study) for each bidder are such that the project would be significantly delayed or would deter potential serious bidders – in such case, some risk sharing along the lines of geotechnical site risk could be a solution 	When Private: <ul style="list-style-type: none"> ▪ Private sector can manage cost-effectively if site study effort is moderate and enough time is provided to bidders. When Shared: <ul style="list-style-type: none"> ▪ Sites where site study effort may not be reasonably completed within the bidding period or may be too expensive for bidders to conduct at the bidding stage without some cost-sharing. 	<ul style="list-style-type: none"> ▪ Private firm will pass to builder which relies on expert testing and due diligence ▪ Give private firm enough time to do site studies ▪ Reimburse part of bidding cost to encourage bidders to prepare their own site studies 	<ul style="list-style-type: none"> ▪ Contract clause requiring private partner to provide performance bond ▪ Contract clause stipulating the conditions and mechanism to compensate private sector for agreed-upon portion of remediation expenses.
Environmental liabilities created during operation	Risk that the use of the project site over the contract term has resulted in significant environmental liabilities (clean up or rehabilitation required to make the site fit for future anticipated use)	Private, if and when: <ul style="list-style-type: none"> ▪ Environmental license and environmental management plan has been approved prior to submission of proposals ▪ Environmental license and management plan 	<ul style="list-style-type: none"> ▪ Private partner is able to manage the use of the asset and attend to its maintenance and refurbishment according to the environmental requirements known at the proposal stage 	<ul style="list-style-type: none"> ▪ During procurement private partner must demonstrate financial capacity or support to deliver the site in the state required by government at the end of the contract ▪ Government to require 	<ul style="list-style-type: none"> ▪ Contract clause defining what constitutes environmental liability and the mechanism to estimate the private partner’s liability and pursue payment ▪ Contract clause

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
		<p>have not been approved prior to submission of proposals – liability is limited to amount estimated in proposal.</p> <p>Government, if and when</p> <ul style="list-style-type: none"> ▪ Environmental license and management plan have not been approved prior to submission of proposals – liability for any excess over investor’s proposed estimate. 	<ul style="list-style-type: none"> ▪ Government is better able to manage environmental requirements not known to bidders at the proposal stage. 	<p>sinking funds if it is to resume the site and its use is liable to result in significant clean up/rehabilitation cost</p>	<p>requiring the establishment of clean-up/ rehabilitation sinking fund</p>
Cultural heritage	<p>Risk of costs and delays associated with archaeological and cultural heritage discoveries</p>	<ul style="list-style-type: none"> ▪ Government to assume risk on government preferred site ▪ Private partner to assume risk on private partner preferred site 	<p>Government generally has a better understanding of procedures, and is usually in best position to manage this risk</p>	<p>Research cadastral records and obtain expert advice</p>	<p>Contract clause defining risk and stipulating site availability schedule and liquidated damages payable in case of delays</p>
Availability of site	<ul style="list-style-type: none"> ▪ Risk that tenure/access to a selected site which is not presently owned by government or private partner cannot be negotiated. ▪ Risk of costs and 	<ul style="list-style-type: none"> ▪ Government to assume risk on government preferred site – private partner may remain responsible for managing the process 	<ul style="list-style-type: none"> ▪ If government preferred site: <ul style="list-style-type: none"> – Government has a better understanding of procedures, has special powers of 	<ul style="list-style-type: none"> ▪ Research cadastral records and obtain expert advice ▪ If government preferred site: <ul style="list-style-type: none"> – Complete land acquisition prior to 	<ul style="list-style-type: none"> ▪ Contract clause stipulating site availability schedule and liquidated damages payable in case of delays

Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
	delays in negotiating land acquisition	<ul style="list-style-type: none"> ▪ Private to assume risk on private partner preferred site 	<p>acquisition and use of land for infrastructure and is usually in best position to manage</p> <ul style="list-style-type: none"> – Government is in better position to negotiate where policy discourages use of compulsory acquisition power <ul style="list-style-type: none"> ▪ If private preferred site: <ul style="list-style-type: none"> – Private partner is in control of site selection 	<p>proposal stage</p> <ul style="list-style-type: none"> ▪ If private preferred site: <ul style="list-style-type: none"> – Oblige bidders to secure access prior to contract signing 	
Design, construction and commissioning risk					
Design	Risk that the design of the facility is substandard, unsafe, or incapable of delivering the services at anticipated cost and specified level of service (often resulting in long term increase in recurrent costs and long term inadequacy of service)	Private – private partner will be responsible except where an express government mandated change has caused the design defect	Private partner has more experience, knowledge and control over the variables that determine the quality of the design (i.e. experience, competent staff, etc.)	<ul style="list-style-type: none"> ▪ Ensure that the feasibility study is available well in advance of the procurement process to adequately inform the design process ▪ Incorporate strict experience and competency requirements in the procurement process ▪ Private partner may 	<ul style="list-style-type: none"> ▪ Contract clause requiring performance bond ▪ Contract clause stipulating liquidated damages

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
				<p>transfer risk to builder/architects and other subcontractors while maintaining primary liability; government has the right to abate service charge payments where the risk eventuates and results in a lack of service -it may ultimately result in termination where the problem cannot be suitably remedied</p>	
Construction	<p>Risk that events occur during construction which prevent the facility being delivered on time and on cost</p>	<p>Private, except when:</p> <ul style="list-style-type: none"> ▪ The event is one for which relief as to time or cost or both is specifically granted under the contract, such as force majeure or government intervention ▪ In situations where the technical or geological complexity (for example, tunnels) prevents from having sufficient and reliable information to 	<ul style="list-style-type: none"> ▪ Private partner has more experience, knowledge and control over the variables that influence construction cost and control over construction process (i.e. schedule, equipment, materials and technology, etc.) – this assumes that private partner has enough information to estimate costs and start operations on schedule and as planned. 	<ul style="list-style-type: none"> ▪ Incorporate strict experience and competency requirements in the procurement process ▪ Ensure that feasibility study is available well in advance of the procurement process ▪ Private firm generally will enter into a fixed term, fixed price building contract to pass the risk to a builder with the experience and 	<ul style="list-style-type: none"> ▪ Contract clause requiring performance bond ▪ Contract clause stipulating liquidated damages contract clause ▪ Contract clause providing partial cost overrun guarantee for complex structures

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
		measure risk, the government may assume part of the risk	<ul style="list-style-type: none"> ▪ A possible exception is in contractually agreed upon situations that classify as force majeure or government intervention. 	resources to construct so as to satisfy the private firm's obligations under the contract	
Commissioning	Risk that either the physical or the operational commissioning tests which are required to be completed for the provision of services to commence, cannot be successfully completed	Private – although government will assume an obligation to cooperate and facilitate prompt public sector attendance on commissioning tests	Private partner is in control of the design and construction process and its inputs, and therefore better positioned to manage this risk	Incorporate strict experience and competency requirements in the procurement process	Contract clause requiring a performance bond Contract clause stipulating liquidated damages (until all physical and operational commissioning tests passed)
Sponsor and financial risk					
Interest rates pre-completion	Risk that prior to completion local currency interest rates may move adversely	Government	Government has more experience and information regarding the factors influencing local currency interest rates and is in better position to manage risk	Construction loan interest rate hedging instrument (if and when available)	Contract clause defining mechanism to compensate private for interest rate changes during construction
Interest rates post-completion	Risk that after completion interest rates may move adversely	Private	Private partner in control of selecting and arranging long-term financing	<ul style="list-style-type: none"> ▪ Interest rate hedging instruments (such as interest rate swap from IFC) ▪ Arrange financing using a mix of foreign 	Contract clause holding government harmless

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
				and local currency	
Exchange rate	Risk that during operation, exchange rates may move adversely, affecting the private partner's ability to service foreign denominated debt and obtain its expected profit	Shared <ul style="list-style-type: none"> ▪ Government to assume part of it by allowing total or partial indexing of payments to exchange rate ▪ Private to assume remainder 	<ul style="list-style-type: none"> ▪ Private partner is in control of selecting and arranging local and foreign currency mix for long-term financing ▪ Government has more experience and information regarding the factors that influence exchange rates 	<ul style="list-style-type: none"> ▪ Private to partially mitigate by partly financing the project in local currency ▪ Private to establish Foreign Exchange Liquidity Facility to cover part of the potential mismatch between project's local currency revenues and foreign currency debt ▪ Government to partly transfer risk to users by allowing payment indexing to exchange rate 	<ul style="list-style-type: none"> ▪ Contract clause requiring establishment of a Foreign Exchange Liquidity Facility ▪ Tariff or payment adjustment contract clause
Currency convertibility and profit repatriation	Risk that local currency cannot be converted into foreign currency as a result of government restrictions	Government	Government has more experience and information regarding the factors that influence currency convertibility	Purchase partial risk guarantee from an International Financing Institution	Contract clause stipulating that private partner can benefit from the guarantee to compensate for losses related to currency convertibility and repatriation of profits
Inflation	Risk that value of payments received during the term is eroded by inflation	Shared <ul style="list-style-type: none"> ▪ Government to assume part of it by allowing total or partial indexing of payments 	Government has more experience and information regarding the factors that influence inflation	<ul style="list-style-type: none"> ▪ Government to transfer part of it to users by allowing total or partial indexing of payments to inflation 	Contract clause defining payment adjustment mechanisms

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
		to inflation <ul style="list-style-type: none"> ▪ Private to assume remainder risk through the methodology adopted to maintain value 		rate <ul style="list-style-type: none"> ▪ Government to ensure its payments do not overcompensate for inflation and to avoid any double payment for after costs adjustments (for example, changes in exchange rate) 	
Financing unavailable	Risk that when debt and/or equity is required by the private firm for the project it is not available then and in the amounts and on the conditions anticipated	Private	Private partner is responsible for arranging finance	Government requires all bids to have fully documented financial commitments with minimal and easily achievable conditionality	Contract clause requiring firm letters of credit from reputable financial institutions
Sponsor risk	<ul style="list-style-type: none"> ▪ Risk that the private partner is unable to provide the required services or becomes insolvent ▪ Risk that the private partner is later found to be an improper person for involvement in the provision of these services ▪ Risk that financial 	Government	If this risk materializes, there is no private partner to transfer the risk to	<ul style="list-style-type: none"> ▪ Ensure project is financially remote from external financial liabilities ▪ Ensure adequacy of finances under loan facilities or sponsor commitments supported by performance bond ▪ Ensure adequacy of finances through the use of non financial 	<ul style="list-style-type: none"> ▪ Contract clause requiring a performance bond and letters of credit ▪ Contract clause requiring minimum liquidity and debt ratios

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
	demands on the private partner exceed its financial capacity causing corporate failure			evaluation criteria and due diligence on private partner	
Further finance required due to government action	Risk that by reason of a change in law, policy or other event additional funding is needed to rebuild, alter, re-equip etc the facility which cannot be obtained by the private firm (resulting in no funding available to complete further works required by government)	Government takes risk that private finance is unavailable – however, private partner to assume best endeavors obligation to fund at agreed rate of return with option on government to pay via an increase in fees over the balance of the term or via a separate capital contribution	Government has more information and is better positioned to manage risk	Government to satisfy itself as to likelihood of need arising, likely criticality if it does arise, and as to financial capacity of private to finance and (if appropriate) budget allocation if government is required to fund it	<ul style="list-style-type: none"> ▪ Contract clause of best endeavors obligation by private to fund with option on government to compensate via fee increase or capital contribution ▪ Contract clause providing a buy-out (put) option or termination with compensation for private, should finance not be obtained and facility cannot be further operated
Change in ownership	Risk that a change in ownership or control of the private firm results in a weakening in its financial standing or support or other detriment to the project	<p>Shared</p> <ul style="list-style-type: none"> ▪ Government risk as to the adverse consequence of a change if it occurs; ▪ Private firm risk that its commercial objectives may be inhibited by a 	<ul style="list-style-type: none"> ▪ If change occurs, the ability of private partner to manage risk is diminished ▪ Private partner would have to accept requirement to sign agreement, hence if condition is not 	<ul style="list-style-type: none"> ▪ Government requirement for its consent prior to any change in control. ▪ Private firm will seek to limit this control to circumstances where substantive issues are of concern such as 	Contract clause requiring government consent prior to any change in control, and providing ability to influence or prevent change only in specific circumstances

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
		restrictive requirement for government consent to a change	acceptable, it could walk away from project	financial capacity and probity	
Refinancing benefit	Risk (upside) that at completion or other stage in project development the project finances can be restructured to materially reduce the project's finance costs	<ul style="list-style-type: none"> ▪ Private partner to benefit; ▪ Government to share in limited circumstances (i.e. symmetrical risk allocation and super profits) 	Similar to interest rate risk - private partner has control over its choice of long term financing – if downside burden is placed on private partner, same principle applies to upside (symmetrical risk allocation)	Government to assure itself that likely benefit has been factored into competitive bids to avoid the risk that the private firm will be allowed to earn super profits from the project	Contract clause spelling out circumstances where government is to share and at what rate
Tax changes	Risk that before or after completion the tax impost on the private firm, its assets or on the project, will change	Private, if and when: <ul style="list-style-type: none"> ▪ Tax increases or new taxes arising from general changes in tax law Government, if and when: <ul style="list-style-type: none"> ▪ Tax increases or new taxes arising from discriminatory changes in tax law 	<ul style="list-style-type: none"> ▪ General changes in tax law affect all businesses in the country ▪ The government is in better position to influence specific discriminatory tax law changes affecting the project 	Private partner to incorporate in project due diligence - financial returns of the private partner should be sufficient to withstand general tax law changes	<ul style="list-style-type: none"> ▪ Contract clause providing compensation terms for discriminatory changes in tax law ▪ Contract clause providing a buy-out (put) option or termination with compensation for private partner when no other compensation mechanism is available
Operating risk					
Inputs	Risk that required inputs cost more than anticipated, are of	Private, except when: <ul style="list-style-type: none"> ▪ Government controls inputs (for example, 	Private partner is in control of the selection of inputs.	<ul style="list-style-type: none"> ▪ Private partner may manage through long term supply contracts 	<ul style="list-style-type: none"> ▪ Contract clause imposing penalties for breach of specific and

Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
	inadequate quality or are unavailable in required quantities	water catchment)		where quality/quantity can be assured; <ul style="list-style-type: none"> ▪ Private partner can address to some extent in its facility design 	well defined performance and quality specifications. <ul style="list-style-type: none"> ▪ Contract clause on compensation to private for issues attributable to government-supplied inputs
Maintenance and Refurbishment	Risk that design and/or construction quality is inadequate resulting in higher than anticipated maintenance and refurbishment costs	Private	Private partner is in control of design and construction processes	Private firm to manage through long term subcontracts with suitably qualified and resourced sub-contractors	<ul style="list-style-type: none"> ▪ Contract clause imposing penalties (and possible termination) for not meeting specific and well defined performance, level of service, and quality specifications ▪ Contract clause requiring performance bond from private
Changes in output specification outside agreed specification range	Risk that government's output requirements are changed after contract signing whether pre or post commissioning <ul style="list-style-type: none"> ▪ Change prior to commissioning may require a design change with capital cost 	Government	Government is in better position to manage and mitigate the occurrence of the risk	Government to minimize the chance of its specifications changing and, to the extent they must change, it will ensure the design is likely to accommodate it at least expense; this will involve considerable time and	<ul style="list-style-type: none"> ▪ Contract clause of best endeavors obligation by private to fund with option on government to compensate via fee increase or capital contribution ▪ Contract clause providing a buy-out

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
	<p>consequences depending on the significance of the change and its proximity to completion;</p> <ul style="list-style-type: none"> ▪ Change after completion may have a capital cost consequence or a change in recurrent costs only (for example, where an increase in output requirements can be accommodated within existing facility capacity) 			<p>effort in specifying the outputs up front and planning likely output requirements over the term</p>	<p>(put) option or termination with compensation for private, should finance not be obtained and change makes project unviable</p>
<p>Operator failure</p>	<p>Risk that a subcontract operator may fail financially or may fail to provide contracted services to specification (failure may lead to service unavailability and a need to make alternate delivery arrangements with corresponding cost consequences)</p>	<p>Private</p>	<p>Private partner is fully and primarily liable for all obligations to government irrespective of whether it has passed the risk to a subcontractor</p>	<p>Government to carry out due diligence on principal subcontractors for probity and financial capacity and commission a legal review of the major subcontracts including the guarantees or other assurances taken by the private partner; if failure does occur the private partner may replace the operator or government may require</p>	<ul style="list-style-type: none"> ▪ Contract clause imposing penalties (and possible termination) for not meeting specific and well defined performance, level of service, and quality specifications ▪ Contract clause requiring performance bond from private

Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
				operator replacement	
Technical obsolescence or innovation	<ul style="list-style-type: none"> ▪ Risk of the contracted service and its method of delivery not keeping pace, from a technological perspective, with competition and/or public requirements <ul style="list-style-type: none"> – Private partner’s revenue may fall below projections either via loss of demand (user pays model) payment abatement (availability model) and/or operating costs increasing; – Government may not receive contracted service at appropriate quantity/quality 	Private – except where contingency is anticipated and government agrees to share risk possibly by funding a reserve	Private partner is able to use its expertise and know-how to minimize this risk	<ul style="list-style-type: none"> ▪ Government to develop detailed, well-researched output specifications ▪ Private partner to develop detailed, well-researched design solution ▪ Private partner may have recourse to designer, builder or their insurers ▪ Private partner to arrange contingency/reserve fund to meet upgrade costs subject to government agreement as to funding the reserve and control of reserve funds upon default; ▪ Both partners to monitor obligations in the contract 	<ul style="list-style-type: none"> ▪ Contract clause imposing penalties (and possible termination) for not meeting specific and well defined performance, level of service, and quality specifications ▪ Contract clause defining the condition required of the facility at the end of the term ▪ Contract clause requiring performance bond from private ▪ Contract clause specifying mechanism to establish a reserve fund (private, public-private, public)
Demand risk					
Demand risk	Risk that operating revenues falls below	Private, except when: <ul style="list-style-type: none"> ▪ Uncertainty in demand 	<ul style="list-style-type: none"> ▪ When demand can be estimated with relative 	<ul style="list-style-type: none"> ▪ Government and private to perform 	Contract clause stipulating the availability payment or

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
	forecast as a result of decrease service volume (i.e. traffic volume, water or power consumption) attributable to an economic downturn, tariff increases or change in consumer habits	forecast is such that providing an availability payment element and/or a minimum revenue guarantee is necessary to attract private investment (for example, greenfield toll road), in which case, the government will share in the risk through an availability payment or a minimum revenue guarantee.	certainty, the private partner is in a better position to mitigate risk through commercial management practices <ul style="list-style-type: none"> ▪ Where government is the primary off-take it has better information to manage risk 	independent market demand analyses commensurate with project scale and characteristics <ul style="list-style-type: none"> ▪ Where users pay private partner will ensure robust financial structure and financier support <ul style="list-style-type: none"> – Adequate debt coverage – Adequate reserves – Credit enhancement, insurance 	mechanism to establish minimum revenue payments
Non-technical losses (tariff avoidance)	Risk of a portion of users or customers not paying or evading payment for service, leading to a shortfall in cash flows	Private, except when: <ul style="list-style-type: none"> ▪ There is limited scope for private to stop service or pursue payment (for example, service delivery or payment collection is controlled by government) 	Private sector has better access to information needed to identify non-paying users and stop/continue service to them.	Private firm to incorporate measures (technological, business processes, and otherwise) to identify non-paying customers and prevent and deter non-payment.	Contract clause giving the ability to private partner to stop service to non-paying customers and stipulating the mechanisms available to collect payment.
Network and interface risk					
Withdrawal of support network	Risk that, where the facility relies on a complementary	Government, where the change discriminates against the project	Government is in control of complementary network management	Government to conduct thorough network planning process when	Contract clause defining what constitutes unfair discrimination against the

Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
	government network, that support is withdrawn or varied adversely affecting the project			developing project concept	project and specifying mechanisms to compensate private (for example, liquidated damages)
Changes in competitive network	Risk that an existing network is extended/changed/re-priced so as to increase competition for the facility	Private, except when: <ul style="list-style-type: none"> ▪ Changes are discriminatory against the project ▪ Competition is government-subsidized (for example, a competing toll-free road on the same corridor) 	Government manages network allowing it to influence the materialization of network risk and its consequences	<ul style="list-style-type: none"> ▪ Government to conduct thorough network planning when developing project concept ▪ Private firm to review likely competition for service and barriers to entry prior to enter agreement ▪ Private firm will seek compensation against change which unfairly discriminates against the project by government subsidizing competition (existing or new) 	Contract clause to provide private partner with non-compete protections and compensation mechanisms
Interface (1)	Risk that the delivery of core services in a way which is not specified/anticipated in the contract adversely affects the delivery of	Private, except when: <ul style="list-style-type: none"> ▪ Changes involve discriminatory to the project – government to provide compensation 	Government manages core service activities allowing it to influence the materialization of interface risk and its consequences	<ul style="list-style-type: none"> ▪ Government to conduct thorough system planning when developing project concept ▪ Upfront assessment 	<ul style="list-style-type: none"> ▪ Contract clause to specify the extent of core services and the way in which they will be delivered so that only manifest and

Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
	contracted services			(by both government and the private partner) of likely interface issues <ul style="list-style-type: none"> Continuous review and monitoring and development of a communications strategy in respect of delivery of the two related services 	adverse changes and deficiencies can trigger this risk <ul style="list-style-type: none"> Contract clause defining compensation mechanism for private partner
Interface (2)	Risk that the delivery of contracted services adversely affects the delivery of core services in a manner not specified/anticipated in the contract	Private	Private firm manages contracted service activities	<ul style="list-style-type: none"> Upfront assessment (by both government and the private partner) of likely interface issues Continuous review and monitoring and development of a communications strategy in respect of delivery of the two related services 	Contract clause requiring a performance bond and specifying liquidated damages
Industrial relations risk					
Industrial relations	Risk of strikes or industrial action causing delay and cost to the project	Private	Private partner is has better information about and control over the causes of industrial action	Private partner (or its sub-contractors) manage project delivery and operations	Contract clause requirement payment of liquidated damages to government
Legislative and government policy risk					

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
Approvals	Risk that additional approvals required during the course of the project cannot be obtained	Private, except when: <ul style="list-style-type: none"> ▪ Government has initiated the change requiring approval 	Government is in better position to manage and mitigate the occurrence of the risk	Private to anticipate requirements	Contract clause to specify private partner compensation mechanism (for example, liquidated damages)
Changes in law/policy	Risk of a change in law/policy of government only, which could not be anticipated at contract signing and which has adverse capital expenditure or operating cost consequences for the private firm	Private, if and when: <ul style="list-style-type: none"> ▪ Changes occur in general law and are not project or service specific Government, if and when: <ul style="list-style-type: none"> ▪ Changes are discriminatory and directed specifically and exclusively at the project or the services 	<ul style="list-style-type: none"> ▪ General changes in law affect all businesses in the country ▪ Government is in better position to influence specific discriminatory tax law changes affecting the project 	<ul style="list-style-type: none"> ▪ Private partner to incorporate in project due diligence - financial returns of the private partner should be sufficient to withstand general law/policy changes ▪ Government to monitor and limit (where possible) changes which may have these effects or consequence on the project ▪ Government to require the private firm to effect the change in a way that the financial effect on government is minimized (for example, pay on a progressive scale); ▪ Government to pass through to end users 	<ul style="list-style-type: none"> ▪ Contract clause allowing compensation to private in a pre-specified ▪ Contract clause to allow pass through to end users

Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
Regulation	Risk that where there is a statutory regulator involved there are pricing or other changes imposed on the private firm which do not reflect its investment expectations	Private, except when: <ul style="list-style-type: none"> ▪ Tariffs or payments are pre-specified in the contract 	The private partner has the ability to undertake its own assessment of the regulatory system	Private firm to assess regulatory system and may make appropriate representations	Contract clause to specify whether payment will be subject to regulator or not, and if not, specify mechanism to set and adjust tariffs.
Force majeure risk					
<i>Force majeure</i>	Risk that inability to meet contracted service delivery (pre or post completion) is caused by reason of force majeure events	<ul style="list-style-type: none"> ▪ Private takes risk of loss or damage to the asset and loss of revenue when risk is insurable (for example, earthquake, floods, fire, and drought) ▪ Government takes some risk of service discontinuity both as to contracted service and core service when risks are uninsurable (i.e. terrorism acts, war, civil unrest, etc.) 	<ul style="list-style-type: none"> ▪ Private partner can buy insurance from the marketplace— commercial ▪ Government is better positioned to manage uninsurable risks 	<ul style="list-style-type: none"> ▪ Private to purchase insurance for insurable risks ▪ If uninsurable, private firm may self-insure by establishing reserve funding; ▪ If uninsurable government to establish contingency for alternate service delivery; 	<ul style="list-style-type: none"> ▪ Contract clause to expressly define events that will constitute acts of God and political force majeure events ▪ Contract clause to relieve private from consequences of service discontinuity; ▪ Contract clause to require that if insurable, private must ensure availability of insurance proceeds towards asset repair and service resumption and government is to be given the benefit of insurance for service disruption costs
Asset ownership risk					

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Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
Default and termination	Risk of 'loss' of the facility or other assets upon the premature termination of lease or other project contracts upon breach by the private firm and without adequate payment	Private firm will take the risk of loss of value on termination	Private firm has more knowledge of the underlying causes of default and can identify risk earlier than government	<ul style="list-style-type: none"> ▪ Only serious breaches by the private firm to lead to termination ▪ Private partner to be given time and opportunity to remedy defaults by the private partner which may lead to termination ▪ If termination occurs pre completion government may (but need not to) make payment for value in the project on a cost to complete basis; ▪ If termination occurs post completion the private partner may receive fair market value less all amounts due to government ▪ Government to require step in rights to ensure access and service continuity until ownership/control issues are resolved 	<ul style="list-style-type: none"> ▪ Contract clause clearly establishing specific contract breaches leading to termination ▪ Contract clause to define options for remediation of default ▪ If and when necessary, contract clause to define method to establish compensation to private in case of termination (pre and post-completion)
Residual value on transfer to	Risk that on expiry or earlier termination of the	Private	Private partner can incorporate lifecycle	<ul style="list-style-type: none"> ▪ Government to impose on the private 	<ul style="list-style-type: none"> ▪ Contract clause specifying the

Risk	Definition	Preferred Allocation	Rationale	Possible Mitigation Strategies	Allocation Instrument
government	services contract the asset does not have the value originally estimated by government at which the private partner agreed to transfer it to government		maintenance, refurbishment, and performance requirements into the design facility, and can manage these process during the term of the contract	<p>maintenance and refurbishment obligations,</p> <ul style="list-style-type: none"> ▪ Government to ensure an acceptable maintenance contractor is responsible for the work, commission regular surveys and inspections; ▪ Government may require private to establish a dedicated sinking fund to accumulate funds sufficient to bring the asset to agreed condition and/or (if required) obtain performance bonds to ensure the liability is satisfied 	<p>conditions in which assets are to be transferred to the government at the end of the term</p> <ul style="list-style-type: none"> ▪ Contract clauses stipulating the performance indicators and frequency of monitoring of these indicators ▪ Contract clause requiring the creation of a sinking fund to cover the cost of bringing the facility up to the desired standard

Developing rules for structuring contingent liabilities and draft contractual mechanisms

The risk allocation principles described above will define what risks the Government is willing or prefers to accept when structuring a PPP. Contracting authorities should then follow established policies for *how* it accepts those risks. This can be done by developing guidelines and rules for structuring the contingent liabilities, and designing the contractual mechanisms by which the associated risks are accepted. As with the risk allocation principles described above, contracting authorities—with help from IPDF, as needed—should develop the policies for how to structure contingent liabilities, and they should be reviewed and approved by a central authority, such as DPCO. Box 3.1 describes what those policies could be.

Box 3.1: Policies for How to Structure Contingent Liabilities

The key principle for allocating risk in PPP projects, as defined in the 2010 PPP policy, is that risk should be borne by the party (private or government) best able to manage it at minimum cost. This principle should also apply when structuring contingent liabilities.

In particular, the Government should seek to bear the risks it is allocated in a way that **minimizes fiscal impact**. This has implications for designing the contractual mechanisms for allocating risk, or in other words for structuring contingent liabilities:

- Where the parties are sharing a risk, in the case where neither party can control it, the Government should accept the minimum level of contingent liability that is consistent with the project having a “bankable” risk profile for the private party³
- Contractual mechanisms for risks the Government will bear should reduce the unpredictability of contingent liability payment requirements wherever possible
- Contingent liabilities should be designed symmetrically, so that the party bearing downside risk also bears upside risk whenever possible.

Examples of contractual mechanisms that are consistent with these principles are:

- Payments for realized contingent liabilities, wherever possible, should be contractually defined to fall due in the fiscal year after the contingent liability realizes (reducing the need for budget flexibility)
- Demand risk (where relevant and borne by Government) should be borne by extension of contract life to achieve a pre-defined net present value (NPV) of revenue. The guaranteed NPV of revenue should be set to allow the proponent to cover the cost of debt repayments only
- The Government may bear the risk of a proponent default, but payment will be conditional on re-tendering contract and equal the value received.

Contracting authorities should also develop draft contract clauses or detailed model contracts for specific PPPs that are common in each sector. These model contracts serve as tool when contracting authorities are developing new projects to streamline the process and ensure they are following the approved principles for structuring PPPs and contingent liabilities more consistently. The model contracts should be also made public to increase transparency and credibility with the private sector. An example of this in practice, is the template power purchase agreement and implementation agreement published by PPIB.

³ Under these principles, the project may still require viability gap funding (VGF) support to be bankable: accepting more risk than the optimal level in lieu of providing VGF does not provide the best value for money for the Government.

We recommend that these efforts be developed and refined over time, as the Government and contracting authorities begin pursuing more projects and gain experience in developing, tendering, and implementing PPPs. For example, some agencies (such as NHA) may take these steps immediately, while the steps will be less urgent for other agencies with a less developed PPP pipeline. IPDF can provide useful support throughout the process, particularly given its recent work developing model tariff and annuity payment contracts.

3.2 Analyzing Contingent Liabilities

Once a PPP is structured, decision makers need to evaluate and approve the proposed project. When decision makers are evaluating a proposed PPP project, they should take into account the entire package of support being provided to the project. This includes viability gap funding—such as equity contributions or capital subsidies, and operating subsidies or incentives to the private proponent—as well as contingent liabilities. The same is true when officials are making regulatory decisions that impact the financial obligations of the Government once a PPP has been implemented. Decision makers can be provided with the information needed to make good decisions if guidelines for analyzing and reporting exposure to contingent liabilities are developed and followed by contracting authorities.

Objective when analyzing contingent liabilities: To inform decision making when the project is structured and approved, and provide a basis for monitoring and budgeting for contingent liabilities.

3.2.1 Why is the function important?

In the past, all officials may not have been fully aware of the cost or risk associated with its financial commitment through contingent liabilities from the PPPs it has implemented. For example, it is unlikely that stakeholders were fully aware of the large fiscal burden that would be created by the Government's obligations to IPPs in the energy sector when retail tariffs were set at a rate that did not allow the power purchaser to fully recover the cost of generation. Similar problems could arise in other sectors, such as highways, if the Government provides toll formula or traffic guarantees without understanding the full implied expected cost or variability of those guarantees.

Analyzing contingent liabilities will help ensure decision makers understand the expected cost and fiscal risk they are accepting when approving a PPP project. It will also improve how PPPs are structured, and provide useful information when monitoring and managing contingent liabilities once a PPP has been executed. Good analysis is also critical when negotiating contract terms with the private sector.

3.2.2 What relevant policies and processes are in place?

There are currently no guidelines in place for analyzing contingent liabilities specifically when considering the level of financial support the Government is providing to a proposed PPP project.

The Project Preparation and Feasibility Guidelines prepared by IPDF include broad instructions for analyzing project and non-project related risks; but these instructions have not been developed to the extent that there can be a consistent approach that is understood by decision makers within contracting authorities, IPDF, and ministries like MOF.

3.2.3 How should the policies and processes be improved?

As part of the project analysis when developing a proposed project, the contingent liabilities the Government will bear should be analyzed and, where possible, quantified. The analysis should follow a prescribed methodology set out in guidelines and clearly understood by all parties involved in developing a PPP.

Because there is inherent uncertainty in contingent liabilities, the risk analysis required when analyzing contingent liabilities can be complex. Therefore, the prescribed methodology for analyzing contingent liabilities should strike a balance between the cost of complexity and the benefits of creating quality information. Over time, staff performing the analysis will develop the capacity to perform more complex, statistically sound analysis. The guidelines that are developed should be sufficiently flexible to evolve as staff becomes more capable at analyzing contingent liabilities.

Options for analyzing contingent liabilities

The key objective of good risk analysis is to understand the profile of the underlying risk—or the shape of the distribution. This can be helpful toward understanding both the expected cost and the loss the Government is exposed to in extreme, low-probability scenarios.

There are several options to achieve this key objective when analyzing contingent liabilities. In practice, each option offers advantages and disadvantages based on the amount of information that is required, the difficulty in making sound assumptions, and the richness of information that can be produced and analyzed. The main difference in various options is the level of quantitative versus qualitative analysis, and whether a statistically sound probabilistic method or a scenario-based method is optimal. Box 3.2 below describes the possible methodologies. We will use a hybrid approach, which is described in more detail below.

Box 3.2: Possible Methodologies for Valuing Contingent Liabilities

Exposure to a contingent liability could result in a range of actual cost outcomes—depending on how the underlying risk variables evolve. Different ways of measuring and expressing the value of a contingent liability require different approaches to capturing this variability. These can be broadly grouped into probabilistic- or scenario-based scenario approaches, as described below.

Probabilistic approach (fully quantitative)

The range of possible cost outcomes from bearing a contingent liability can be expressed in terms of an **expected value**—that is, the probability-weighted sum of all possible outcomes—and measures of variability such as **standard deviations or percentile values**.

However, the probability and value of payments or costs often depend on a combination of underlying risk variables, each of which can vary independently or in combination, making it difficult or impossible to calculate the expected value directly. Instead, probability distributions for each underlying risk variable can be defined. A risk modeling program, such as Crystal Ball, can then be used to randomly simulate thousands of outcomes and the resulting cost calculated in each case. The average of these calculated cost outcomes gives an estimate of the expected value of the contingent liability and their distribution (expressed using graphs or percentile values) gives an estimate of the degree of variability around that value.

Scenario-based approach (partially quantitative)

Rather than attaching probability distributions to underlying risk variables, certain set scenarios—that is, specific combinations of risk variables—can be defined, and the resultant cost determined under each scenario. Scenarios could include “basecase”, “upside”, and “downside” values for variables such as exchange rates, or capture the occurrence of a trigger risk event such as default by the private party. The values calculated using this approach do not take into account the likelihood of each scenario occurring.

The approaches described in Box 3.2 differ in the complexity of analysis, the extent of the required inputs and assumptions, and the completeness of the information they provide. In practice, through previous assignments, we have found that a combination of these approaches can work best to achieve a balance between the efficiency of the analysis and richness of information. A combined approach also avoids producing quantitative valuations based on loosely defined assumptions.

Taking this approach means the optimal methodology should be tailored to different types of contingent liabilities. For example:

- Single-variable guarantees such as demand (or minimum revenue) and exchange rate guarantees contain fewer inputs and can be usefully analyzed using a probabilistic approach to produce an expected value, based on the assumed behavior of the underlying variable (demand and exchange rate behavior, respectively)
- Debt guarantees may be better analyzed semi-quantitatively, by calculating the total cost if a payment was required and analyzing—perhaps including further scenario analysis, for example under different financial structures—and tracking financial robustness to understand the likelihood of a default
- Guarantees covering damage due to force majeure events may also be better analyzed semi-quantitatively—by calculating the payment required if the trigger event occurs—due to the difficulty of assigning meaningful probabilities to those events.

Based on this, a combination of these approaches can be used to analyze the contingent liabilities the Government bears in a PPP. The next section describes how the approaches would apply in practice to different categories of contingent liabilities in Pakistan.

Analyzing categories of contingent liabilities in Pakistan

Table 3.2 below organizes common contingent liabilities into four categories and describes to what extent the probability and amount of each contingent liability can be analyzed. We also identify the preferred valuation method. The four main categories in Table 3.2 are also described under each of the subheadings below.

Termination and Force Majeure payments

Analyzing contingent liabilities for the case when a contract is terminated will need to account for the limited information that may be available and ensure the method is practical to implement. For example, it may be impractical to create a financial model for every individual PPP project.

Each contract may define several different types of termination events, each requiring a different payment calculation. These payments are typically defined as some combination of outstanding debt, un-recovered equity, and other amounts that are specific to each contract.

Importantly, while the process for analyzing termination and force majeure payment guarantees is similar, the events that trigger payment and therefore the underlying risks are quite different.

Demand and regulated price guarantees

Demand and revenue guarantees specify a floor at which the government agency will compensate the private proponent if revenue or user-ship should fall below. Regulated price guarantees provide for the difference to the private proponent if tariffs are not adjusted according to the terms of the contract. These guarantees are typically two-variable payments. In these cases, it is relatively straightforward to create a simple model that estimates the expected values and distributions using Crystal Ball and standard input assumptions. The model can be used to estimate a range of scenarios to determine the impact of the regulated price or demand fluctuation over time.

While the *process* for analyzing demand and regulated price guarantees is similar, it is important to not that, in practice, the two guarantees are quite different. Demand guarantees represent genuine commercial risk in the project. By contrast, price guarantees are a regulatory risk that is within the control of regulators or government officials.

Other commercial risk bearing

In some cases, the Government will have accepted significant commercial risk on a project. This is the case, for example, when the contracting authority makes annuity payments (which themselves are not contingent) to the private proponent, as is the case with the Shadala Flyover implemented by NHA. To the degree that obligations can be associated with specific PPPs, contracting authorities should create financial models to analyze and forecast the financial conditions of the PPP.

In other cases, the Government will be exposed to multiple contingent liabilities by guaranteeing the entire set of obligations of a contracting authority that develops PPPs. Often it will be difficult to disentangle the source of the Government's exposure for each project. It may be more useful to evaluate the exposure to the operating inefficiencies and default of the contracting authority. In these cases, the financial condition of the contracting authority and source of the liabilities based on sector policy will be analyzed. An example of this is the exposure that the Government is exposed to in the energy sector through WAPDA/PEPCO's power purchase commitments.

Miscellaneous guarantees

Miscellaneous guarantees that provide compensation for changes in tax law or guarantees exchange rate convertibility are common, but can be difficult to assess. Often it is not practical or useful to analyze them for individual projects; however, it is possible to identify the guarantees and make recommendations about how to evaluate these in the future should these particular risks emerge.

Table 3.2: Analyzing Categories of Contingent Liabilities from PPPs

Guarantee	Probability <i>Is the trigger quantifiable? How?</i>	Amount <i>Is the amount quantifiable? How?</i>	Recommended valuation method
Termination payments			
Termination payment in the event of Proponent default (not due to <i>force majeure</i>)	Not fully. However, can be quantified to some extent by reviewing project performance, financial statements and forecasts to evaluate: <ul style="list-style-type: none"> ▪ If milestones are being met ▪ Financial ratios <ul style="list-style-type: none"> – Project Loan Coverage Ratio – Debt Service Coverage Ratio – Negative net assets – Un-recovered equity return. 	Yes, payment inputs include: <ul style="list-style-type: none"> ▪ Outstanding debt ▪ (other contract-specific provisions). Often the Government will assume existing assets	<ul style="list-style-type: none"> ▪ Measure and report the gross exposure to termination ▪ Evaluate and report termination triggers/ratios and determine if the project is high, medium, or low risk for termination
Termination payment in the event of GOP default or <i>force majeure</i>	No, it is not possible to determine the probability of a <i>force majeure</i> event causing the proponent to terminate the contract, or of the Government defaulting on its own obligations	Yes, payment inputs include: <ul style="list-style-type: none"> ▪ Outstanding debt ▪ Un-recovered equity ▪ Discounted cash flow to equity holders ▪ (other contract-specific provisions). Often the Government will assume existing assets	<ul style="list-style-type: none"> ▪ Measure and report gross exposure ▪ Clearly identify the triggers.
Demand and regulated price guarantees			
Demand or revenue guarantee	Yes, by assuming a distribution function for expected demand and observing actual demand levels	Yes, with a simple 2-variable payment calculation <ul style="list-style-type: none"> ▪ Demand shortfall ▪ Tariff. 	Construct a simple valuation model that uses scenario and probabilistic methods to estimate the expected value of demand/revenue guarantees

Guarantee	Probability <i>Is the trigger quantifiable? How?</i>	Amount <i>Is the amount quantifiable? How?</i>	Recommended valuation method
Regulated price guarantee if tariffs are not set at the level specified in the contract	Not fully. It is difficult to determine the ex ante probability that tariffs won't be approved according to contract terms. However, it is possible to value the guarantee under various scenarios	Yes, with a 2-variable payment calculation <ul style="list-style-type: none"> ▪ Demand ▪ Tariff shortfall. 	Construct a simple valuation model that uses scenario (and probabilistic) methods to estimate the expected value of regulated price guarantees
Other commercial risk-bearing			
Other commercial risk bearing: <ul style="list-style-type: none"> ▪ Commercial obligations of utilities (WAPDA/KESC) ▪ PPPs where the contracting authority bears full or significant commercial risk. 	To the degree that obligations are associated with specific PPPs, create a financial model to analyze and forecast the financial conditions of the PPP	<ul style="list-style-type: none"> ▪ Create a full financial model of project 	
Miscellaneous guarantees			
Change in legislation or tax law	No, it is not possible to determine what changes in laws may occur, or the probability that they will occur	No, it is not possible to determine what adverse impact unidentified changes in laws may have on a project. However, guidelines can be provided for future scenarios	<ul style="list-style-type: none"> ▪ None for existing guarantees ▪ Make recommendations on how to assess the guarantee if you know what changes to laws you want to evaluate
Exchange rate insurance	No, it is not possible to determine the probability of NBP default	Not fully. It is not practical to estimate the fx risk or at what point NBP would default. However, a value of total foreign denominated currency that is insured can be estimated	Make qualified assessments of the maximum exposure based on the amount of foreign-denominated capital
Convertibility/remittability guarantee	No, it is not possible to determine the likelihood that funds could not be converted/remitted	Not fully. It is not practical to estimate the amount, or at what point the GOP would default	Make qualified assessments on the maximum exposure based on the amount of locally-denominated funds

3.3 Approving Contingent Liabilities

Once a PPP project has been structured and proposed, and the contingent liabilities have been analyzed, the financial commitments from the Government should be approved. This is particularly the case with contingent liabilities, because the amount of the financial commitment and the associated fiscal risk is not easily knowable, and so it should be subject to additional analysis (as described in Section 3.2) and scrutiny.

Objective when approving contingent liabilities: To ensure the use of Government resources in the form of contingent liabilities is focused on policy priorities; represents value for money; and is consistent with good fiscal management.

3.3.1 Why is the function important?

Currently, there is no central process being consistently followed by which the Government can evaluate and approve its financial commitments through contingent liabilities to PPPs. This has created a situation where Government officials are sometimes not fully aware of what PPPs, across all sectors, it is party to. Moreover, there is not a consistent process by which the Government can evaluate and approve the fiscal risk and exposure from contingent liabilities for the PPPs that exist. Because accepting contingent liabilities under PPP projects uses Government resources, the contingent liabilities—along with all other forms of financial support—should be centrally approved to ensure the PPP is focused on the Government’s policy priorities, represents value for money, and is consistent with good fiscal management.

3.3.2 What relevant policies and processes are in place?

There are no specific requirements or rules for taking the contingent liabilities to be accepted under a proposed project into consideration when approving a PPP project. Although the 2010 PPP Policy specifies that all financial commitments of the Government under PPP projects must be approved by MoF, the requirements and process for PPP project approval in general are not clearly specified.

The FRDL Act limits the issue of new guarantees during a fiscal year to two percent of the estimated GDP for that year. This limit does not currently apply to contingent liabilities accepted under PPP projects, but could feasibly be extended to do so (as described in Section 3.1). Checking consistency with that limit would then form part of the process of approving a proposed PPP project.

3.3.3 How should the policies and processes be improved?

The PPP Policy 2010 specifies that all financial commitments of the Government under PPP projects must be approved by the MOF. Since contingent liabilities constitute financial commitments, then consideration of these liabilities should be part of that approval. As described in Section 4, where we discuss institutional options for managing contingent liabilities, this aspect of PPP project approval could potentially be delegated by MOF to another entity—or internally—if appropriate. Under the PPP Policy, it is MOF’s responsibility to ensure contingent liabilities are approved.

We recommend two aspects of contingent liabilities are checked when evaluating and approving a PPP:

- The structure of each proposed contingent liability
- The overall fiscal impact of the project.

Check 1: Have the contingent liabilities been structured well?

At a minimum, the agency responsible for evaluating and approving the contingent liabilities under a proposed PPP project should check that those liabilities have been structured according to the principles described in Section 3.1 above. If those principles have been followed, this means that each risk has been allocated to the party able to bear it at lowest cost, and the fiscal impact of each risk the Government bears has been minimized. That is, the total cost of risk-bearing for the project has been minimized, and in that sense the proposed contingent liabilities are cost-benefit justified. When evaluating the structure of contingent liabilities it is also important to take into account the entire package of financial support and obligations provided by the Government.

However, particularly in cases where a risk (such as exchange rate, or demand risk) is shared, finding the optimal risk allocation by following the principles may be difficult. In these cases, the Government could consider specifying rules or strategies to avoid accepting too much risk. Two options for doing so, and the potential benefits and disadvantages of each, are described in Table 3.3 below.

Table 3.3: Possible Rules for Approving Contingent Liabilities

Option	Example	Potential Benefit	Potential Disadvantages
1—define limits on certain types of risk	The expected cost (or defined percentile) of providing a level of demand guarantee must not exceed x% of total project cost	Helps avoid the Government bearing more risk than it needs to. If the guaranteed level of demand is set too high, this is effectively a subsidy to the project and should be considered as such	<ul style="list-style-type: none"> ▪ No clear basis for setting level of limit—cut-off point for project approval may be somewhat arbitrary ▪ Requires consistent, quantitative assessment of contingent liabilities—only applicable to risk types that can be quantitatively assessed
2—charge a fee to the private investor for certain types of guarantees, and make those guarantees optional	Offer a demand guarantee for a fee equal to the Government’s expected cost of providing the guarantee	The private investor must decide whether the guarantee is worth the fee. If the private party actually expects its cost of bearing the risk would be lower, it will turn down the guarantee—this helps make sure risks are allocated to the party able to bear them at lowest cost	Requires consistent and accurate valuation of the Government’s expected cost

Both the options described in Table 3.3 require consistent, quantitative valuation of the Government’s expected cost of accepting a contingent liability. As described in Section 3.2, valuing contingent liabilities can be a complex and difficult task. Therefore, specific options for setting rules when approving contingent liabilities would be best to fully adopt in the

future, once staff have developed the capability need to analyze contingent liabilities, and the PPP program and contingent liability management framework is fully functioning.

Check 2: What is the overall budget and debt impact of the contingent liabilities under the proposed project?

The Government should also consider the overall impact of the contingent liabilities under the proposed PPP, and whether this can be accommodated within budget and debt limits. Just as budget limitations mean the Government may not be able to undertake every economically beneficial project, even where the contingent liabilities of a proposed project are well structured, the overall fiscal impact could be considered too high.

For most government expenditures, this consideration is addressed through the budget process. The overall budget envelope is defined taking any debt limits into consideration, and this amount is then allocated among departments based on policy and project priorities. However, contingent liabilities are unusual in that they have no budget impact at the point at which the decision is made to accept them. Table 3.4 describes options for taking the overall fiscal impact of the contingent liabilities into account when considering whether to approve a PPP project proposal. As for the first check on the structure of individual liabilities, all of these options would require consistent, quantitative valuation of the Government's cost of accepting contingent liabilities. Similarly, these rules would be best to fully adopt in the future, once staff have developed the capability need to analyze contingent liabilities, and the PPP program and contingent liability management framework is fully functioning.

Table 3.4: Possible Rules to Limit Overall Fiscal Impact of Contingent Liabilities

Option	Example	Potential Benefit	Potential Disadvantages
<p>1—define limits for total stock of contingent liabilities from PPP projects, or on new contingent liabilities in any fiscal year</p>	<p>Limits could defined by:</p> <ul style="list-style-type: none"> ▪ Setting a specific limit on contingent liabilities from PPPs, or ▪ Specifying that contingent liabilities from PPPs should be included under the limits specified in the Fiscal Responsibility and Debt Limitation (FRDL) Act, namely: <ul style="list-style-type: none"> – Overall debt limit of 60% of GDP – Overall limit on new guarantees in any fiscal year of 2% of GDP. <p>In each case, the nature of the limit would need to be carefully defined (For example, whether on maximum or expected exposure)</p>	<ul style="list-style-type: none"> ▪ This approach is simpler than integrating contingent liabilities into the overall budget process, while ensuring the overall fiscal impact of the contingent liabilities under a proposed project is taken into account ▪ Limits could be defined on expected cost, or on another measure such as maximum exposure (which may be simpler to calculate). 	<p>Creates “dual budget”, which may create a bias towards either guarantees or subsidies (depending on whether budget or contingent liability limit is binding) that does not achieve value for money—it would be more efficient to incorporate into actual budget process (since the overall fiscal envelope should reflect debt limits)</p>
<p>2—incorporate contingent liabilities into subsidy (VGF) analysis</p>	<p>Include cost of guarantee when calculating total financial support to a project, including VGF, and applying the same decision rules</p>	<p>Takes into account the subsidy element of providing a guarantee</p>	<ul style="list-style-type: none"> ▪ Subsidy decision rules not yet fully defined or implemented in practice ▪ Requires consistent and accurate valuation of the Government’s expected cost.
<p>3—require contracting authorities to budget upfront for expected cost of contingent liabilities</p>	<p>Contracting authorities must include the expected, lifetime cost of the contingent liability in their annual budget in the fiscal year in which the liability is accepted. Where the contracting authority is not a government department that participates in the budget allocation process, the same effect could be achieved by charging a guarantee fee to the authority</p>	<p>Forces contracting authorities to consider cost of guarantee explicitly when considering affordability of project—that is, consistency with budget priorities</p>	<ul style="list-style-type: none"> ▪ Introduces an opportunity cost of budgeting for the contingent liability for which no expenditure may ever be required ▪ Requires consistent and accurate valuation of the Government’s expected cost ▪ Requires systems to deal with the budgeted amount—for example, setting this aside against future payments for realized liabilities (see Section 3.8 below).

3.4 Accepting Contingent Liabilities

Once contingent liabilities have been approved for a proposed PPP project, the Government should formally accept or issue the contingent liabilities. Formally accepting contingent liabilities through an explicit agreement—to which the Ministry of Finance is typically a signatory—makes the Government’s commitment to its obligations under the PPP contract clear. This may reduce the perceived risk and increase the confidence of private investors.

Objective when accepting contingent liabilities: To clarify the Government’s commitment to its contingent liability obligations, and to ensure the executed contract is consistent with earlier analysis and approval.

3.4.1 Why is the function important?

Under current policy, the Government’s commitment to contingent liabilities is not explicit and there is not a consistent processes for checking that executed contracts include the approved terms. This creates uncertainty about which contingent liabilities the Government is committed to and which commitments it is likely to uphold. Moreover, during contract negotiations with a preferred bidder, contracting authorities may come under pressure to change the terms of the contract to accept more project risk. As described above, accepting the right contingent liabilities is the most important step in contingent liability management. Having followed the process of structuring, analyzing and approving the contingent liabilities under the proposed or draft contract, it is important that the final contract terms are checked for consistency—and any differences assessed and approved—before the contingent liabilities are formally accepted.

3.4.2 What relevant policies and processes are in place?

There is currently no single process in place for a central agency, like MOF, to *formally* accept contingent liabilities from PPPs across all sectors. PPIB signs implementation agreements on behalf of the Government to contractually define the extent of the Government’s obligations, including contingent liabilities, to independent power producers. In other sectors, however, there is no formal mechanism by which the Government accepts contingent liabilities.

The DPCO currently certifies that new debt guarantees are compliant with the FRDL Act and in some cases the Ministry of Finance issues a comfort letter to formally acknowledge the issuance of a guarantee.

3.4.3 How should the policies and processes be improved?

Once the project has been tendered and the final contract agreed, the Government should formally accept the contingent liabilities in the project by:

- Checking the final contract to verify that the contingent liabilities have not materially changed since the project was approved.
- Signing an “agreement letter” to formally accept the contingent liabilities under the PPP project.

Checking the final contract

Once the requirement for issuing an “agreement letter” (see below) has been established, the Government could specify that the agreement will only be provided when the final contract is consistent with the approved draft. A process should be defined for assessing and approving or reconciling any differences (as discussed under the institutional options in Section 4 below).

Signing an agreement letter

The agreement letter would be similar to the implementation agreements that are signed by the PPIB and independent power producers. That document is effectively a means for the Government to formally acknowledge the contracting authority’s commitments under the PPP. However, these implementation agreements (IA)s are extensive agreements specifying many terms of the contract with IPPs. Following the 2010 PPP Policy, risk allocation for PPPs should be comprehensively specified in the PPP contract itself. Therefore, the “agreement letter” should simply confirm the Ministry of Finance’s commitment to ensuring the contracting authority is able to honor its obligations under the PPP contract.

3.5 Monitoring Contingent Liabilities

After a PPP has been executed, the Government should monitor and, when necessary, reevaluate its exposure to contingent liabilities. This will ensure officials have access to updated information on the Government’s portfolio of contingent liabilities and can track, and take action to mitigate, emerging risks. It will also facilitate the budgeting and paying for obligations under realized contingent liabilities

Objective when monitoring contingent liabilities: To provide information needed to disclose, act on emerging issues and, if necessary, budget for contingent liabilities.

3.5.1 Why is the function important?

The Government does not maintain a central database of what PPPs it has implemented, what contingent liabilities are contained in the PPP contracts, and what risks are associated with the contingent liabilities. Improving the collection and monitoring of information will help the Government track its exposure to fiscal risk from year to year, and improve its ability to take action to reduce the cost or likelihood of an event triggering a payment occurring should risks emerge.

Moreover, effective monitoring should be done in way that facilitates the other important functions in managing contingent liabilities, including:

- Disclosing that exposure at the project and portfolio level (see Section 4.6)
- Identifying and acting on any emerging issues (see Section 4.7)
- Budgeting for contingent liabilities, depending on how realized contingent liabilities are paid for (see Section 4.8).

3.5.2 What relevant policies and processes are in place?

The 2010 PPP Policy specifies that contracting authorities are responsible for monitoring PPP projects. The PPP Policy also states that the DPCO is responsible for “ultimate management” of any contingent financial obligations, including PPPs, arising from the PPP

program. This follows the FRDL Act (2005), which specifies that the DPCO is responsible for monitoring the Government's guarantee stock.

However, there are no requirements or guidance provided for how monitoring should be done, or for how DPCO and contracting authorities should work together during the project implementation stage

3.5.3 How should the policies and processes be improved?

During project implementation (construction and operations), the Government should systematically collect up-to-date information on project performance, and periodically update its evaluation of the contingent liabilities under the project accordingly. This can be effectively carried out by:

- Including reporting requirements in draft contracts
- Requiring the use of monitoring plans
- Maintaining a central database.

Including reporting requirements in draft contracts

The Government should ensure that requirements for the private proponent to report and provide information to the contracting authority are included in draft contracts for proposed PPP projects. The Government should then check to verify that the reporting requirements are included when approving a project (see Section 3.3). Requirements for the contracting authority to report and provide information to the government agency charged with managing contingent liabilities—DPCO, as specified in the 2010 PPP Policy—should be included in the “agreement letter” used by the Government to formally accept the contingent liabilities (see Section 3.4).

Require the use of monitoring plans

The Government should also require that contracting authorities prepare monitoring plans that include details of the project and information on the contingent liabilities. The plan should be used to identify potential risk and should lay out an action plan for dealing with problems that may increase the Government's exposure or cause a contingent liability to trigger. A sample of a monitoring plan that could be used as a template by contracting authorities is shown in Table 3.5. Contracting authorities should be required to submit the monitoring plan as part of the PPP approval process (see Section 3.3).

Table 3.5: Sample Template Monitoring Plan

[NAME OF PROJECT] CL Management Plan

Contingent Liability	Value (state measure)	Underlying Risk Factors	Timing			Sources of Information	Accountable Agents	Management Approach	Priority Level as at [date]	Notes, To-Do or Key Dates
			Pre-Construction [dates]	Construction [dates]	Operations [dates]					
1	- Add brief description of payment as defined in contract - Add quantitative measures of value where possible	A	Y/N Show dates if timing differs from overall dates (e.g. applies for only first years of operations)			List sources of information by risk factor	List accountable agents (inside or outside Government) by risk factor	Describe how risk will be managed	Classify as high, medium or low priorit and reason for classification	List key dates or to-do points
		B								
		C								
		D								
2										
3										

Maintaining a central database

Finally, the Government should maintain a central database as part of the process for monitoring contingent liabilities. DPCO is the sensible host of the database given its mandate to manage contingent liabilities in the 2010 PPP Policy. The database should include the monitoring plans submitted by contracting authorities, as well as any other relevant project information. The project information should be collected according to the reporting requirements specified in the draft contracts and “agreement letter”. The analysis of the contingent liabilities reevaluated and the monitoring plans should be updated on at least an annual basis.

3.6 Disclosing Contingent Liabilities

Once PPPs are in the implementation stage, the Government should disclose the exposure to contingent liabilities that it has accepted. Doing so improves the accountability of decision makers and the credibility of the Government’s actions. It also gives credit rating agencies and lenders access to accurate information, so they are not overestimating the Government’s creditworthiness.

Objective when disclosing contingent liabilities: To improve accountability for decision-makers, and increase transparency of the Government’s commitments to third parties (such as credit agencies and lenders).

3.6.1 Why is the function important?

The Government has good practices in place for publicly reporting its fiscal and debt policies and status. Including contingent liabilities from PPPs in these reports would bring the Government further in compliance with its own policies. Further, disclosing contingent liabilities under PPP projects provides real benefits and strengthens the other steps in the contingent liability management framework.

Reporting on exposure to contingent liabilities will increase transparency and improve the accuracy and completeness of information available to external parties. This avoids external parties such as lenders and credit agencies, who are likely to take a cautious approach, having to guesstimate the country’s exposure when assessing the country’s creditworthiness, for example, for defining a credit rating (as described in Box 3.3 below). Disclosure also enhances accountability and publicly signals the Government’s commitment to introduce policies to effectively manage fiscal risk, providing stronger incentives to decision-makers throughout the process.

Box 3.3: How Disclosure can Improve a Country's Credit Ratings

Credit rating agencies take into account a country's contingent liabilities when assessing creditworthiness. There are two primary ways in which contingent liabilities are evaluated and incorporated into ratings:

- By determining if there is “imminent crystallization of contingent liabilities”, and
- By checking if the government has adequate funds to cover its contingent liabilities.

Disclosure can improve the credit rating of a country by giving an accurate profile of its exposure. This provides auditors with greater confidence that large contingent liabilities are not impending, and that the government has enough funds to cover payments and maintain fiscal stability if high-risk contingent liabilities are realized.

Source: Moody's Sovereign Risk Group.

3.6.2 What relevant policies and processes are in place?

The FRDL Act (2005) requires “consistent and authenticated information” on guarantees, including their budgetary impact, to be included in an annual debt policy statement. This is included among the responsibilities of DPCO, who releases the annual Debt Policy Statement. DPCO has also started disclosing the stock of contingent liabilities in the Annual Economic Survey; however, so far, this has only include debt guarantees to financial institutions on behalf of public entities and not contingent liabilities from PPPs.

3.6.3 How should the policies and processes be improved?

There are two factors to consider when determining how the Government should disclose its contingent liabilities:

- Where information on the contingent liability stock from PPP projects should be published
- What information should be disclosed.

Where information should be published

Other governments include contingent liability information either within public financial management statements or reports, or as a standalone report. The latter approach is used in Chile, for example, and can make the information more accessible. However, in Pakistan, the annual Debt Policy Statement provides an obvious mechanism for this disclosure: a high-profile and relevant document. This statement already includes a section on “guarantees” (covering loan guarantees only). The guarantee section should be made more generic and cover other types of contingent liability, including those from PPPs, or the report should include a separate section on contingent liabilities to PPPs.

What information should be disclosed

Any information disclosed about the Government's CL exposure should be:

- Accurate and complete, but not excessively burdensome to produce
- Aligned with, or an improvement on, international standards and practices.

At a minimum, a report disclosing contingent liabilities should include information on each project, the nature of each contingent liability, and measures of the exposure and potential cost. The Government should start with a relatively limited set of information, and look to

expand this over time as staff become more capable of analyzing contingent liabilities and the contingent liabilities management system becomes fully functional. Table 3.6 shows a suggested list of information that could be included in the Debt Policy Statement prepared by DPCO.

Table 3.6: Example of Disclosure Information

Portfolio-level reporting
<ul style="list-style-type: none"> ▪ Estimates and a brief description of: <ul style="list-style-type: none"> – Total exposure to contingent liabilities (annual and net present value) – Total probability-weighted expected value of contingent liabilities (annual and net present value) – Measures of the variability (95th percentile) and distribution of total exposure and expected value. ▪ Brief explanations of each measure and how it was calculated.
Project-level reporting
<ul style="list-style-type: none"> ▪ A comprehensive contingent liabilities table, including: <ul style="list-style-type: none"> – A description of the nature of the contingent liabilities and the associated project – Key underlying risks – Estimated cost of payment if contingent liabilities are realized (annual and net present value) – Probability-weighted expected value of contingent liabilities (annual and net present value) – Measures of the variability (95th percentile) and distribution of possible payments – A description of the management approach. ▪ Brief explanations of each measure and how it was calculated.
<p>A summary table listing the projects being monitored during the year and reporting the expected value, estimated cost of payment if contingent liabilities are realized, and measures of variability (95th percentile)</p>

3.7 Acting on Emerging Contingent Liability Risks

Beyond simply monitoring exposure to contingent liabilities from BOT projects, the Government should actively manage that exposure where possible, by identifying and taking action on emerging issues. Taking early action can help reduce the cost to Government of bearing contingent liabilities. Acting to mitigate risk can also help to keep decision makers, regulatory bodies, and the private party accountable and, in turn, improve the credibility of the Government’s guarantees.

Objective when acting on emerging risks from contingent liabilities: To help reduce the cost to Government of bearing contingent liabilities by reducing the likelihood or cost of those liabilities realizing.

3.7.1 Why is the function important?

In some cases, the Government could have avoided costs associated with problems in the past if risks were identified and action was taken to reduce the likelihood or cost of liabilities realizing. For example, with appropriate monitoring policies in place, some stakeholders may have identified earlier what costs would have been incurred by keeping retail tariffs below cost recovery in the energy sector, and acted to either gradually increase tariffs early on or

avoided accepting further obligations. Similarly, the Government and NHA may have chosen to increase the toll on the Lakpass Tunnel and eliminate the need to compensate the private proponent.

3.7.2 What relevant policies and processes are in place?

As described in Section 3.5 for monitoring contingent liabilities, the 2010 PPP Policy suggests that responsibility for actively managing those liabilities would be shared between contracting authorities and the DPCO. However, no further guidance is provided.

3.7.3 How should the policies and processes be improved?

Systematically monitoring contingent liabilities under PPP projects, as described under Section 3.5 above, enables the Government to identify contingent liabilities that may be at increased risk of realizing. By identifying this early, the Government can then consider the possible actions that could reduce the likelihood or cost of needing to make a payment.

It is difficult to define any specific actions the Government could take, since emerging issues could vary widely. Any action should be analyzed to understand the potential costs and benefits of alternative responses. Appropriate action plans should be included in the monitoring plans as described in Section 3.5. Actions could include:

- Following up with third-party Government agencies to ensure they are providing required inputs (for example, permits) in a timely manner
- Informing Government decision makers responsible for policy or regulatory decisions that may adversely affect the project of the potential costs of an adverse decision
- In certain cases, changing levels of tariffs or charges (and subsidies) to help increased demand keep the financial performance secure
- In extreme cases, re-negotiating the contract or triggering buyout by the Government.

Section 4 describes options for who could be responsible for considering the possible responses and, when appropriate, carrying out any responses found to be justified.

3.8 Budgeting and Paying for Realized Contingent Liabilities

While managing contingent liabilities effectively can reduce the cost or likelihood of needing to make payments, some contingent liabilities will be realized and payments will inevitably be required. The Government should implement a systematic process to budget and pay for contingent liabilities when they do realize to strengthen incentives and provide the private proponent with a clear and credible policy for the Government to meet its obligations.

Objective of analyzing contingent liabilities: To ensure resources are available to make payments promptly when required—improving credibility and clarity as to how costs of contingent liabilities will be borne, and mitigating the fiscal impact.

3.8.1 Why is the function important?

A well-defined system for budgeting and paying for contingent liabilities will ensure the Government has the resources available to meet its obligations and mitigate the fiscal or

budgetary impact of contingent liabilities. By doing so, the Government will also improve the private sector's confidence in the Government's guarantee. More specifically, effective policies to budget and pay for contingent liabilities can help to:

- Incentivize decision-makers to accept the right contingent liabilities, by making it clear who will be responsible for meeting the cost if those contingent liabilities realize
- Improve the credibility of the Government's commitments, by making clear the process and timeline with which the private partner will be paid
- Reduce the adverse fiscal impact of needing to make a payment, by reducing the need for in-year budget cuts or overall expenditure shocks to accommodate the sudden need for an unexpected payment.

3.8.2 What relevant policies and processes are in place?

There is no defined policy for budgeting and paying for contingent liabilities from PPP projects.

3.8.3 How should the policies and processes be improved?

The challenge in budgeting and paying for realized contingent liabilities is that payment obligations may arise unexpectedly during a fiscal year. This means payment obligations may not be able to be reflected in the annual budget, as for other types of Government expenditures, and resources may not be immediately available.

There are several options for budgeting and paying for realized contingent liabilities, as described in Table 3.7. Table 3.7 below describes and evaluates four options, which are not mutually exclusive, for Pakistan:

- Structuring contingent liabilities to reduce the need for unexpected payments
- Requiring contracting authorities to set aside funds in advance against possible future payments
- Budget for payments that may occur in the forthcoming year
- Create budget flexibility to make unexpected payments when required.

Not all of these options will be practical in Pakistan based on existing public financial management legislation. The attractiveness of each option may also depend on the relative importance of the objectives described above. MOF, in collaboration with IPDF, should evaluate the practicality of these options and determine what alternative, or combination of alternatives, is acceptable to private investors and will best achieve the Government's objectives while aligning Pakistan's budgeting laws and accounting practices.

Table 3.7: Approaches to Budgeting and Paying for Realized Contingent Liabilities (CLs)

Possible approach	Description	Relative Advantages and Recommendation
<p>Approach 1: Structure CLs to reduce need to make unexpected payments when contingent liabilities do realize</p>	<p>As described under Section 3.1, well-structured CLs can reduce need for unexpected payments. For example:</p> <ul style="list-style-type: none"> ▪ Defining termination payments as conditional on re-tendering the project and receiving payment from the new contractor (resulting in both increased income and expenditure in the year in question) ▪ Avoiding need for demand-related payments; or if required, define that payments for particular risk guarantees will be due in the year after the shortfall takes place, once the required amount is known and can be budgeted for. 	<p>Where possible, this is the simplest solution to the challenge of budgeting and paying for realized CLs, and should be pursued as a priority. However, it may not be possible for all types of CL; depending on the range of types of CL the Government faces, they may need to adopt one or both of the other approaches</p>
<p>Approach 2: Set aside funds in advance against possible future payments</p>	<p>Setting aside funds in advance can help: (i) create incentives for contracting authorities to take on the right risks (although not necessarily to manage them well, if “already paid for”) and (ii) reduce the need for budget flexibility at the time a CL realizes, since the required payment has effectively already been budgeted for in advance. In turn, this helps improve credibility, since private parties know the Government has funds to make payments.</p> <p>Under this option, contracting authorities would transfer some measure of the cost of the CL (could be expected value or some risk-adjusted expected value) from their budget at the time the CL is accepted, into some kind of fund, which could be:</p> <ul style="list-style-type: none"> ▪ Held as a dedicated Government account that would remain part of the treasury funds ▪ Set up as an external institution, to which funds can be paid from the budget and which would not be considered part of treasury funds (see Section 4). <p>Any set-aside funds should be earmarked by contracting authority (or by project). That is, payments for CLs from a given agency can be made up to the amount that the agency has contributed to the fund.</p>	<p>Setting aside funds could provide strong incentives, reduce fiscal shocks, and increase credibility; however, it has a high opportunity cost and would require more complex valuation</p>

Possible approach	Description	Relative Advantages and Recommendation
<p>Approach 3: Budget for payments that may occur in the forthcoming year</p>	<p>The Government could budget for possible CL payments in the forthcoming year, by:</p> <ul style="list-style-type: none"> ▪ Including a “reserve” or “contingency” item in the overall budget—this could be a standard item, or could reflect the most recent understanding of the likelihood of payments being made, based on monitoring information ▪ Requiring contracting authorities to include in their budget for the forthcoming year any CL that is considered likely to require a payment, even if the CL has not yet realized. <p>In these cases, the relevant budget allocation could be used to make the payment if it is indeed required; if not, it would be re-absorbed into the general fund at the end of the fiscal year</p>	<p>This option reduces the need for in-year budget reallocations or shocks to the fiscal deficit. However, it has several disadvantages:</p> <ul style="list-style-type: none"> ▪ Opportunity cost of not allocating those budgeted funds to some other use ▪ Difficulty of defining the threshold for determining what CLs should be budgeted and getting the budget approved ▪ Risk of prejudicing outcome, by reducing incentives to mitigate CL or acknowledging a contested CL.
<p>Approach 4: Create budget flexibility to make unexpected payments when required</p>	<p>Even applying the above approaches, unexpected payments may need to be made. The Government may want to define how such payments will be accommodated. Any unexpected payment could be accommodated either by cutting expenditure on other budget items, or by increasing the overall fiscal envelope for that year. In the latter case, additional sources of finance must also be found; this could include setting up a dedicated contingent credit line, to ensure finance is always available. For example:</p> <ul style="list-style-type: none"> ▪ Payments could be appropriated and made automatically, extending the fiscal envelope and borrowing from a contingent credit line. Repayments could be part of general Government debt, or could be recouped from agency budgets in the future (if debt repayments can be allocated) ▪ Payment requirements could lead to a supplementary appropriation from the agency, which the MOF would decide how to handle ▪ If an internal “fund” is used, payments could be made by that fund borrowing (subject to automatic Government guarantee) to make payments. 	<p>Need to have some kind of system in place because unexpected payments will always be necessary occasionally. The exact arrangement depends heavily on existing public financial management legislation</p>

4 Who Should be Responsible for Managing Contingent Liabilities

In Section 3 we described each of the recommended eight functions for managing contingent liabilities and how policies and processes could be improved to ensure these functions are performed successfully. To be effective, these functions must link together as a coherent system, with clearly defined institutional roles and responsibilities. In this section we describe and analyze these institutional roles and responsibilities—that is, who should carry out the functions described in Section 3.

The two main options that we consider for allocating the responsibilities to manage contingent liabilities are:

- Option 1: Strengthening existing institutions—contracting authorities, IPDF, MOF and DPCO—by enhancing their roles and responsibilities
- Option 2: Establishing an independent guarantee fund to accept the bulk of responsibilities for managing contingent liabilities

These two options are described in the sections that follow (Sections 4.1 and 4.2).

While there are clear advantages and disadvantages to both options, **we recommend Option 1: that Pakistan adopt an institutional framework for managing contingent liabilities that strengthens existing institutions** and allocates the responsibility for performing the recommended functions to:

- The **Ministry of Finance (MOF) as the oversight agency** responsible for approving financial commitments to PPP, including contingent liabilities
- The **Debt Policy Coordination Office (DPCO) as the division within MOF responsible for the central management of contingent liabilities**, including evaluating submissions, certifying compliance with policy and law, formally accepting, monitoring, disclosing, and ensuring action is taken to mitigate emerging risk associated with contingent liabilities
- **Contracting authorities as the contracting authorities responsible for appropriately allocating risk and structuring contingent liabilities**, complying with submission and approval requirements, monitoring, reporting to DPCO, and taking action on emerging risk
- The **Infrastructure Project Development Facility (IPDF) as the agency responsible for supporting contracting authorities** throughout the steps in the PPP development and contingent liability management lifecycle.

This incremental option is better suited than Option 2 (establishing an independent guarantee fund) to the size of Pakistan’s current exposure to contingent liabilities and allows for sufficient flexibility and speed in implementation.

Option 2 has further disadvantages over the incremental approach. Establishing a Guarantee Fund would certainly need significant investment in further research and institutional design, as well as up-front commitment of Government capital. Because of current exposure to contingent liabilities is heavily concentrated in the energy sector, we do not believe the

exposure justifies setting aside reserves to manage existing fiscal risk in Pakistan. It is important that the energy crisis, which is a large fiscal burden, is addressed; but otherwise resources would be better spent focusing on structuring and completing PPP transactions, so Pakistan can make progress developing capacity and experience in its PPP program. Therefore, we do not recommend the Government establishes an independent Guarantee Fund. In our view, the complexity and cost of this option outweighs the immediate need to address problems with the contingent liability in the Pakistan and has uncertain benefits.

4.1 Option 1: Strengthen Existing Institutions

Option 1 is to develop a contingent liabilities management system that relies on strengthening existing institutions by clarify and formalizing existing mandates and adding new responsibilities. This option focuses on making incremental improvements that:

- Complement the policies and process in place, or currently being developed, for assessing and approving PPP projects
- Use the resources and capacity in existing institutions with the Government.

The primary institutions that could perform the functions we recommend for managing contingent liabilities include:

- **Contracting authorities**—the agencies that enter into PPP contracts, such as PPIB and NHA, are typically responsible for developing and assessing PPP projects, and therefore also for structuring and analyzing the associated contingent liabilities. As the agency with the direct relationship with the contractor, the contracting authority also typically plays a key role in monitoring and taking action on emerging contingent liability risks
- **Infrastructure Project Development Facility (IPDF)**—IPDF has been established within MOF to support contracting authorities in carrying out their functions in developing PPPs and completing new transactions. IPDF is also intended to have a role in monitoring and managing projects during the implementation stage
- **Debt Policy Coordination Office (DPCO)**—DPCO was established in MOF to oversee the Government’s debt policies and manage exposure to debt guarantees and other contingent liabilities. The 2010 PPP Policy explicitly states that DPCO is responsible for the management for contingent liabilities
- **Ministry of Finance (MOF)**—MOF is responsible for the Government’s fiscal policy, including the allocation of budgetary resources and the payment of contingent liabilities should they be realized. The 2010 PPP Policy explicitly states that MOF is responsible for approving all financial commitments to PPP projects.

There are number of options for how the roles and responsibilities for performing the functions described in Section 3 could be allocated to these institutions. The optimal allocation should comply with 2010 PPP Policy and its enabling legislation, which is currently being drafted. It should also work to create efficiencies with the processes that are in place for moving a project through the PPP lifecycle. This includes both the process followed by contracting authorities with experience developing PPPs—such as PPIB and NHA—and the project preparation and feasibility guidelines developed by IPDF. Finally,

the optimal allocation should take into account the ability of each institution to successfully perform the functions based on the resources and capacity within the institutions.

Based on these broad criteria, we have developed a preferred option for allocating responsibilities to manage contingent liabilities. Under the preferred option, contracting authorities have primary responsibility for structuring contingent liabilities and analyzing exposure, as well as having overall responsibility for monitoring and managing that exposure. IPDF is available to provide support to contracting authorities when performing these functions under the same arrangement for preparing and developing PPPs. MOF and DPCO are responsible for evaluating requests, approving, and formally accepting contingent liabilities for particular PPPs. As part of the evaluation process, MOF and DPCO has responsibilities for checking and certifying that approved contingent liabilities are compliant with the structuring principles and guidelines—developed by contracting authorities and approved by MOF—and governing PPP and debt management policies. MOF and DPCO will also have support and oversight role in monitoring and managing emerging risks.

Option 1 has the key advantage of making incremental improvements to the status quo, capitalizing on the strengths of the existing system, and avoiding the need for major institutional change. In our view, Option 1 has other specific advantages:

- Consistency with the mandates of each entity—the 2010 PPP Policy states MOF’s role in approving all financial commitments to PPPs, DPCO’s role in overall management of contingent liabilities, and the role of contracting authorities in structuring and monitoring PPPs
- Alignment of incentives—the distribution of responsibilities between contracting authorities, which have an interest in developing PPPs, and MOF and DPCO, which have an interest in managing fiscal risk, strikes an appropriate balance between implementation incentives (the desire to execute new contracts) and oversight incentives (the desire to limit exposure to risk)
- Resource requirements are consistent with exposure—while the contingent liabilities in the energy sector are large and demonstrate the need for good decision making and risk management policies, outside of the energy sector, exposure to contingent liabilities is currently limited. By focusing on strengthening existing institutions, the Government avoids attempting to develop and implement a new, complex entity that requires excessive resources, will require additional time to become operational, and may prove to be unsuccessful
- More flexible and faster implementation—while there is need for training and capacity building at all levels of Government, this option attempts to best utilize the existing institutional knowledge and organizational capacity in contracting authorities, IPDF, and DPCO. An entirely new entity for managing contingent liabilities would likely take longer to become operational. A more incremental approach also makes it easier to revise and adjust the approach as needed, without requiring major overhauls.

Table 4.1 below lists which of these key institutions would perform the functions under the preferred option. We also provide an alternative for allocating each function among the key institutions and explain what the advantages and disadvantages are compared to the preferred allocation that we are recommending.

Table 4.1: Analysis of Alternatives for Strengthening Existing Institutions

Function	Preferred Option 1 <i>Who should perform the function?</i>	Alternative Option 1 <i>Who should perform the function?</i>
Structuring CLs	<p>The contracting authority, since it is the entity responsible for developing the PPP structure. IPDF can provide support to contracting authorities, as needed.</p> <p>Principles and guidelines should be approved by MOF (since MOF will need to approve the set of CLs, as part of the Government’s financial commitment to the project)</p>	<p>Alternatively, MOF and IPDF could take a more central role in developing PPP structuring principles and contractual mechanisms that would apply to all projects. This approach is more centralized, but does not allow the approach to be tailored to the specific needs and circumstances in each sector</p>
Analyzing CLs	<p>The contracting authority because it is the agency responsible for developing the project proposal—following approved guidelines set by MOF. IPDF can provide support, as needed</p>	<p>The agency responsible for approving CLs (such as DPCO) because the analysis could be done as part of project development <u>or</u> project assessment—following approved guidelines set by MOF</p>
Approving CLs	<p>MOF should provide the final approval based on certification of compliance from DPCO</p> <p>This aligns with the 2010 PPP Policy, which states that:</p> <ul style="list-style-type: none"> ▪ MOF should approve all the Government’s financial commitments to PPP projects, including contingent liabilities ▪ DPCO is responsible for managing contingent liabilities. 	<p>Alternatively, MOF could give DPCO final authority to approve CLs or delegate authority to IPDF</p>
Accepting CLs	<p>MOF should sign the “agreement letter” after the contingent liabilities are evaluated, final PPP contracts are checked, and DPCO has certified compliance with relevant policies (FRDLA and PPP Policy)</p>	<p>Alternatively, MOF could give DPCO final authority to sign “agreement letters” or could delegate authority to contracting agencies. However, this alternative reduces some of the advantages of having the central Government formally issue CLs</p>
Monitoring CLs	<p>Contracting authorities should be responsible for gathering data and for analyzing and re-valuing exposure, and required to report exposure to DPCO, following a prescribed and approved monitoring plan</p> <ul style="list-style-type: none"> ▪ According to the Pakistan PPP Policy (2010), the contracting authority is responsible for monitoring the PPP project, while the DPCO is responsible for managing contingent liabilities 	<p>Contracting authorities could supply data directly to DPCO or IPDF, which could be responsible for analyzing that data, updating the CL valuation, and maintaining monitoring plans</p>

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	<ul style="list-style-type: none"> ▪ IPDF can provide support to contracting agency, as needed—assign “project officer” for projects above a certain value. 	
Disclosing CLs	DPCO should include contingent liabilities from PPPs in the annual Debt Policy Statement. Information for completing the report should be collected through the monitoring function (see above)	Contracting authorities could independently disclose. However, this alternative involves less oversight and is less efficient
Taking action on emerging CL risks	<p>The contracting authority will invariably be central to taking any action to manage the Government’s exposure, since this agency has the direct relationship with the private contractor.</p> <p>Involvement of a central agency is important to ensure the contracting authority is taking actions where necessary, and to support the contracting authority in doing so</p>	In some cases, it will be appropriate for MOF, DPCO, or IPDF to take more of a role in responding to emerging risks, but this not a mutually exclusive alternative
Budgeting and paying	Contracting authorities should have budgetary accountability for contingent liabilities to provide better incentives to accept the right contingent liabilities, and to manage those contingent liabilities well (in cases where the contracting authority is able to control the risk factor on which the CL depends)	No suitable alternative.

4.2 Option 2: Establish an Independent Guarantee Fund

An emerging idea in the international infrastructure community is for governments to establish independent entities to issue and manage guarantees to private infrastructure operators and investors. These Guarantee Funds are designed to take over the contingent liability management function for PPP projects from the government. Establishing such an entity is a second, and considerably more sweeping option for Pakistan to manage its contingent liabilities.

Under this option, the Government would establish and allocate capital to establish an independent Guarantee Corporation as a Government-owned company. The Guarantee Fund would be governed by a board of directors chaired by a representative of MOF. Its day-to-day operations and management would be contracted out to a private financial institution. Besides providing the mechanism by which the Government will make upfront budget commitments to cover contingent liabilities, the Guarantee Fund would manage and oversee the entire process for assessing, approving, and monitoring contingent liabilities, and managing emerging risk.

The Board of the Guarantee Fund would approve requests from contracting authorities for guarantees that would create contingent liabilities to PPP projects and enter into guarantee agreements. When issuing a guarantee, the Guarantee Fund would charge a fee to the contracting authorities. The fee would be valued based on assessment and valuation of the expected cost of providing the guarantee. If the guarantee is not approved or the fee is too high, the contracting authority would need to restructure the project to better manage the risk. Under this option, the total value of the Government's stock of contingent liabilities would not be allowed to exceed the Guarantee Fund's capital, which would depend on the allocation from MOF and any external funding received by the Guarantee Fund.

Outsourcing the management contingent liabilities to an independent Guarantee Fund has a number of advantages over the alternative of maintaining the functions within existing Government institutions. These include:

- Independence from political influence, in particular the temptation to under-value guarantees to meet budgetary and investment targets
- Strong technical capacity for valuing and assessing risk if the Guarantee Fund is operated by a private financial institution
- Potential for the Guarantee Fund to build its own relationships, for example with external financial institutions, and achieve credibility among private investors higher than that of the central government.

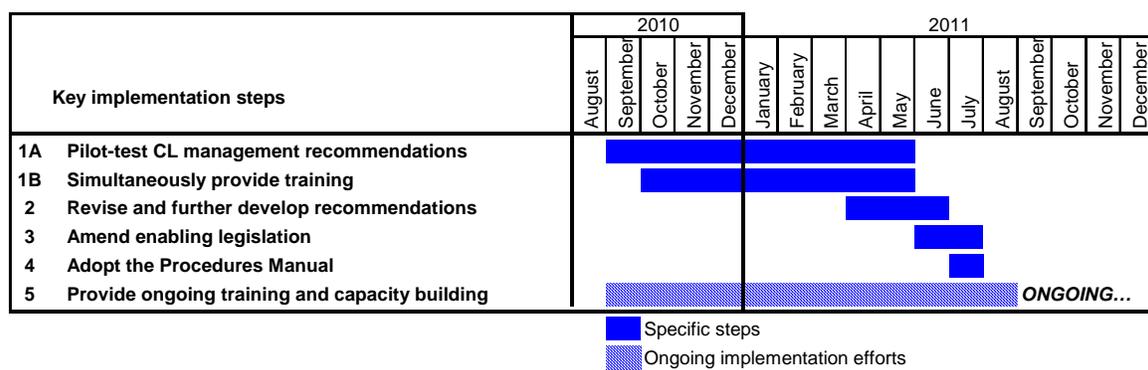
The main disadvantage of outsourcing these functions, in addition to the increased on-going cost of the private financial institution's contract fee, is the relative complexity of establishing the Guarantee Fund as an independent entity. There is very little international experience in developing Guarantee Funds, and the possible advantages have for the most part not been tested. The success of the fund also depends on the participation of private investors and insurers or multi-lateral institutions, which may be difficult to secure. The advantages of establishing a Guarantee Corporation in practice are therefore far from certain.

5 How to Implement the Recommendations

This section describes how Pakistan can adopt, test, revise, build capacity, and fully implement the recommendations we described in Sections 3 and 4 of this Report.

Following the completion of the current assignment, at least five steps will be required to adopt the recommendations and fully implement the policies and processes for managing contingent liabilities. Figure 5.1 shows the steps and provides an indicative timeline for the completing each one. The structure and timeline we present in the figure draws from our past experience providing training to government agencies for adopting and operationalizing components of a contingent liability management framework.

Figure 5.1: Timeline of the Implementation Action Plan



The steps illustrated in Figure 5.1 include:

- **Step 1A—Pilot-test the recommendations on one or more live cases.** We recommend that the Government pilot-test these contingent liability management recommendations on at least one live PPP project that is in the early development or feasibility stage. A pilot-test will provide an opportunity to evaluate and refine the recommendations and will also help close high priority PPP transactions, which IPDF has struggled with to date. A pilot-test could also be expanded to include other parts of the PPP development and implementation process, such as evaluation and approval of viability gap funding—we describe the potential need for this Appendix A where we provide a summary of the workshop
- **Step 1B—Simultaneously provide training.** Training while pilot-testing a PPP project would provide the staff in contracting authorities, IPDF and DPCO, with hands-on experience as well as guidance while implementing for the first time the contingent liability management recommendations
- **Step 2—Revise the contingent liability management framework and develop further guidelines and tools to facilitate the implementation.** The pilot-test in Step 1 will provide the opportunity to evaluate the effectiveness of the proposed contingent liability management framework. Following this evaluation any necessary revisions should be made to improve and finalize the recommendations based on lessons learned. Under each function we have also identified tools or guidelines that may be required to implement the function.

These tools and guidelines should be further develop and approved by MOF, when necessary, as indicated in the body of this report

- **Step 3—Amend enabling legislation.** Each of the functions we have recommended aligns with the current 2010 PPP Policy, however, the policy should be updated or supplemented to include the specific requirements for contingent liability management. The PPP Bill, which we understand will serve as the legislative vehicle to enforce the PPP Policy and is currently being drafted and finalized, should also be amended to ensure the contingent liability management policy is enforceable
- **Step 4—Adopt the Draft Procedures Manual.** As part of this assignment, Castalia has developed a Draft Procedures Manual to help Government agencies in Pakistan fulfill their role in the contingent liability management framework. We recommend that the procedures in the manual be adopted by, for example, MOF issuing a statement to establish the role and responsibility of DPCO as the division within MOF leading contingent liability management and clarifying that project approval will require compliance with the policies and procedures in the Procedures Manual
- **Step5—Provide ongoing capacity building and training**—the Government will likely need to provide some ongoing training to staff within DPCO, IPDF and contracting authorities. The training and capacity building needs should be assessed during the pilot-test of the recommendations..

6 Evaluation of International Experience

There has been a general increase of international interest in managing contingent fiscal liabilities. International standards increasingly require disclosing these liabilities in public accounts, and countries are introducing new approaches to managing and controlling their exposure. However, there is relatively limited international consensus on managing fiscal risk specifically arising from PPP projects in infrastructure. Governments seeking to manage their exposure to risk from guarantees to infrastructure PPPs have done so in a number of ways, reflecting their specific objectives and institutional strengths or limitations.

It is nonetheless useful to consider experiences from other countries. Learning from tried-and-tested common features, and considering what drives the differences that exist, may help Pakistan decide on the best options for its own contingent liability management system. There are frameworks in place or under development in other emerging markets that incorporate some or all of the following features:

- Defining acceptable risks and structuring contingent liabilities
- Defining a standard approach to valuing contingent liabilities
- Defining decision rules for assessing and approving contingent liabilities
- Monitoring and disclosing contingent liabilities
- Budgeting or setting aside funds to cover expected or actual costs (that is, realized costs, which may exceed expected cost) of contingent liabilities
- Paying for contingent liabilities when called.

The mechanisms used to implement these principles, for example the allocation of responsibilities between different entities within government, differ between countries. In the following sections, we present case studies from a range of countries: Colombia, Brazil, Chile, Indonesia, and the State of Victoria, Australia. We then examine the commonalities and differences between these frameworks, and briefly summarize lessons for Pakistan.

6.1 Colombia

During the 1990s, the Government of Colombia issued guarantees for a wide variety of risks in respect of electricity, roads, and telecommunication PPP projects. The value of the contingent liabilities to the Government of Colombia from having issued these guarantees was estimated at around 1.5 percent of the country's gross domestic product in 1997.

At that time, the consensus was that guarantees were issued indiscriminately by implementing government agencies. There were no rules on how to decide whether to issue a guarantee or not, and none on how to cover the Government of Colombia's exposure from these guarantees. As result, many guarantees were offered to poorly structured projects in which the Government of Colombia was bearing an excessive amount of risk.

Between 1998 and 2003, the Government of Colombia defined new rules and procedures for issuing BOT-related guarantees, with a series of laws, decrees, and policy documents. The primary objective of these was to manage the fiscal risks associated with future government guarantees.

Overview

The provision of guarantees in Colombia is now controlled by the Risk Management Unit in the Ministry of Finance. This unit is responsible for assessing and approving guarantee requests prepared by implementing institutions, according to well-specified criteria of acceptable risks. Budget provisions against guarantees are made by transfers from the implementing institution to a contingency fund, a special government account which is managed by a private company.

The Contingency Fund was established by law in 1998. In 2001, a Decree defined detailed rules and procedures for managing contingent liabilities, supplemented by policy documents defining acceptable types of risk, and how each should be managed. In 2003, a further law required the Ministry of Finance to approve the value of the contingent liability of a proposed guarantee.

Projects and risks

Risks that the Government was prepared to guarantee were clearly defined, based on the principle that risk should be allocated to the party that is best placed to value and to control the risk, and that had best access to mitigation, protection and diversification instruments.

For each sector, the Government defined the specific risks that it was prepared to bear or share, as well as the mechanisms that should be used for mitigation. For example, for a toll road project, the Government is only prepared to bear land acquisition risk. Demand risk is borne by the concessionaire, but shortfalls are dealt with by extending the term of the contract until the concessionaire achieves a pre-agreed level of expected revenue, avoiding a fiscal cost.

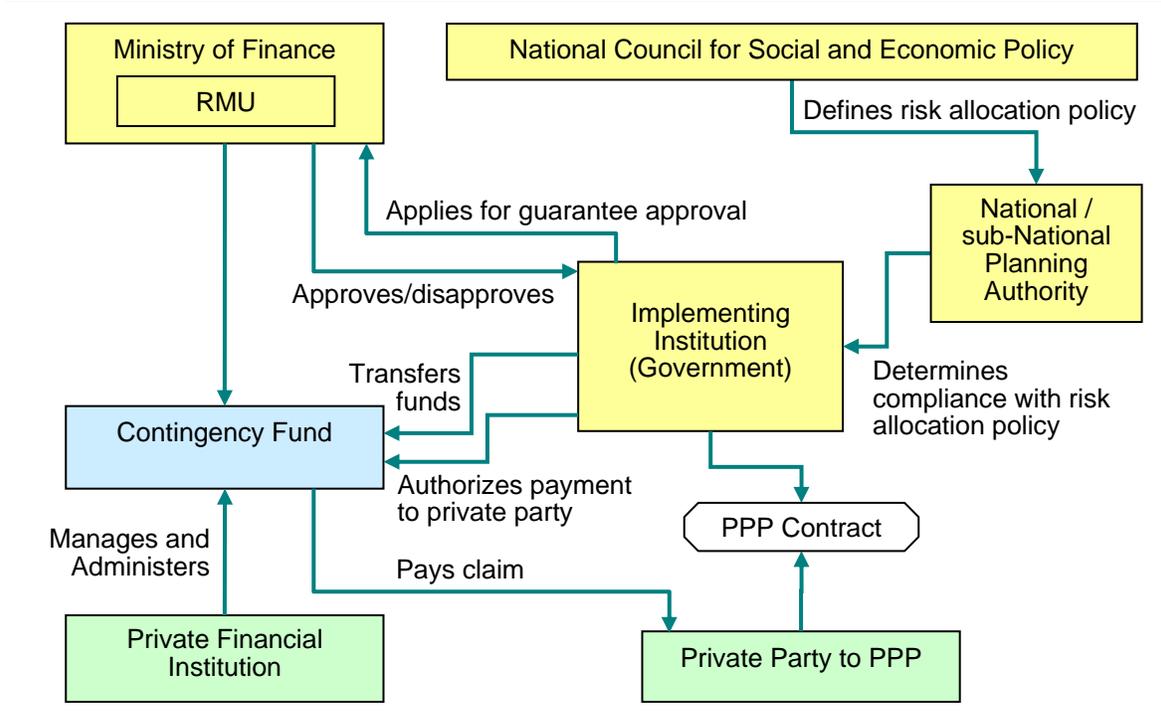
Institutional structure

The institutional structure for managing guarantees in Colombia is summarized in Figure 6.1 below. Responsibilities for setting policy with regard to guarantees, for assessing guarantee proposals and evaluating associated contingent liabilities, and for making the appropriate financial provision, are allocated between the implementing institution, the Ministry of Finance Risk Management Unit, and other government planning authorities:

- Implementing government institutions identify and prepare projects, estimate the value of contingent liabilities, and make transfers into a Contingency Fund according to their proposed payment plan, once approved by the Ministry of Finance. The implementing institution is also responsible for authorizing claim payments, and for meeting payment costs if these exceed the project provision within the Fund
- The National Council for Social and Economic Policy defines the risk allocation policy, while the relevant planning department (for example, national or provincial) determines the compliance of a particular proposal with this policy
- The Risk Management Unit of the Ministry of Finance defines the policy for valuing contingent liabilities. It is responsible for approving guarantees, along with their valuation and associated payment plans. This decision is based on information submitted by the Implementing Institution, as well as a recommendation from the relevant planning office.

The Contingency Fund, a special account administered by a private financial institution under contract to the Ministry of Finance, is essentially a vehicle for making budget provisions against guarantees. There is no direct contractual relationship between the Fund and the private investor.

Figure 6.1: Colombian Guarantee Management—Institutional Structure



Operating policies

In preparing and approving claims, and managing the contingency fund, the Government and contracting private financial institution are guided by policies designed to manage the fiscal risk of providing guarantees:

- Guidelines for calculating the value of the contingent liabilities—that is, the present value of the expected cost of the guarantee to the Government—require the use of risk-pricing modeling methods such as Binomial trees or Monte Carlo simulations
- Mandating the implementing institutions to make transfers to the Contingency Fund equal to the expected value of the guarantee ensures the expected value of the total stock of guarantees does not exceed the assets of the Fund. These transfers are made up-front, and may be topped up over time if the expected value of the guarantee changes.

The Contingency Fund holds a separate account for each project, funded by the transfers from the implementing institution. In the case of a payment claim, any shortfall is met by the government institution that is party to the PPP contract.

6.2 Brazil

Brazil established its current PPP and Risk Management Framework between 2004 and 2006. Brazil was relatively new to the involvement of private finance in infrastructure provision, so the primary objective of the framework was to mobilize private capital to finance extensive infrastructure investment.

Overview

In Brazil, an independent Guarantee Fund—the *Fundo Garantidor de Parcerias Publico-Privadas* (FGP)—forms the basis of the institutional structure for managing PPP Guarantees. The decision to approve guarantees proposed by government agencies is controlled by the government as the sole shareholder; all other functions are the responsibility of a management contractor. Provisions against guarantees will be made by allocation of the fund's assets—hence the stock of guarantees is capped by the size of the fund. The Government nonetheless remains liable for any realized payment obligations that exceed the size of the fund.

A PPP Law in 2004 defined the legal framework for PPPs in Brazil, the general guidelines for project contracting, and also authorized the creation of the FGP. The initial capitalization of the FGP, to a limit of US\$ 1.5 billion, was authorized by a 2005 Decree. It was formally launched in February 2006, but its operating policies have not been fully published.

Selection of risks

The FGP provides guarantees to cover the financial obligations of government entities under PPP contracts, which generally constitute direct payments for specified services. Certain risks faced by the private PPP investors are explicitly covered or mitigated by Government through this structure, namely:

- The risk of the government entity party to the contract facing insolvency, or becoming illiquid—that is, facing a temporarily inability to make a due payment—this includes the risk of lower receipts due to a demand downturn
- The risk of payment delay due to a protracted legal process, and a long queue of payment claims, in case of dispute.

The framework does not have any specific guidelines as to what other risk events guarantees may cover. This is left to the discretion of the FGP.

Institutional structure

The FGP is a government-owned stock corporation, which was capitalized by the Government with US\$ 1.5 billion in shares of publicly traded companies and state-owned enterprises (SOEs). The Government controls company decision-making through the Shareholder Assembly, including approval of guarantee proposals. Funds are thereby kept segregated from the budget process, enabling multi-year payment commitments.

The FGP is managed by the government-owned commercial bank Banco de Brasil (BB), which manages its day-to-day financial operations, as well as having the following responsibilities:

- Establishing the process for project valuation and analysis
- Designing and preparing potential PPP project guarantee proposals, for approval by the Shareholder Assembly

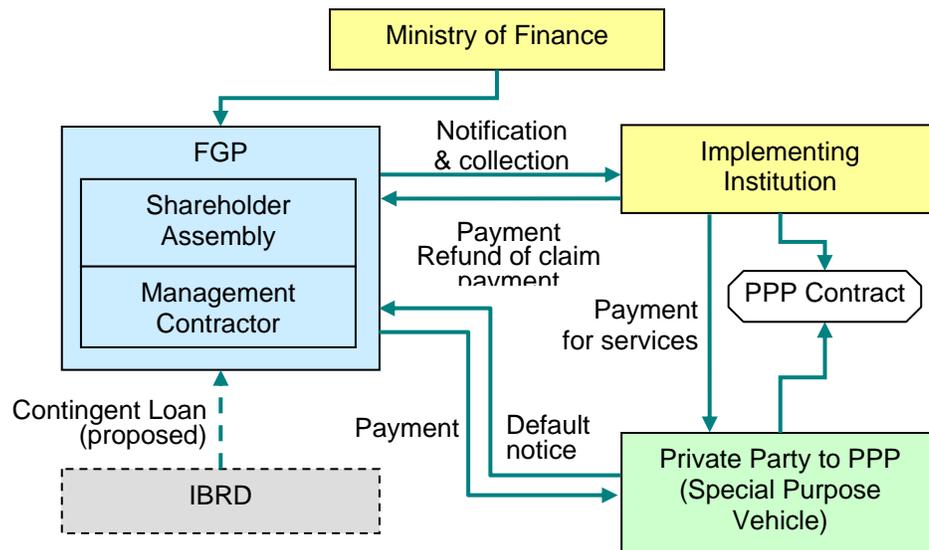
- Drafting guarantee contracts and representing FGP in judicial processes, and
- Publishing financial statements and information on the stock of guarantees.

Guarantees are triggered by non-payment of the implementing institution, if unrelated to performance issues. Disputed claims are subject to a private law process of arbitration. The framework contains a commitment to pay within a certain time frame of either the trigger, or the resolution of a dispute—the FGP’s private entity status exempts it from the constitutional requirement of complying with judicial decisions in chronological order. The guarantee agreement includes a provision for the FGP to recover from the Institution the cost of paying a claim under the guarantee.

The World Bank agreed in principle to provide contingent capital to the FGP, most likely in the form of a contingent loan, to ensure funds are available should guarantee calls exceed the capital in the fund. This increases the credibility to the private sector of FGP guarantees.

The institutional structure for managing guarantees in Brazil is summarized in Figure 6.2.

Figure 6.2: Brazilian Guarantee Management – Institutional Structure



Operating policies

The operating policies of the FGP have been established by Banco de Brasil, particularly with regard to the criteria and processes by which the eligibility of projects for guarantees will be assessed. Developing these is part of the mandate of the FGP management.

Some provisions have been made for how the fiscal risk arising from the contingent liabilities will be managed. The present value of all guarantees provided by the FGP is capped at the level of its assets. A definition on how the “present value of the guarantees” is calculated has not been published. FGP can use various types of guarantee instruments, but each must be covered with assets of similar characteristics, such as liquidity and average life. However, the capitalization of the FGP with shares only may limit the capacity to achieve this.

6.3 Indonesia

In the early to mid 1990s, Indonesia established a large number of PPPs, mainly in the power, road, and telecommunications sectors. In the absence of any defined framework for Government support to PPPs, these deals were opaque, often involving general, ambiguous guarantees such as letters of support to PPAs. When the Asian financial crisis hit Indonesia in the late 1990s, the drop in demand and devaluation of the Indonesian rupiah left many projects unsustainable and subject to forced renegotiations or cancellation.

As a result, public private partnership development in Indonesia stopped until 2005–2006. At this time a new focus on PPPs in infrastructure emerged and the Government began to develop a legal and institutional framework for infrastructure PPPs. The key objective of this framework is to mobilize private investment in infrastructure by provision of credible Government guarantees.

Overview

The Government has recently developed a new risk management framework for PPP projects. As part of that framework, an independent Guarantee Fund, the *PT Penjaminan Infrastruktur Indonesia* (PII), was formally established in December, 2009. The PII is a fully state-owned corporation, and has been established with an initial capital transfer from the Government of IDR 1 trillion (around USD 107 million). Additional capital is expected to be provided in the coming years. The Government intends PII to be a commercially-run guarantee company, issuing guarantees in its own name and subject to its own policies (to be developed with substantial support, and further capital contribution, from the World Bank).

The establishment of this fund supplements and supersedes the previous institutional arrangements for managing risk from PPP projects. Presidential Regulation 67, issued in 2005 (PR67) defined the legal basis for PPPs in Indonesia. This was supplemented by the Ministry of Finance regulation PMK38, issued in 2006, which provided a framework for managing the associated risks (defining acceptable risks and processes to manage their fiscal impact), under the Risk Management Unit of the Ministry of Finance. Both regulations have since been circumvented in practice.

Projects and risks

The PMK38 regulation established broad categories of risk against which the Government should consider issuing guarantees, based on the principle that that risk should be allocated to the party best able to mitigate or absorb it. These included political risk, demand risk, and certain project performance risks such as land acquisition and contract changes. The regulation also stipulated that projects must be technically and financially feasible, and awarded through competitive tender, to be eligible for guarantee. However, a number of projects that do not appear to fulfill these criteria have since been approved for Government support. The PII has yet to publish any criteria as to specific risks for which it will consider providing a guarantee.

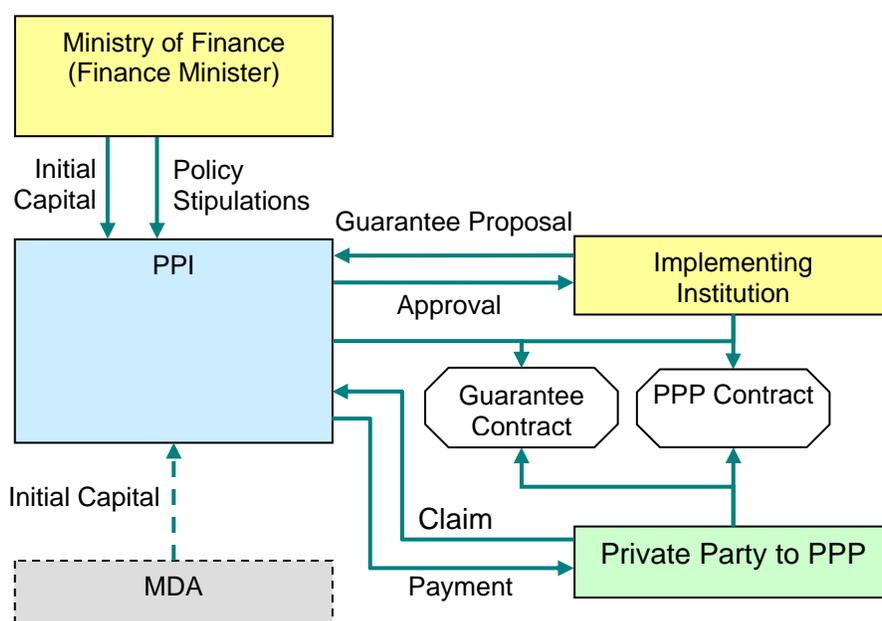
Institutional structure

Until recently, the Risk Management Unit (RMU) within the Ministry of Finance oversaw the guarantee process. The RMU's responsibilities—as defined in the PMK38 regulation—were to verify the compliance of the project with the criteria outlined above and to analyze the fiscal costs and risks resulting from proposed support. The decision of the Minister of Finance on whether to provide a guarantee, as proposed by an implementing institution, was

based on the recommendation of the RMU, along with verification by the National Committee for the Acceleration of Infrastructure Provisions (KKPPI) that the project is in line with policy priorities.

In order to better manage fiscal risk and improve the credibility of guarantees, the Ministry of Finance has now established the *PT Penjaminan Infrastruktur Indonesia* (PII), an independent Guarantee Fund, as a state-owned enterprise. The PPI has been capitalized by Government, with an initial transfer of IDR 1 trillion. The PPI will report directly to the Minister of Finance; its internal structure has not been publicly announced. It is intended to operate as a commercially-run guarantee or insurance company—issuing guarantees in its own right for a premium charged to the private contractor, and managing its assets to adequately cover the cost of required payments. The proposed institutional structure for managing guarantees in Indonesia is summarized in Figure 6.3 below.

Figure 6.3: Indonesian Guarantee Management – Suggested Institutional Structure



Operating policies

The PMK38 regulation introduced the broad criterion that guarantees would be issued only when the resultant fiscal cost and risk does not “exceed the fiscal capacity of the State to bear.” The new institutional structure will concretize this principle, by limiting PPI to issuing guarantees that can be covered by the value of its assets, thereby both ensuring provision against expected losses, and placing an overall cap on the exposure to guarantees. Detailed policies for PPI have yet to be developed, with substantial support (as well as a further capital injection) from the World Bank. These policies will include the approach to assessing and pricing proposed guarantees. No approach to recovering costs of guarantee payments triggered by Government behavior has yet been defined.

6.4 Chile

Chile began its PPP program in the early 1990s, with highway concessions as a solution for reducing its infrastructure deficit while maintaining fiscal discipline and ensuring that highways were properly maintained once they were built. The Concessions Law was passed in 1991 and the concessions program began in earnest in 1994. Chile's concession program now includes highways, airports, jails, and other types of public infrastructure (such as stadiums and public transport transfer stations).

The Government of Chile offers some guarantees to infrastructure PPPs, mainly focused on traffic levels (the bulk of the projects involve transportation). Its goal is to reduce the risk profile of a given project in which investment decisions made by the Government could lower the project's cost of capital and thus the total cost of the project. The Government considers that its guarantee program has successfully achieved this goal.

The Government is in a strong fiscal position. It has maintained a structural budget surplus of one percent of GDP since 2001. The major risk rating agencies—Fitch Ratings, Moody's, and Standard & Poor's—have rated its sovereign bonds as “investment grade” since before 2000. Its sovereign risk, measured in basis points, was the lowest in Latin America for eight years, until creeping just above Mexico's in September 2007. Chile's framework for managing the fiscal risk of government guarantees reflects its sound fiscal position, and is geared toward monitoring the fiscal implications of the guarantees.

Overview

Chile's framework for managing government guarantees to infrastructure projects centers around structuring and valuing the contingent liabilities that arise from these guarantees. In 2003, the Government instituted a policy for valuing, reporting, and monitoring all of its contingent liabilities. This includes not only guarantees to infrastructure projects, but also to the debt of state-owned companies, financing for higher education, and minimum pensions.

Although the policy has been followed continuously since 2003, it was made into law by the Fiscal Responsibility Law (*Ley de Responsabilidad Fiscal*), approved in 2006. The Concessions Law (*Ley de Concesiones*) and the Law of Financial Administration of the State (*Ley de Administración Financiera del Estado*) also underpin Chile's policies on issuing government guarantees.

The Government—through the Ministry of Public Works—is currently party to concessions for 22 inter-city highway projects, seven urban highway projects, 10 airports, two jails and several other public buildings. All but three of the inter-city highway projects, and most of the airports, have a minimum revenue guarantee. Only two urban highways have a minimum revenue guarantee.

The value of the contingent liabilities associated with guarantees to infrastructure PPPs has been very low since the policy of valuing and reporting them began in 2003. Their value has fluctuated between 0.15 and 0.25 percent of GDP, or approximately 0.3 to 0.8 percent of the Government's annual budget. The present value of the future payments under guarantees to infrastructure PPP projects at the end of the 2009 fiscal year was US\$342 million.

Projects and risks

There are no formal rules regarding the types of risks that the Government may accept through guarantees, or the projects that it may provide guarantees to.

All public investment projects—including concessions, are subject to a thorough evaluation involving the Ministry of Public Works, Ministry of Planning and Cooperation, Ministry of Finance, and the Comptroller General. The objectives of this evaluation are to ensure that projects:

- Are consistent with the Government’s infrastructure plan
- Pass a social cost-benefit analysis
- Are undertaken by the public sector or private sector depending on which is best-placed to carry them out, and
- Are acceptable from a macroeconomic and fiscal sustainability perspective.⁴

Under the Law of Financial Administration of the State, the Ministry of Finance must also approve the procurement documents of any concession or PPP contract before it goes to bid. The terms of the guarantees are included in these documents. The Contingent Liabilities, Guarantees and Concessions Unit (*Unidad de Pasivos Contingentes, Garantías y Concesiones*) in the Ministry of Finance is responsible for reviewing and approving the guarantees included in the procurement documents.

Types of guarantees the Government has provided include:

- Minimum revenue guarantees, for projects in which decisions made by the Government have a significant effect on the revenues of a project. Minimum revenue guarantees to highway projects constitute the largest component of Chile’s infrastructure guarantee program. These have more recently been replaced, by introducing variable-length contracts, where the length of the concession varies to allow the concessionaire to achieve a certain minimum level of revenue. This type of guarantee does not create a contingent liability for the Government
- Guarantees against devaluation of the Chilean peso were provided until 2005 by mutual agreement with concessionaires in which both down-side and up-side risks were shared. Development of the domestic capital market has since allowed concessionaires to raise peso-denominated debt, obviating the need for these guarantees.

Companies bidding on a concession may choose whether or not to accept the guarantee offered in the procurement documents. If they choose to accept it and win the concession, they must make a payment to the Government equal to the present value of the expected cost of the guarantee, as measured by the Government. The Government typically also offers a termination payment guarantee, should the project company default on its obligations. However, since the payment is conditional on the government re-tendering the concession and set equal to the price obtained, this creates no contingent liability for the government.

Policies for managing guarantees

The Chilean Government’s system for managing its exposure to risk from contingent liabilities focuses on structuring its guarantees well to minimize fiscal risk, and on valuing and reporting its exposure. Line ministries bear the cost of guarantees once these have been called.

⁴ International Monetary Fund, *Public-Private Partnerships, Government Guarantees, and Fiscal Risk*. Washington, D.C. 2006.

The Contingent Liabilities, Guarantees, and Concessions Unit of the Ministry of Finance is responsible for **valuing** the exposure. This unit estimates the present value of the government's contingent liabilities using stochastic analysis through Monte-Carlo simulations to measure the risk associated with the risk factors underlying the guarantees, and Black-Scholes to value the guarantees.

The Government began **reporting** the value of its contingent liabilities in its annual Report on Public Finances (*Informe de Finanzas Públicas*) in 2003. Since 2007, the Government has issued a more detailed annual report on contingent liabilities. In these reports, the Government also publishes the value of the payments that it knows it will have to make under its guarantees. The obligation to report the value of contingent liabilities was formalized in the Fiscal Responsibility Law of 2006.

The minimum revenue guarantees are **paid** at the end of the fiscal year. Government agencies and ministries that are party to guarantees—including the Ministry of Public Works—subtract the value that must be paid on the guarantees from the next year's budget to determine the amount of money they may spend in the next year. For example, concessionaires' revenue shortfall in 2009 determines how much the Government must pay to them under the minimum revenue guarantee. The Government knows what this amount is at the end of the 2009 fiscal year. This amount is subtracted from the Ministry of Public Works' budget for the 2010 fiscal year.

Although payments on Government guarantees come from line ministries, the Government's net exposure from minimum revenue guarantees is offset by the initial payment made by the concessionaire. However, the Government incorporates the guarantee fee into its consolidated accounts and has not set up accounts to show guarantee claims offsetting the guarantee fee.

The Government has considered establishing a guarantee fund for infrastructure PPPs. However, because the value of the contingent liabilities in relation to GDP and the Government's budget is so small, the Government has determined that the benefit of establishing this fund would be minimal. The Government monitors the value of the contingent liabilities but has not found it necessary to put into place any other mechanisms to cover its exposure from these liabilities.

6.5 Victoria, Australia

Under Australia's federal system of government, most infrastructure development falls within the responsibility of State governments. PPP policies have largely been developed at a State level—the policy of the state of Victoria is a good example.

Victoria introduced a PPP program in 2000, since which time twenty projects have been successfully developed. The program's primary objective is achieving value-for-money in public expenditure on infrastructure.

Overview

The Victorian State government has very strong finances, and a triple-A credit rating. This means there is little need for explicit fiscal risk mitigation measures to cover government guarantees to PPP projects. Overall project risks do nonetheless need appropriate management. The Victorian Government has therefore introduced a comprehensive management framework for PPPs—"Partnerships Victoria"—to ensure that the risks the

Government undertake through PPP projects are justified and provide good value-for-money.

The “Partnerships Victoria” framework was outlined in a policy document and has been periodically updated with the publication of implementation guides⁵. There is no specific legal framework for the development of PPP projects, although project-specific legislation has been passed for certain major projects, for example when new regulatory authority is necessary.

Risk and project selection

The main thrust of the Partnerships Victoria policy is the definition of those risks the Government will accept in relation to PPP contracts.

The initial policy document laid down the principle that, after pre-supposing that the private party bears all project risks, the Government should “take back” those risks it can manage at lower cost. Two further principles were also established: whoever is allocated risk must have the freedom to choose how to handle and minimize it, and the materiality of the risk should be a consideration in its allocation.

The Government set out its initial approach to the allocation of each type of PPP project risk in the Risk Allocation and Contractual Issues Guide, issued in 2001. In 2005, in light of its experience in creating and implementing PPP projects, the government published the Standard Commercial Principles Guide, which acts as a basis for all PPP contracts. This includes an updated set of risk allocation preferences, and defines how these will be reflected in the terms of a PPP contract.

The evaluation process for each PPP project is also clearly outlined in the Partnerships Victoria policy. This involves a quantitative cost-benefit analysis of PPP provision, including the cost of the guarantees incorporated in the PPP contract, in comparison with other alternatives such as public sector provision. Concessionaires are selected by way of a rigorous and transparent system of public tendering.

Institutional structure and policies for managing contingent liabilities

The Victorian Department of Treasury and Finance has overall responsibility for PPP policy. Ministers and department heads are responsible for procuring PPP contracts within their portfolio and departmental responsibility, and have the authority to enter into contracts on behalf of the state government. State Cabinet approval is required, however, at several stages in the planning and procurement process, which is set out in the Partnerships Victoria policy. Any guarantees that form part of a PPP project are contained within the project contract; no independent Government guarantees are issued.

Since most Partnerships Victoria projects are paid for by Government departments, rather than users, those payments are known and must be factored into the budget of the relevant department. These kinds of PPP project obligations are reported as part of State debt as “financial leases”. Even for the limited user-pays projects (such as the EastLink toll road), the Government has not borne demand risk. This means that in all cases, the risks retained by the Government are very limited. The State of Victoria budgets for most of these risks, when quantifiable—which are largely during the construction period—by including an estimated value in the relevant department’s budget. This approach is seen as relatively

⁵ Partnerships Victoria materials are available online, at www.partnerships.vic.gov.au.

inefficient, since the budgeted amount is almost always spent. The State of Victoria reports all contingent liabilities as a note to the balance sheet in its accounts, as required by the Financial Management Act (1994). This includes information on contingent liabilities from PPP projects where applicable: typically, this comprises a paragraph describing the contingent liability.

6.6 Lessons from the International Examples

The examples presented in Sections 6.1 to 6.5 illustrate that, despite their largely common principles, there are both similarities and differences between different countries' systems for managing the provision of guarantees to PPP projects. Learning from tried-and-tested common features, and considering what drives the differences that exist, may help Pakistan decide on the best options for its own contingent liability management system.

As a starting point, certain basic institutional features are common to all or most countries:

- Risk and contingent liability management frameworks are established by law—ensuring policies and responsibilities are mandatory and enforceable, and so credible to the private sector
- There is a central approval process for PPP projects, including contingent liabilities—since it is the National Government that ultimately bears the risk of PPP project guarantees, and is best placed to weigh up the costs and benefits of competing demands for fiscal resources
- A specialist unit within the Ministry of Finance oversees the policy with respect to government guarantees to PPPs—since some specialist skills and knowledge are required.

Figure 6.3 below summarizes the different countries' approaches to the risk and contingent liability management functions listed in the introduction to this note. In the remainder of this section, we discuss these functions in turn, analyzing the reasons behind the various international approaches, and drawing lessons for Pakistan.

Table 6.1: International Approaches to Contingent Liability System Features

Feature	Colombia	Brazil	Indonesia	Chile	Victoria
Defining acceptable risks and structuring contingent liabilities	Specific risks and mitigation mechanisms defined by sector	To be developed	Principle for risk allocation defined; guarantee structures in development	None, but strong precedent in practice	Specific risks and appropriate contract terms defined
Setting standard valuation approach	Defined—modeled Expected Values and range	In development	In development	Defined—modeled Expected Values and range	Defined—modeled Expected Values and range
Assessing or approving contingent liabilities—defining decision rules	For all but low-probability guarantees, contracting authorities must budget up-front: decision thereby integrated into budget process	In development. Overall exposure capped by size of guarantee fund	In development. Overall exposure capped by size of guarantee fund	Guarantee fee charged to private contractor and guarantee optional (for revenue and exchange rate guarantees)	None distinct from definition of acceptable risks
Monitoring and disclosing contingent liabilities	Exposure monitored to inform required budget transfers to fund (to maintain level for each project equal to expected value). No explicit reporting of contingent liabilities from PPP projects	Exposure monitored by guarantee fund; reporting requirements not yet clear	Exposure monitored by guarantee fund; reporting requirements not yet clear	Exposure monitored by finance ministry, and disclosed annually in a detailed annual report	Exposure monitored by finance ministry, and disclosed annually in notes to State balance sheets
Budgeting or setting aside funds to cover expected or actual value (above expected cost) of contingent liabilities	Expected cost covered by transfers to fund. If actual value exceeds expected cost, difference met from budget of implementing institution	Expected cost covered by allocating guarantee fund assets—actual cost covered by any remaining non-committed guarantee fund assets	Expected cost covered by allocating guarantee fund assets—actual cost covered by any remaining non-committed guarantee fund assets	None	Contracting authority includes expected value of quantifiable liabilities (typically small) in relevant year’s budget

Confidential

Feature	Colombia	Brazil	Indonesia	Chile	Victoria
Paying for contingent liabilities	Contracting authorities transfer expected cost of guarantees to fund and must cover any unexpected additional costs from budget	Guarantee fund pays from its assets	Guarantee fund pays from its assets	Costs of guarantees charged back to contracting authorities ex-post	Contracting authorities pay from budgeted amount (or additional appropriation) for quantifiable liabilities; others paid through mid-year adjustment if required

Defining acceptable risks and structuring contingent liabilities

Since providing guarantees constitutes a cost to government, most countries seek to ensure this cost is justified. By defining the risks the government is prepared to bear, countries can attempt to maximize the benefits from provision of guarantees to PPPs.

The level of detail to which acceptable risks are defined varies between countries, and broadly increases with the country's level of experience in planning and implementing PPP projects.

In Indonesia, for example, the principles by which risks should be allocated, and some broad categories of risk the government may accept, are outlined, whereas in Colombia, with a longer history of PPP investment, specific acceptable risks are defined for each sector. In Chile, there are no formal rules, but there is strong precedent as to what types of risks and projects the Ministry of Finance has approved guarantees to, and increasing sophistication as to how these guarantees are structured. In Victoria, the acceptable risks, and best methods for allocating these through contract terms, have been laid out in more detail over time in successive policy guides.

This trend could occur for a number of reasons:

- As governments implement more PPP projects, they become more conscious of the necessity to accurately define risks the government is prepared to guarantee, to prevent excessive fiscal exposure (as was the case in Colombia)
- Governments may prefer to postpone the introduction of constrictive definitions of acceptable risks, while gaining PPP experience (as in Victoria, Australia).

In the early stages of a PPP program, the total risk exposure to PPP projects is small relative to the government budget. The government may choose, at this stage, to accept risks beyond those justified by optimal efficient risk allocation, in order to attract private investors and build confidence in the PPP program. That is, the government may rationally accept heightened fiscal risk as part of the cost of developing a culture and understanding of PPP. In Brazil, for example, the selection of risks to guarantee is left to the discretion of the FGP.

Setting a standard approach to valuing contingent liabilities

Of the possible components of a system to manage the fiscal risk arising from government guarantees mentioned above, the one consistently present across countries is a standard approach to valuing contingent liabilities. Whatever risk management structures are in place, they rest on properly valuing the expected cost of the guarantees.

Defining decision rules for acceptable contingent liabilities

The extent to which the government sets specific decision rules for acceptable contingent liabilities also varies between countries:

- In Victoria, there are no specific criteria on contingent liabilities: these will be accepted if the project is overall cost-benefit justified (based on rigorous analysis) and the risks are appropriately allocated
- In Indonesia and Brazil, the overall size of the guarantee fund provides a cap on the total possible contingent liability exposure, within which any given project must fit. No further decision rules are specified on the acceptable extent of contingent liabilities at the project level, beyond general project eligibility criteria

- In Chile and Colombia, different mechanisms of charging for contingent liabilities are used to inform the decision as to whether these should be accepted. In Colombia, contracting authorities must transfer the expected cost of most quantifiable liabilities to the contingency fund: this means the cost of those liabilities must be considered in that agency's budget decision-making. In Chile, this decision has, in the past, been passed to the private contractor, by offering and charging for "take it or leave it" guarantees on revenues and exchange rates.

Monitoring and disclosing contingent liability exposure

Monitoring contingent liability exposure is a key part of the system for managing that exposure, in particular in Chile and Colombia. In Colombia, contingent liabilities are re-valued each year, and additional transfers required from the contracting authorities should the amount in the project's "account" in the contingency fund be lower than the current expected value. In Chile, contingent liabilities are re-valued each year for public reporting.

Contingent liability exposure is disclosed in Chile and Australia, following international Government accounting standards. This disclosure takes different forms in the two countries. In Chile, a "contingent liability report" is published annually, and includes quantitative valuations of contingent liabilities (where possible) as well as extensive discussion of this exposure. This report was introduced in 2007, and initially focused on contingent liabilities under PPP projects. Over time, it has been extended to cover other types of contingent liabilities. This disclosure is the central feature of Chile's approach to managing contingent liabilities from PPP projects.

In Victoria, Australia, information on contingent liabilities from PPP projects is published in a note to the balance sheet in the State's accounts statements, alongside information on all other sources of contingent liability exposure. Since the contingent liabilities that Victoria accepts under PPP projects are limited and generally not quantifiable, the information published is qualitative in nature and typically brief.

Setting aside funds towards future payments on contingent liabilities

Setting aside funds for expected and unexpected losses helps manage the fiscal impact of bearing contingent liabilities. Again, the approach to these functions differs between sample countries. This may be for a number of reasons:

- Experience with management of PPP guarantees—in particular whether they have been paid as and when owed
- Size of the stock of contingent liabilities which must be managed
- Vulnerability of government finances to fiscal shocks; for example, if a country has a fiscal surplus or low fiscal deficit and relatively easy access to loan financing, it is better able to meet sudden fiscal demands.

An important related factor is the degree of credibility of the government's guarantees. If the private sector perceives that the vulnerability of government finances to the contingent liability arising from government guarantee is low—whether because of the small stock of PPP projects, or lower vulnerability in general—it will have more reason to believe that the government will meet its commitments in case of a claim. Where this is not the case, there is a greater need for a dedicated fiscal risk management for government guarantee provision.

In Victoria, Australia, there is no need for an explicit framework for managing fiscal risk for guarantees. Victoria has an AAA rating, runs a fiscal surplus, and has low financial liabilities. While Victoria is very careful to take on only justified risks from PPP projects, it does not need to incur the expense of earmarking funds against guarantees to achieve credibility, or fiscal stability. The situation is similar in Chile, where the government's fiscal position is sound (structural surplus of one percent), the stock of contingent liabilities is small, and guarantees are well-structured to limit their fiscal impact.

The Governments of Colombia, Brazil and Indonesia, in contrast, have established guarantee funds, to set aside funds for future payments against contingent liabilities from PPP projects. These funds differ in nature:

- The Colombian fund is essentially a Government account, allowing budget transfers by contracting authorities to be set aside to the value of expected costs (without provision for unexpected losses: that is, cases when actual costs exceed expected costs). Decisions on issuing and paying for guarantees are made by the relevant Government departments
- The Brazilian and Indonesian funds are independent legal entities, separate from government accounts, privately managed, and capitalized upfront by transfers from central government. Under this approach, responsibility for assessing and valuing guarantee proposals is placed fully in the hands of the private financial institution managing the fund. Any payments required are made from the fund's resources.

Both of these types of system are costly to implement. Direct costs include the up-front cost of establishing the institution and on-going management fees. There is also an opportunity cost of setting aside funds, including the use of credit availabilities from international institutions—this is particularly high when substantial funds are set aside upfront against possible future projects as in Brazil and Indonesia. However, doing so substantially reduces the fiscal risk from realized liabilities and can help improve the credibility of payments (if the fund is well-financed, particularly if supported by an international financial institution). The extent to which this approach is cost-benefit justified will depend on the Government's objectives for managing contingent liabilities. In Indonesia, for example, the guarantee fund is being considered in part to overcome the lack of credibility of the Government's guarantees due to its history of renegeing on PPP contracts.

Paying for realized contingent liabilities—charging contracting authorities

In the systems described above in Brazil and Indonesia, there is no requirement for contracting authorities to make budget provisions against guarantees to their own PPP projects. This potentially weakens the incentive for the institution to accept appropriate risks, and accurately value guarantees. Instead, the guarantee financial institution plays a “gatekeeper” role to ensure only properly valued and structured guarantees are issued.

In Chile, in contrast, contracting authorities are generally required to pay for the cost of guarantees in the following year, ensuring these agencies do ultimately bear the cost. In Colombia, funds set aside in a contingency fund against expected costs of guarantees to PPP project are provided from the budgets of the proposing institutions, which also bear any cost of a call over and above the contingency amount. While the funds are managed centrally by a private financial institution, and decisions are subject to central oversight, institutions are

essentially responsible for their own budget provisions, resulting in a strong incentive to accurately value and appraise proposed guarantees to PPP projects.

The advantage of the latter approach—particularly that of Colombia—is that, since implementing institutions must directly budget for the full cost of PPP projects including guarantees, these projects will be subject to more rigorous scrutiny and prioritization in the course of each institution’s internal budget process. However, it places a high demand on the capacity of the institutions to properly evaluate guarantees. Since individuals within institutions are exposed to political pressures—unless supervision and accountability of the process is strong—perverse incentives to under-value risks may remain. Where the PPP program is young, there may also be a need to build interest among institutions, and so central government may choose to take on more of the risk of projects at this early stage.

Appendix A: Status Quo Report

This Appendix presents the Status Quo Report submitted during the first phase of this assignment.

Executive Summary

This Status Quo Report is the second deliverable in Castalia's assignment, funded by the World Bank, to improve how contingent liabilities are managed in Pakistan. In the report we identify the existing public private partnerships (PPPs) and their associated contingent liabilities in Pakistan. We also provide an assessment of the effectiveness of the policies and processes governing PPPs generally and contingent liabilities specifically to identify ways of improving how contingent liabilities are managed in the future.

We find that:

- The Government is exposed to contingent liabilities in the energy sector through its obligations to Independent Power Producers (IPPs) and Rental Power Plants (RPPs)
- Outside of the energy sector, there is limited exposure to existing contingent liabilities due to the few PPP projects that have been implemented
- Policies and processes in place are not adequate to facilitate good decision making when structuring PPPs, accepting contingent liabilities, and managing risks.

This suggests there is an opportunity to adopt an institutional framework that will facilitate the development of PPPs that create more value for money while effectively managing the Government's fiscal risk associated with those PPPs.

What are contingent liabilities and what are they for?

For the purpose of this assignment a contingent liability is an explicit, contractually-defined financial obligation associated with an infrastructure PPP, the timing and/or magnitude of which depends on the occurrence of some uncertain future event. A well-designed PPP will often create contingent liabilities for the Government because the value for money of a project can be increased if the Government retains some risks that it is more practical or efficient for the public sector to manage. Contingent liabilities create the possibility that the Government may need to make unexpected, and in some cases substantial, payments to the private proponent in a PPP contract. These unexpected payment obligations expose the Government to fiscal risk that, if severe, can create significant budgetary uncertainty and put the public debt on an unsustainable path.

What PPPs have been developed in Pakistan?

The definition of PPP has been clarified in Pakistan's 2010 PPP Policy to include any arrangement involving the financing, development, operation, and maintenance of infrastructure by the private sector which would otherwise have been provided by the public sector. Instead of the public sector procuring a capital asset and providing a public service, the private sector develops the asset and delivers a service in return for payment that is linked to performance.

By this definition, the current PPPs in Pakistan that we are aware of include:

- Thirty IPPs and at least nine RPPs contracted by the Private Power Infrastructure Board (PPIB), totaling approximately 8,500 MW of electricity generation capacity
- Three concession agreements that the National Highway Authority (NHA) is party to
- At least 11 concession agreements for terminal facilities contracted by Pakistan's port authorities and one dry port railway terminal.

Pakistan has limited experience developing PPPs in other sectors. The Infrastructure Project Development Facility (IPDF) was created within the Ministry of Finance (MOF) to develop and implement PPPs, but to date IPDF has not completed a transaction.

Where is the Government of Pakistan exposed to contingent liabilities?

The Government's existing stock of contingent liabilities is mainly in the energy sector. Outside of this sector, the Government has limited exposure to contingent liabilities.

Concession agreements for national highway services include the following obligations that create contingent liabilities for the Government:

- Termination payment clauses in the event of default by the company or the Government, or a force majeure event
- A guarantee on the regulated toll rate for Lakpass Tunnel
- Commercial risk the Government has retained on Shahdara Flyover.

Concessions on shipping terminals also include termination payment clauses, but there is not enough information available to determine the extent of the contingent liabilities under those agreements. Moreover, it is unclear whether the Government intends to include port authorities in the efforts to strengthen the policies and processes for PPPs and contingent liability management.

Within the energy sector, contingent liabilities arise in the 30 implementation agreements signed between IPPs and PPIB on behalf of the Government and in at least nine rental power agreements signed with RPPs. These contingent liabilities include primarily the financial obligations of the power purchaser and termination payments in the event of default or force majeure. The contingent liability associated with the guarantee of the power purchaser has effectively realized—in 2008, for example, the Central Power Purchasing Authority failed to pay about 51 billion Rupees owed to IPPs.

While the contingent liabilities in the energy sector are known, assessing the full magnitude of the liabilities and the associated fiscal risk is complicated by the current energy crisis in Pakistan, which has created a large, ongoing fiscal burden. In the past, the Government has negotiated solutions to some of these fiscal challenges and we understand there are current efforts to address the energy crisis that go well beyond the scope of this assignment.

How can Pakistan better manage contingent liabilities and why is it important?

There are currently no clear or consistent policies in place for managing contingent liabilities in Pakistan. Existing PPPs have been developed by contracting authorities, following their own specific processes with limited external approval. However, some elements of the 2010 PPP Policy, and some of the efforts of IPDF to develop and implement PPP guidelines,

provide a basic framework for strengthening how contingent liabilities are dealt with in the future.

Our findings suggest that there is an opportunity to improve how Pakistan manages contingent liabilities by adopting policies and guidelines for carrying out a series of proven functions that:

- Improve how contingent liabilities are structured to increase value for money and help to develop more sound PPPs in the future
- Create an environment for better decision-making when approving PPPs and accepting contingent liabilities
- Facilitate central processing and monitoring of contingent liabilities going forward

These functions should include: structuring contingent liabilities and contractual mechanisms; analyzing and formally accepting contingent liabilities; monitoring emerging risks and taking mitigating action; disclosing; and budgeting and paying for realized contingent liabilities. To be implemented successfully, the functions should be embedded in an institutional framework that is not overly cumbersome to put into practice and uses the existing resources in Government—in MOF, the Debt Policy Coordination Office, and IPDF, as well as contracting authorities like the NHA and the PPIB. The institutional framework should also work to strengthen the 2010 PPP Policy and build on the parallel guidelines that have been developed to complement that policy.

A.1 Introduction

The Government of Pakistan (the Government) wants to strengthen the institutional framework for managing contingent liabilities associated with public private partnerships (PPPs) in infrastructure. **Castalia has been asked to evaluate the existing institutional framework for approving and managing contingent liabilities, including an assessment of current contingent liabilities and underlying fiscal risks, and to develop policy recommendations and guidelines to improve how the Government accepts and manages contingent liabilities in the future.** This report is the second deliverable for the assignment, which is funded by the World Bank.

The purpose of this report is to answer the following questions:

- **Why is it important to manage contingent liabilities from PPPs?** Answering this question provides the background needed to assess the existing institutional framework governing contingent liabilities in Pakistan
- **What PPPs exist in Pakistan and where do contingent liabilities arise?** Answering this question provides a preliminary assessment of the Government's existing exposure to fiscal risk from contingent liabilities, and allows us to determine the effectiveness of existing policies and processes and the benefits that could be achieved by improving how contingent liabilities are managed
- **What are the current policies and processes for managing contingent liabilities from PPPs in Pakistan?** Answering this question helps determine the specific gaps that should be addressed to achieve the benefits of managing contingent liabilities well.

The following sections of this report present analysis to answer each of these questions. The remainder of this introduction provides background on the assignment (Section 1.1) and describes the content of the report (Section 1.2).

Background on the Assignment

The Government has identified public private partnerships as an important option for delivering infrastructure services and closing the financing gap in infrastructure investment in Pakistan. PPP contracts have been entered into in the past—particularly, in energy, roads, and ports and shipping sectors—and the Government intends to use PPPs more widely and increase the number of PPPs in infrastructure going forward.

A well-designed PPP will often include contingent liabilities from the Government to reduce the total upfront project costs by retaining some risk that it is more practical or more efficient for the public sector to manage. The Government has issued some contingent liabilities in existing PPPs and as the Government's stock of PPPs grows, so will its exposure to underlying risk associated with these obligations. However, there are costs associated with the provision of contingent liabilities.

Contingent liabilities create the possibility that the Government may be obligated to make unexpected and substantial payments. **These uncertain payment obligations expose the Government to fiscal risk that can create budgetary uncertainty and put the public debt on an unsustainable path.** Therefore, effective PPP policy will include a sound framework for deciding when to issue guarantees and managing the fiscal risk arising from guarantees. Improving how contingent liabilities associated with infrastructure PPPs are

managed can encourage better decision making, enhance fiscal stability, improve sovereign credit ratings, and lower the cost of borrowing.

This assignment aims to develop policies, procedural guidelines and implementation plans for managing contingent liabilities through four primary tasks:

- **Task 1: Inception**—Identify the scope of the assignment and prioritize the objectives of an institutional framework for managing contingent liabilities
- **Task 2: Assess Current Framework and Exposure**—Preliminarily assess the Government’s existing exposure to fiscal risk arising from contingent liabilities; identify and assess the current institutional framework governing contingent liabilities in Pakistan; and determine the gaps that should be addressed to strengthen the policies and processes for managing contingent liabilities from PPPs
- **Task 3: Identify and Analyze Options**—Identify and analyze options that address the key gaps in the institutional framework from Task 2 and will achieve the benefits of good management of contingent liabilities in Pakistan
- **Task 4: Develop Final Recommendations**—Develop a final set of policy recommendations, guidelines, and tools needed to implement the preferred institutional framework for managing contingent liabilities from Task 3.

The assignment is a continuation of a previous assignment completed by Castalia in 2008. For that work, Castalia submitted a report on *Advice for Fiscal Management of Infrastructure PPPs in Pakistan*. Since 2008, the Government has announced an interest in continuing to pursue PPPs to develop new infrastructure and approved a new PPP Policy in January 2010. The Debt Policy Coordination Office (DPCO) in the Ministry of Finance (MOF) is expected to be the key beneficiary of Castalia’s work under this assignment.

Content of the Report

The purpose of this report is to assess the existing policies and processes for developing and approving PPPs that create contingent liabilities, preliminarily assess the exposure to fiscal risk created by contingent liabilities, and determine why and how the Government should better manage contingent liabilities in the future. Conclusions from this report will then serve as the basis for developing detailed recommendations for strengthening the existing institutional framework in subsequent reports. The contents of this report are organized in three sections after this introduction:

- Section A.2 lays out the importance of managing contingent liabilities and the key functions of good contingent liability management frameworks
- Section A.3 provides a list of existing PPP projects in Pakistan and characterizes the associated contingent liabilities
- Section A.4 assesses the existing policies and processes that are in place to manage contingent liabilities from PPPs in Pakistan.

A.2 Importance of Managing Contingent Liabilities

Before assessing the existing institutional framework for contingent liabilities in Pakistan, it is important to understand **why it is important to manage contingent liabilities from PPPs**. By answering this question, we can start to determine how Pakistan might be able to best manage its existing exposure to contingent liabilities. In turn, this will ensure that we are presenting the right analysis to decision makers when evaluating options for strengthening the policies and processes for managing contingent liabilities—the principle goal of the next task in this assignment.

In this section we first explain the purpose of providing contingent liabilities in a PPP contract (Section 0). We then describe what can be achieved by managing contingent liabilities well and outline the key functions of a good contingent liability management framework (Section 0).

What Are Contingent Liabilities and What Are They For?

Presently, there is considerable disagreement and uncertainty within Pakistan about what comprises a public private partnership and where contingent liabilities may arise. Pakistan is not unique in this respect—there is also no universally agreed definition for PPPs and contingent liabilities internationally. However, it is important to have an agreed definition to create a common language and ensure that policies and processes can be designed to achieve targeted benefits. As such, this section presents the definition of “public private partnership”, which has recently been established in the 2010 PPP Policy to address the lack of clarity (Section 0). We also present our working definition of “contingent liability” (Section 0). These definitions help to clarify the scope of the assignment and the context for Castalia’s recommendations. Based on these definitions we describe the purposes served by accepting these contingent liabilities (Section 0)

Definition of public private partnership

For the purpose of this assignment we use the following definition of “public private partnership”:

A public private partnership (PPP) is any arrangement involving the financing, development, operation and maintenance of infrastructure by the private sector which would otherwise have been provided by the public sector. In a PPP, instead of the public sector procuring a capital asset and providing a public service, the private sector creates the asset through a dedicated standalone business (usually designed, financed, built, maintained and operated by the private sector) and then delivers a service to the public sector entity or consumer in return for payment that is linked to performance.⁶

This definition was recently established in the new official policy on public private partnerships in Pakistan, which was approved by the Economic Coordination Committee January 2010. The complete text describing what comprises a public private partnership in Pakistan is provided in Box 0.1 below. Based on this definition, the most obvious PPPs that either currently exist or may be developed in the future in Pakistan include:

⁶ As defined in the Pakistan Policy on Public Private Partnerships: *Private Participation in Infrastructure for Better Public Services*. Approved by the Economic Coordination Committee of the Cabinet 26 January 2010. (2010 PPP Policy)

- Roads and tunnels that have developed by the National Highway Authority (NHA) through concession agreements with private operators
- Independent Power Producers (IPPs) that have been contracted through the Private Power Infrastructure Board and signed Power Purchase Agreements (PPAs) with Pakistan’s power utilities—the Water and Power Development Authority (WAPDA) and the Karachi Electricity Supply Company (KESC)
- Projects with similar contractual arrangements in other sectors including, for example: ports and shipping, water supply, sanitation, solid waste, and mass transit.

Box 0.1: Definition of Public Private Partnership in Pakistan

The following text is used in the 2010 PPP Policy for Pakistan to define what comprises a public private partnership:

Public Private Partnerships (PPP) involve the financing, development, operation and maintenance of infrastructure by the private-sector which would otherwise have been provided by the public sector. Instead of the public sector procuring a capital asset and providing a public service, the private sector creates the asset through a dedicated standalone business (usually designed, financed, built, maintained and operated by the private sector) and then delivers a service to the public sector entity/ consumer in return for payment that is linked to performance. Therefore the public sector is able to redirect its efforts to serving other urgent social and economic needs. A PPP may include an equity joint venture between GOP and the private sector.

The capital and operational expenses incurred by the private investor can be recovered under the PPP modality by charging users for the service provided or via fixed (or partially fixed) periodic payments (annuities) disbursed by the public sector over the concession period, or by a combination of both.

PPPs allow each partner to concentrate on activities that best suit their skills. For the public sector this means planning and identifying infrastructure service needs and focusing on developing national, provincial and local sector-specific policies, but also to oversee these and to enforce the PPP agenda. For the private sector, the key is to deliver effectively the needs required by the public sector and consumers at the project level.

Some sectors, such as power, have already developed independent and effective regulators, and these will be expanded across other sectors in the future. Meanwhile, in this initial phase, PPP Policy supported by contract will allow PPP to proceed on a project by project basis in most other sectors.

Source: Pakistan Policy on Public Private Partnerships: *Private Participation in Infrastructure for Better Public Services*. Approved by the Economic Coordination Committee of the Cabinet 26 January 2010.

Definition of contingent liability

The Government may be exposed to a range of contingent liabilities. For this assignment, we use the following definition of “contingent liability”:

Explicit contractual financial obligations associated with infrastructure PPPs, whose timing and/or magnitude depending on the occurrence of some uncertain future event.⁷

⁷ See for example: Cebotari. “Contingent Liabilities: Issues and Practice”. IMF. 2008

This definition for contingent liabilities covers only part of the Government's overall contingent liability exposure. The Government may have several other sources of contingent liabilities—such as guarantees on third-party borrowing unrelated to PPP projects, guarantees on savings deposits, or pension guarantees—that are outside the scope of this assignment. While this assignment is designed to achieve the benefits of specifically managing contingent liabilities from PPPs, eventually, the Government may want to expand the recommendations and approach to apply to the full range of exposure from other sources of contingent liability.

There may also be contingent liabilities related to PPP projects that fall outside the scope of this definition. For example, the definition does not include implicit guarantees, which are not legally or contractually defined, but are instead based on political or moral obligations of the Government. Implicit guarantees of this nature can include, for example, financial bailouts of failed public enterprises and government relief in response to a natural disaster or environmental cleanup. The optimal approach to managing exposure to implicit liabilities under PPP projects is to establish policies and process to make these liabilities explicit in future projects—for example, by more completely specifying contractual obligations. This is the approach we take in developing our recommendations.

Purpose of accepting contingent liabilities in PPP contracts

The types of contingent liabilities that this assignment will focus on arise from various financial obligations to the project sponsors of a PPP or from the Government retaining some commercial risk in the project. A well-designed PPP will often include these contingent financial obligations from the Government to reduce the total upfront project costs by retaining some risk that it is more practical or more efficient for the public sector to manage. The private sector may also demand a specific guarantee or prefer not to accept some risks to make a PPP transaction financially bankable.

From the Government's perspective, **the purpose of providing contingent liabilities in PPP contracts is to close PPP transactions that have an optimal allocation of risk and provide the greatest value for money.** In some cases, the Government may be better able to manage and spread project risks. For example, it may be too costly for the private sector to accept the risks associated with non-insurable force majeure events, such as military conflict or certain natural disasters. By providing a contractual guarantee to repay investors should the force majeure events occur, the Government can structure a project that is financially viable and lower cost. In other cases, the Government may be in a better position to control and mitigate the costs of certain project risks. For example, the private sector is typically unwilling to accept risk associated with regulatory or policy decision and, therefore, requires a guarantee of compensations for changes in laws, such as unexpected changes in regulated fees that are charged to the users of infrastructure.

While contingent liabilities are a particular form of financial support to a potential PPP project, they should be economically justified like any other public sector contribution. That is, contingent liabilities, like viability gap funding and public subsidies, should provide economic benefits that exceed the economic costs.

What Can Be Achieved By Managing Contingent Liabilities?

We understand that a major objective of this assignment is to facilitate the origination of new PPP projects by improving the process by which contingent liabilities are structured in PPP contracts and approved. By improving how contingent liabilities are used, PPPs can be

used more effectively to close Pakistan's infrastructure deficit. There are also other important benefits to managing contingent liabilities from infrastructure PPPs throughout the lifecycle of a project. This section summarizes the primary benefits of managing contingent liabilities (Section 0) and describes the common components of a contingent liabilities management framework that are used to achieve those benefits.

Benefits of good management of contingent liabilities from PPPs

There are important benefits that can be achieved by strengthening the process for approving and managing guarantees to infrastructure PPPs. These benefits contribute to Pakistan's ongoing efforts to enact sound PPP policies and contribute to good fiscal risk and debt management. When assessing the current situation in Pakistan, we have concentrated on identifying to what extent the existing policies and processes that are in place achieve the following benefits:

- **Accepting risks that maximize value for money** in provision of infrastructure by choosing good projects, then structuring and implementing those projects well
- **Controlling the cost of accepting risk** by minimizing the payments the Government needs to make, and ensuring these payments do not threaten fiscal stability.

These benefits can be achieved by strengthening the policies and processes for managing contingent through:

- **Improving incentives to make good decisions**, to help ensure:
 - The Government accepts risks and approves contingent liabilities that provide value for money
 - Decision makers manage existing risks well
- **Improving credibility** by:
 - Making the Government's exposure transparent and signaling a commitment to managing risk, thereby decreasing the likelihood that credit rating agencies and others assessing Pakistan's sovereign risk overestimate risk exposure
 - Implementing a systematic process that defines how payments will be made and reduces uncertainty, thereby increasing investors' confidence, attracting greater investment, and lowering the cost of borrowing
- **Reducing adverse fiscal impact** by implementing a systematic process that reduces the uncertainty of payment obligations, minimizes the cost of realized contingent liabilities, and limits the impact of payments on the fiscal deficit, debt levels, and budget priorities.

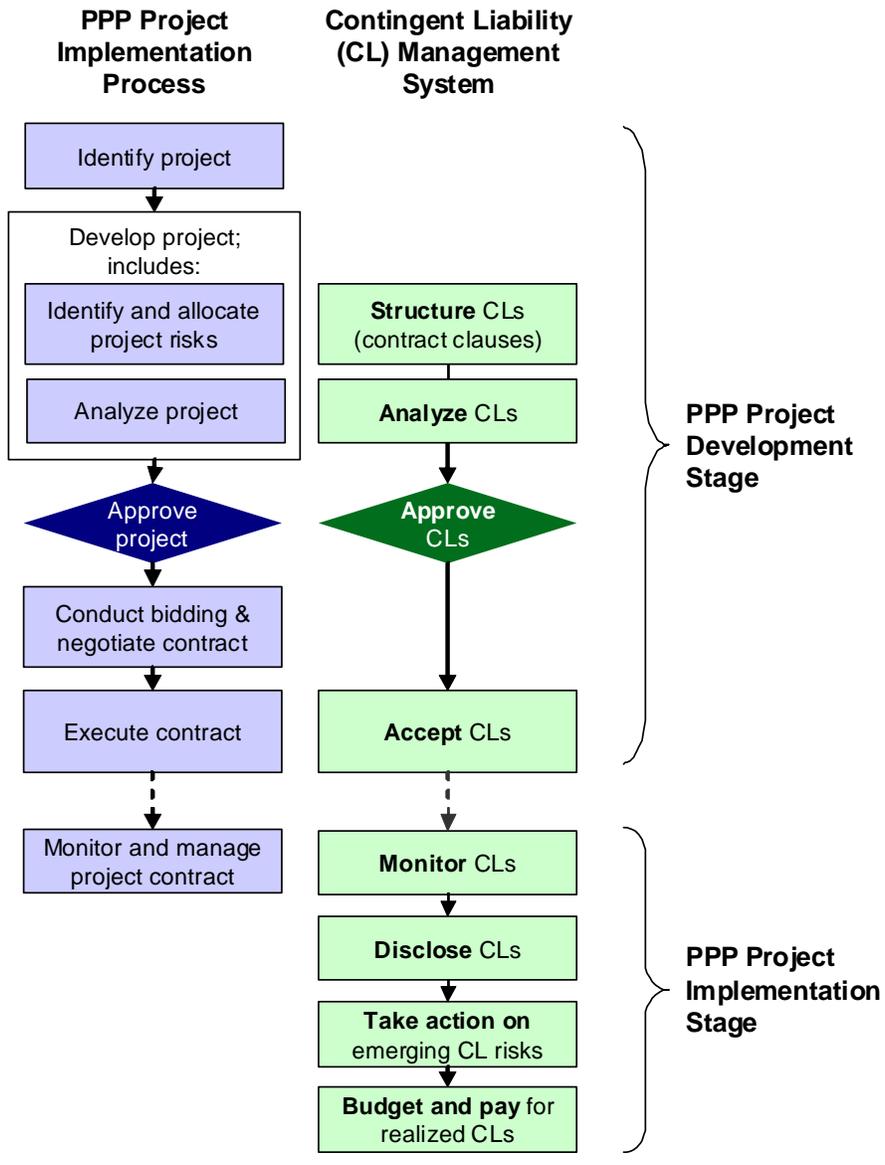
Good practice in managing contingent liabilities from PPPs

To evaluate the effectiveness of existing policies and process for managing contingent liabilities in Pakistan, it is useful to use international good practice as a benchmark. Elsewhere, contingent liability management frameworks include systematic processes to carry out some or all of the following functions, spanning the lifecycle of a PPP project:

- **Structuring contingent liabilities and designing contractual mechanisms** according to good principles for allocating risk in PPP projects and contract design
- **Analyzing** the contingent liabilities that will be accepted under a proposed project
- Reviewing executed PPP contracts and **formally accepting** the contingent liabilities to make the contingent liabilities explicit
- **Monitoring** those contingent liabilities while the project is being constructed and implemented
- Regularly and publicly **disclosing** the contingent liability exposure
- **Taking mitigating action** where necessary to reduce the likelihood or cost of the contingent liability becoming real
- When necessary, **budgeting for and paying** for contingent liabilities that have realized.

Figure 0.1 illustrates where each of these functions fit within the process of developing and implementing a PPP project. In Section A.4 we clarify the purpose of each function, before assessing how effectively the existing framework in Pakistan accomplishes the functions and achieves the benefits of managing contingent liabilities well.

Figure 0.1: Functional Components of Managing Contingent Liabilities



A.3 PPPs and Contingent Liabilities in Pakistan

After determining why it is important to manage contingent liabilities, we **identify and assess the PPPs that exist in Pakistan and the contingent liabilities that arise from those PPPs**. This information will be used to complete a preliminary assessment of the Government's existing exposure to fiscal risk to determine the significance of the benefits that can be achieved by strengthening the policies and processes for managing contingent liabilities and further understand how to best achieve those benefits.

Since the early 1990s, Pakistan has recognized the benefits of using public private partnerships to develop and deliver infrastructure services. At that time a policy and regulatory framework was established to facilitate private sector participation in power generation. As a result, over 5,000MW of generating capacity was developed in the 1990's by independent power producers (IPPs) through power purchase agreements (PPAs) with power utilities in Pakistan. Despite this early success, further development of IPPs has slowed in recent years due to challenges in the energy sector. The inability to expand capacity in recent years has contributed to the current energy crisis in Pakistan.

Outside of the energy sector, there has been only limited private sector participation in other areas. For example, the National Highways Authority (NHA) currently has two signed concession agreements—one for an operational tunnel, one for an expressway, and one for a service station. Port authorities have also executed concession agreements on shipping terminals. The Government's current efforts—particularly the development of the 2010 PPP Policy and the ongoing efforts of the Infrastructure Project Development Facility (IPDF)—are intended to apply the experience in the energy sector and lessons learned from international good practice to develop a comprehensive policy framework—including guidelines for managing contingent liabilities—aimed at encouraging the development of public private partnerships in other critical sectors.

With this background, the remainder of this section identifies and assesses the PPPs and contingent liabilities in key sectors, including: the energy sector (Section 0); the roads sector (Section 0); and other infrastructure sectors (Section 0). In each section, we first present an overview of the sector and relevant policy before then listing the PPPs that exist, identifying and characterizing the contingent liabilities, and presenting the pipeline of future PPP projects.

PPPs and Contingent Liabilities in the Energy Sector

This section presents a preliminary assessment of the contingent liabilities from PPPs in the energy sector. We first present overview of the energy sector and a brief summary of relevant policy (Section 0). Then we list the PPPs that already exist in the energy sector, which include independent power producers and rental power producers (RPPs) (Section 0), and characterize the contingent liabilities that are associated with the PPPs (Section 0). Finally, we list the development pipeline for private energy generation in Pakistan (Section 0).

Overview of energy sector and policy

This section provides an overview of the energy sector, focusing on the evolution of policies governing private sector development and the status of sector reforms—specifically, the unbundling and planned privatization of the vertically-integrated utility WAPDA (Water and Power Development Authority), and the recent push to develop rental power plants.

Structure of the energy sector

Two power utilities—WAPDA and KESC—are the principle entities in Pakistan’s energy sector. WAPDA supplies power to all of Pakistan, except the metropolitan city of Karachi and some of its surrounding areas, which are supplied by KESC.

In 1997, the Government adopted a policy to unbundle the vertically-integrated, state-owned utilities and restructure the power sector. The NEPRA Act (1997) and the WAPDA Act (1998) provided the basis for these reforms. Unbundling consists of separating responsibilities for energy sector policy, regulation, and operations. Responsibility for energy sector policy remains with the central Government. Responsibility for regulation has passed to the National Electric Power Regulatory Authority (NEPRA). Responsibility for operations is being divided among generation, transmission, and distribution companies as follows:

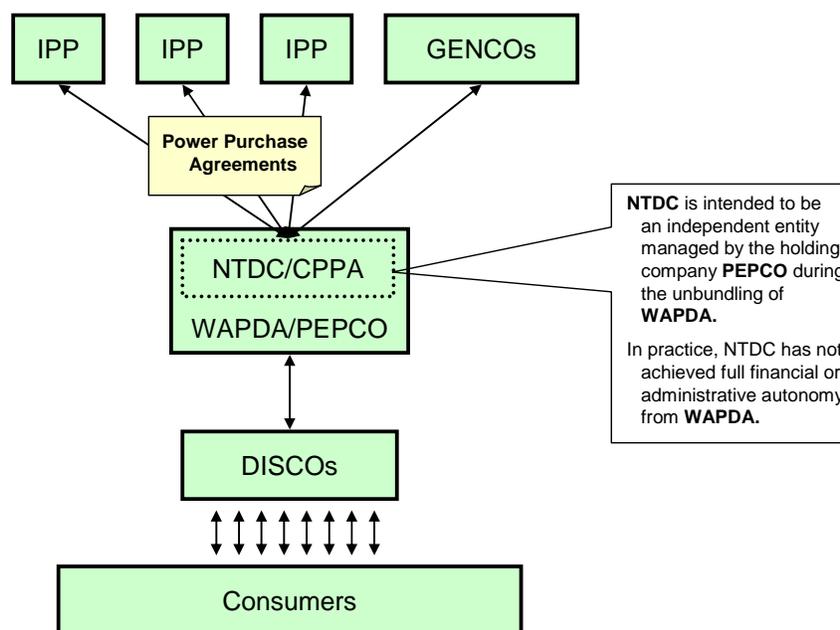
- Four generation companies (GENCOs)
- The National Transmission and Despatch Company (NTDC)
- Nine distribution companies (DISCOs).

The Government is planning to eventually privatize the generation and distribution companies created from WAPDA.

Although KESC has been successfully privatized as an integrated utility, progress on unbundling the operations of WAPDA has been slow. The distribution companies have been created, but they have not yet achieved administrative or financial autonomy from WAPDA. Similarly, NTDC, the power purchasing authority, remains under the control of the Pakistan Electric Power Company (PEPCO), which was established as a management authority to oversee the unbundling of WAPDA. In practice, NTDC has not achieved autonomy or separation of accounts from WAPDA.

Figure 0.2 below illustrates the current structure of the energy sector in Pakistan. Private sector participation in the energy sector is contracted through Power Purchase Agreements (PPAs) with IPPs. The Private Power Infrastructure Board (PPIB), created in 1994, is the Government agency with the authority to facilitate private sector investment in energy generation and implement IPPs. Currently there is about 8,500 MW of capacity contracted through PPAs with IPPs. About 6,500 MW of that capacity is commissioned. In Figure 0.2, the role of NTDC is highlighted as the Central Power Purchasing Authority (CPPA) that is purchasing power from IPPs and selling it to distribution companies.

Figure 0.2: Structure of the Energy Sector



Evolution of Pakistan's policy for private sector participation in energy

Pakistan's energy sector is governed under a series of policies promoting private sector participation—most recently, the 2002 Power Policy. Pakistan's first policy for private sector participation in electricity generation dates from 1986. However, progress on attracting investment under this policy was slow, and a new policy was implemented in 1994. The 1994 policy was called "Policy Framework and Package of Incentives for Private Sector Power Generation Projects in Pakistan." The 1994 policy aimed to provide a package of incentives to attract foreign investment in private power generation projects. It included the following:

- Attractive project structure in terms of assured cash flow for debt payment and return on investment
- A reduction in local currency investment requirements (from what was specified in the 1986 policy)
- Indicative average tariff of US cents 6.5/kWh for the first 10 years
- Transfer of inflation and fuel cost risk to the public utility (Power Purchaser), through tariff indexation mechanisms
- Steps to create and encourage a domestic corporate debt securities market
- Exemption of IPPs from income, sales, and other taxes
- Creation of PPIB as a one-window facility to streamline project approval and closure processes, and to facilitate dialogue between the Government and private investors.

The 1994 policy allowed investors to make their own proposals regarding the technology and fuel to be used. Under the 1994 policy, 15 power plants with a total capacity of 2,911MW—representing a total investment of approximately US\$5.3 billion—were procured by PPIB

and developed by the private sector as IPPs. The IPPs signed long-term PPAs with one of Pakistan's two utilities—WAPDA and KESC.

WAPDA financial difficulties and tariff renegotiations

The 1994 policy was initially successful, but the capacity contracted under IPPs grew faster than demand in the mid- to late-1990s. Demand growth slowed further as the Pakistani economy suffered the effects of the Asian financial crisis and the economic sanctions placed on the country after its 1998 nuclear tests. As a result, WAPDA faced difficulties meeting its payments to the IPPs as the cost of purchasing power reached 50 percent of WAPDA's total operating costs.⁸⁹

Rather than attempt the politically and socially difficult task of raising electricity tariffs to consumers, the Government attempted to renegotiate the tariffs specified in the PPAs. These attempts were unsuccessful and the IPPs later became a focus of corruption investigations under the Bhutto government.

HUBCO—the largest foreign investment project in the country (US\$1.6 billion) and the largest IPP—was a principal target of corruption allegations and of the Government's efforts to reduce tariffs. In 1998, HUBCO and WAPDA entered into a prolonged legal dispute. In December of 2000, the dispute was resolved with a decrease in the tariff paid by WAPDA. In October 2000, KAPCO also agreed to a tariff reduction.

Notices of intent from PPIB to terminate other contracts also resulted in tariff renegotiations. The average decrease in the levelized tariff was approximately 10 percent. In exchange for these tariff reductions, the terms of the PPAs were extended from approximately 20 to 30 years. The renegotiations were carried out under an "Orderly Framework for IPP Negotiations," drafted with help from the World Bank and adopted in 1998.

1998 and 2002 Power Policy

The Government issued a revised power sector policy in 1998, which introduced international competitive bidding and increased the role of the regulatory body, the National Electric Power Regulatory Authority (NEPRA). Due to the ongoing difficulties with existing IPPs at the time, this policy attracted no new investment.

By 2002, the tariff renegotiations had been completed and the outlook for foreign investment in Pakistan had recovered. In 2002, the Government announced an updated policy on private sector participation in electricity generation, "Policy for Power Generation Projects, Year 2002."

The 2002 policy was similar to the 1998 policy, but offers additional tax incentives and clarifies the division of responsibility between the federal and the provincial governments. The 2002 policy states that all future investment in power generation is expected to come from the private sector. It also clearly delegates responsibility for all projects over 50MW to the federal government, and responsibility for all smaller projects to provincial governments.

⁸ A portion of the tariffs paid by WAPDA is indexed to the U.S. dollar/Rupee exchange rate. The Rupee devalued by 45 percent during the economic crisis.

⁹ Fraser 2005, p. 8

The 2002 policy was designed to provide sufficient capacity for power generation at the least cost. The Government wished to avoid the power shortages that were predicted for the winter of 2003–2004 and keep consumer prices within affordable limits—a key lesson from the crisis of the late 1990s. Under the 1994 policy, the private partners of IPP agreements could specify the technology and fuel to be used. There were no explicit incentives for investors to use least-cost technologies. This resulted in higher payment obligations for WAPDA and contributed to the crisis.

To date, 3,000 MW of capacity has been contracted with IPPs under the 2002 policy, but only a small fraction has been commissioned. In contrast to the late 1990s, demand now exceeds supply and a lack of generation capacity is seen as a serious constraint to economic growth.

Meeting short-term demand with rental power

The Government decided in 2008 to use rental power plants to close the energy supply gap in the short term. In February 2008 the Economic Coordination Council approved the acquisition of 1,200 MW of capacity through rental power agreements (RPAs). An additional 1,050 MW of capacity was approved in 2009. Initially the aim was to have rental power plants producing power by the end of 2009; however progress has been slow and hindered by allegations of corruption. RPAs are essentially short-term power purchase agreements with both fixed and variable payments—capacity and energy payments. The lengths of the RPAs vary from five to six years.

Wholesale energy market

The Government has had long-term plans to create a competitive wholesale energy market, which was originally intended to begin functioning in 2012, but has not progressed as planned. If successful, this would eliminate the PPAs signed between IPPs and Government-owned utilities. Once a competitive market is created, IPPs would sell their power directly to distribution companies and large industrial consumers. PPAs would be replaced by contracts with individual customers—distribution companies and industrial customers. Therefore, the Government guarantee on the PPAs (established in the IA) would no longer be necessary. The current term of PPAs is approximately 25 years. It is unclear how the Government plans to dismantle these PPAs and the associated IAs if the wholesale market is introduced.

What PPPs are in the energy sector?

As described above, the energy sector in Pakistan has considerable experience with private sector participation in electricity generation. Currently, there is about 8,500 MW of capacity contracted through PPAs with independent power producers. Roughly 6,500 MW of this capacity is commissioned. Table 0.1 below lists the IPPs that have implemented through PPIB and characterizes the contingent liabilities associated with each.

The Government has also signed Rental Power Agreements (RPAs), which are effectively short-term PPAs, to provide a short-term solution to the energy shortage. Nearly 1,500 MW of capacity has been recently contracted with rental power plants, but only one plant has been commissioned. Table 0.2 lists the RPAs that have been signed with the private sector.

Table 0.1: List of Independent Power Producers in Pakistan

Project	Contracting Authority	COD	Contingent Liabilities
Kot Addu Power Company Limited (KAPCO) - 1,638 MW - listed on Pakistani Stock Exchanges	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ June 1996 ▪ Before 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Hub Power Company Limited – RFO - 1,200 MW – 30 years PPA - listed on Pakistani Stock Exchanges and GDRs listed on Luxembourg Stock Exchange	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ March 1997 ▪ Before 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Kohinoor Energy Limited – RFO - 131 MW – 22 years PPA - listed on Pakistan Stock Exchanges	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ June 1997 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Tapal Energy (Pvt.) Limited – Furnace Oil - 126 MW – 22 years PPA	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ June 1997 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance

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Project	Contracting Authority	COD	Contingent Liabilities
			<ul style="list-style-type: none"> ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
AES Lal Pir (Pvt.) Limited – RFO - 365 MW capacity – 30 years PPA	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ November 1997 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Gul Ahmed Energy – Furnace Oil – 136 MW - 22 years PPA	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ November 1997 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
AES Pak Gen (Pvt.) Ltd – RFO - 365 MW – 30 years PPA	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ February 1998 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Southern Electric Power Company Limited – RFO - 135 MW – 30 years PPA - listed on Stock Exchanges in Pakistan.	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ July 1999 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk

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Project	Contracting Authority	COD	Contingent Liabilities
			<ul style="list-style-type: none"> ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Habibullah Coastal Power Company (Private) Limited - Gas - 140 MW – 30 year PPA	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ September 1999 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Fauji Kabirwala Power Company Limited. – Gas - 157 MW – 30 years PPA	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ October 1999 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Rousch (Pakistan) Power Limited (RPPL) – RFO - 412 MW – 30 years PPA	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ December 1999 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Saba Power Company Limited – RFO – 114 MW – 30 years PPA	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ December 1999 ▪ 1994 Power 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser

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Project	Contracting Authority	COD	Contingent Liabilities
		Policy	<ul style="list-style-type: none"> ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Japan Power Generation Limited - RFO - 120 MW – 30 years PPA - listed on Pakistani Stock Exchanges	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ March 2000 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Uch Power Limited – Low BTU Gas - 586 MW – 30 years PPA	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ Oct 2000 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Altern Energy Limited – Gas – 29 MW – 30 years PPA	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ June 2001 ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Liberty Power Limited – Gas - 235 MW – 25 years	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ September 2001 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser

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Project	Contracting Authority	COD	Contingent Liabilities
PPA		<ul style="list-style-type: none"> ▪ 1994 Power Policy 	<ul style="list-style-type: none"> ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Attock Gen Limited – LSFO – 165 MW – 25 years PPA – IA signed in Aug 2007	PPIB/WAPDA	<ul style="list-style-type: none"> ▪ March 2009 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination and Force Majeure ▪ Guarantee of fuel supply agreement
Orient Power Project - 229 MW – IA signed in Nov 2006	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned April 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination
Sapphire Power Project – Gas - 234 MW – IA signed in Mar 2007	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned May 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination
Fauji Mari Power Project – 185 MW – IA signed in Aug 2007	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned May 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk

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Project	Contracting Authority	COD	Contingent Liabilities
			<ul style="list-style-type: none"> ▪ Fx insurance ▪ Compensation Upon Termination
Saif Power Limited – Gas - 231 MW	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned April 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination
Atlas Power Limited – RFO – 219 MW – IA signed in Sept 2007	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ COD unknown ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination
Nishat Churian Power Project - 200 MW – IA signed in Sept 2007	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned June 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination
Nishat Power Limited - 200 MW – IA signed in Sept 2007	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned May 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination
Bhikki (Halmore) Power Project - 225 MW – IA signed in Oct 2007	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned September 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance

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Project	Contracting Authority	COD	Contingent Liabilities
			<ul style="list-style-type: none"> ▪ Compensation Upon Termination
Engro Energy Limited - 227 MW – IA signed in Oct 2007	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ COD unknown ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination
Fauji Mari Power Project – 185 MW	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned May 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination
Liberty Power Tech Project – 200 MW – IA signed in June 2008	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned September 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination
HUBCO Narowal project. – RFO - 225 MW – IA signed in Oct 2008	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned September 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser ▪ Regulatory risk ▪ Fx insurance ▪ Compensation Upon Termination
New Bong Escape Hydropower Project – low head run-of-the-river - 84 MW – IA signed in Aug 2007	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ COD unknown ▪ 1995 Hydel Power Policy 	Unknown

Table 0.2: List of Rental Power Agreements in Pakistan

Project	Contracting Authority	COD	Contingent Liabilities
Gulf Rental Power Project – 81 MW	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ April 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser
Karkay Rental Power Project – 249 MW	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned May 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser
Reshma Rental Power Project – 220 MW	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned June 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser
Sumandri Road Rental Power Project – 150 MW	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Planned Sept 2010 ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser
Guddu Rental Power Project – 110 MW	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Unknown ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser
Sahuwal Sialkot Rental Power Project – 150 MW	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Unknown ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser
Satiana Road Rental Power Project – 200 MW	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none"> ▪ Unknown ▪ 2002 Power Policy 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser ▪ Energy payment obligation of power purchaser
Naudoro Rental Power Project – 51 MW	PPIB/ PEPCO/	<ul style="list-style-type: none"> ▪ Unknown 	<ul style="list-style-type: none"> ▪ Capacity payment obligation of power purchaser

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Project	Contracting Authority	COD	Contingent Liabilities
	CPPA	<ul style="list-style-type: none">▪ 2002 Power Policy	<ul style="list-style-type: none">▪ Energy payment obligation of power purchaser
Engro Rental Power Project – 227 MW	PPIB/ PEPCO/ CPPA	<ul style="list-style-type: none">▪ Unknown▪ 2002 Power Policy	<ul style="list-style-type: none">▪ Capacity payment obligation of power purchaser▪ Energy payment obligation of power purchaser

What contingent liabilities exist in the energy sector?

Contingent liabilities in the energy sector arise from guarantees contained in the implementation agreement signed between IPPs and PPIB on behalf of the Government. The implementation agreement specifies the entirety of the Government's responsibility to an IPP. The contingent liabilities created by guarantees provided by the Government in the implementation agreement cover:

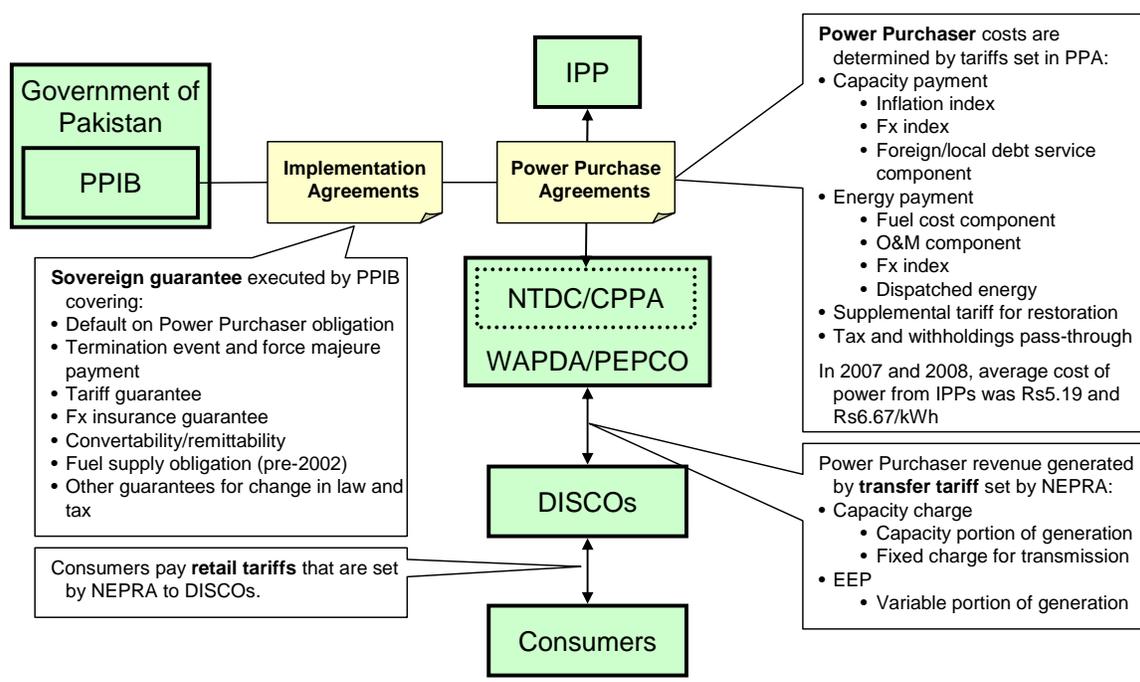
- Financial obligations of the power purchaser—PEPCO through the National Transmission and Despatch Company (NTDC) and Central Power Purchasing Authority (CPPA)¹⁰—should the power purchaser default on its payment to IPPs. This specifically includes a guarantee of the capacity payment and energy payment specified in the power purchase agreement
- Termination payments triggered by the default of the IPP, default of the Government, or a force majeure event
- Foreign exchange rate insurance provided by the National Bank of Pakistan and provisions for the convertibility and remittability of funds
- Other guarantees for changes in law and tax status.

A guarantee of the obligation of the fuel supplier has also been included in some Implementation Agreements, but PPIB stopped providing this guarantee after the 2002 Power Policy was enacted.

Figure 0.3 illustrates where and how these contingent liabilities arise in the energy sector. The main source of contingent liabilities is the commercial risk that the Government is exposed to through its guarantee of the obligation of the power purchaser—PEPCO through NTDC and CPPA. The power purchaser has costs that are defined in the capacity and energy fees in the power purchase agreement, and generates revenue from selling power to distribution utilities at the transfer tariff rate. Distribution utilities then sell power to consumers at the retail tariff rate. Both transfer tariffs and retail tariffs are set by NEPRA.

¹⁰ KESC also remains the power purchaser in two power purchase agreements contracted with IPPs.

Figure 0.3: Structure of IPPs and Contingent Liabilities in the Energy Sector



Currently, PEPCO through NTDC and CPPA has been unable to meet some its payment obligations to IPPs because retail tariffs charged to consumers have not allowed the full recovery of generation costs otherwise permitted by National Electricity Power Regulatory Authority. Therefore, the receipts from distribution companies (DISCOs) are insufficient to pay IPPs the contracted cost of generation. While payments to IPPs are given preference over other obligations, the stock of payables has continued accumulate in recent years. For example, in 2008 NTDC/CPPA failed to pay about 51 billion Rupees owed to IPPs for energy purchased in 2008. In the same year, the Government provided over 61 billion Rupees in cash subsidies to WAPDA/PEPCO and the Government reduced the debt service obligation of WAPDA/PEPCO by 52 billion Rupees.

While NTDC/CPPA is currently overdue on its payments to IPPs, no IPPs have officially called on the sovereign guarantees provided in Implementation Agreements. In other words, the contingent liability associated with the guarantee of the power purchaser has been realized, but the Government is continuing to handle the outstanding obligations through negotiations, like the circular debt settlements where the Government resolved default payments between the Government-owned fuel supplier (Pakistan State Oil), IPPs, and PEPCO. This situation makes it very difficult to assess the contingent liabilities in the energy sector. For future IPPs, it is possible to estimate the shortfall that would be created by the commercial risk that the Government bears by contracting to purchase IPP-generated power at a higher cost than revenue generated from consumer retail tariffs.

Energy sector development pipeline

The Private Power Infrastructure Board has an investment plan for private sector generation that includes over 9,000MW of additional capacity with commission dates planned before 2015. This investment plan includes approximately:

- 2,442MW of oil power with an estimated capital cost of US\$1,800 million
- 1,919MW of gas power with an estimated capital cost of US\$1,510 million
- 4,874MW of hydro power with an estimated capital cost of US\$5,675 million
- 2,400MW of coal power with and estimated capital cost of US\$2,400 million.

This additional capacity would be developed by IPPs under the 2002 Power Policy. The contingent liabilities arising from the project would match the description provided in above. Table 0.3 below lists the private sector development pipeline for the energy sector. The list includes planned commission dates published by PPIB, however many projects are behind schedule.

Table 0.3: Energy Sector Development Pipeline for IPPs

Project	Contracting Authority	Planned COD
Sialkot Rental Power Project, 65.00 MW	PPIB / PEPCO / CPPA	Sep 2010
Ruba Energy Rental Project, 155.55 MW	PPIB / PEPCO / CPPA	Sep 2010
Tapal Rental Power Project, 70.00 MW	PPIB / PEPCO / CPPA	Sep 2010
Walters Power Rental Project, 205.00 MW	PPIB / PEPCO / CPPA	Oct 2010
Radian Power Project, 150.00 MW	PPIB / PEPCO / CPPA	Jun 2012
Grange Holdings Power Project, 146.50 MW	PPIB / PEPCO / CPPA	Dec 2012
Uch II Power Project, 375.20 MW	PPIB / PEPCO / CPPA	Dec 2012
Green Power Project, 170.95 MW	PPIB / PEPCO / CPPA	Jun 2013
Star Thermal Power Project, 125.84 MW	PPIB / PEPCO / CPPA	Jun 2013
Kandra Power Project, 120 MW	PPIB / PEPCO / CPPA	Dec 2013
New Bong Escape Hydrel Project, 84 MW	PPIB / PEPCO / CPPA	Dec 2013
Rajdhani Hydro Power Project, 132 MW	PPIB / PEPCO / CPPA	Jun 2014
Gulpur Hydro Power project, 100 MW	PPIB / PEPCO / CPPA	Jun 2014
Patrind Hydropower Project, 150 MW	PPIB / PEPCO / CPPA	Dec 2014

Project	Contracting Authority	Planned COD
Kotli Hydel Project, 100 MW	PPIB / PEPCO / CPPA	Dec 2014
Sehra Hydel Project, 130 MW	PPIB / PEPCO / CPPA	Dec 2014
AES Imported Coal Project, 1200 MW	PPIB / PEPCO / CPPA	Jun 2015
Karot Hydel Project, 720 MW	PPIB / PEPCO / CPPA	Aug 2015
Madian Hydropower Project, 157 MW	PPIB / PEPCO / CPPA	Dec 2015
Asrit-Kedam Hydel Project, 215 MW	PPIB / PEPCO / CPPA	Dec 2015
Azad Pattan Hydel Project, 222 MW	PPIB / PEPCO / CPPA	Aug 2016
Kalam-Asrit Hydel Project, 197 MW	PPIB / PEPCO / CPPA	Dec 2016
Chakothe-Hattian Project, 139 MW	PPIB / PEPCO / CPPA	Dec 2016
Shogosin Hydropower Project, 127 MW	PPIB / PEPCO / CPPA	Dec 2016
Shushgai Zhendoli Hydel Project, 102 MW	PPIB / PEPCO / CPPA	Dec 2016
Gabral-Kalam Hydropower Project, 101 MW	PPIB / PEPCO / CPPA	Dec 2016
Suki Kinari Hydropower Project, 840 MW	PPIB / PEPCO / CPPA	Jun 2017
Kohala Hydropower Project, 1100 MW	PPIB / PEPCO / CPPA	Dec 2017
Kaigah Hydel Project, 548 MW	PPIB / PEPCO / CPPA	Dec 2017

PPPs and Contingent Liabilities in the Roads Sector

This section presents a preliminary assessment of the contingent liabilities from PPPs in the roads sector. We first present background on the energy sector and a brief summary of relevant policy (Section 0). Then we list the PPPs that already exist in the roads sector (Section 0), and characterize the contingent liabilities that are associated with the PPPs (Section 0). Finally, we list the PPP development pipeline for roads (Section 0)

Overview of roads sector and policy

The road sector in Pakistan includes national roads, provincial roads and local roads. The National Highway Authority (NHA) in Pakistan has the authority to plan, promote, organize and implement the construction and operations of national highways and strategic roads. This includes service area concessions and tolled motorways and tunnels.

Provincial roads are, by default, those roads that are not “national highways or strategic roads”. Following the establishment of the Local Government Ordinances (LGOs) intra-district roads are implemented by local governments while legislative authority remains with the Provincial Assemblies.

For the purposes of this assignment only national highways and strategic roads, implemented by NHA, are relevant.

National Highway Authority Act

The primary legislation for national highways and strategic roads is the National Highway Authority Act (NHA Act). It establishes the NHA as a statutory body to develop and implement road transport projects at the Federal level. In some cases, the NHA Act also enables the execution of projects at the provincial and local levels where such projects are entrusted to NHA by the respective governments.

The NHA Act defines an approval process whereby any project above 100 million Rupees requires, in order, the review and approval of the NHA Executive Board, the National Highway Council, the Ministry of Communications and the Central Development Working Party before being implemented by the NHA.

According to the NHA Act, the Federal Government can declare a road to be a “national highway or strategic road” by notification in the Official Gazette or by the road being included in the Schedules to the NHA Act.

National Highways PPP Policy

In May 2009, the Government approved the “PPP Policy and Regulatory Framework for Private Sector Participation in National Highways, Motorways, Tunnels and Bridges” (Highways PPP Policy). The Highways PPP Policy explicitly recognizes that the private sector’s technical, managerial and financial resources can be useful to the NHA’s efforts to develop highways in Pakistan:

*“The concept of Public Private Partnership (PPP) covers a wide range of situations and is subject to various interpretations. A now well-known definition is: **“a PPP is a risk-sharing relationship between the public and private sectors based upon a shared aspiration to bring about a desired public policy outcome,”** typically, the provision of new or improved infrastructure to provide a new public service.”*

The Highways PPP Policy states that PPP should involve investment of private capital to design, financing, construction, operations, and maintenance of a project for public use for specific term during which a private proponent is able to collect revenue from the users of the facility. The Policy further states that for financially viable projects, the tolls charged would be one of the key criteria when evaluating proposals from the private sector. However, for economically viable, but financial unviable projects, the criteria for awarding a concession will be the least subsidy or support required from the NHA. According to the

Policy, the range of support that NHA could provide to a project includes, but is not limited to: traffic guarantees, revenue guarantee, equity stake, annuity payments, and a contribution to project cost.

The Highways PPP Policy recognizes that attracting private sector participation is a complex task that requires a dedicated PPP unit in NHA (the Private Sector Cell). The PPP unit is generally responsible for project development and negotiations with the private sector. The Policy lays out some specific components of the PPP project development and procurement process, which include:

- Development of PPP highway program
- Development of pre-feasibility reports
- Dissemination of list of approved PPP Projects
- Pre-qualification of interested parties
- Provision of requests for proposals to all pre-qualified bidders
- Bidding, evaluation and ranking of parties submitting proposals
- Negotiations with highest ranked bidder and timeframe for achievement of financial close

What PPPs are in the roads sector?

In 1995, the NHA established its Private Sector Cell with the assistance of the World Bank. The National Highways PPP Policy, as described above, further defined the authority and function of the Private Sector Cell to promote more private sector participation in the roads sector. However, to date, there have been only a few PPPs contracted by the NHA.

In 1997 NHA entered into its first concession agreement with Daewoo Corporation for financing, construction, commissioning, management, operations and maintenance of Services Areas on M-2 (the Lahore Islamabad Motorway) for a period of 15 years. Ten Service Areas were to be constructed under the Agreement.

In 2005, the Private Sector Cell of NHA was reorganized and in 2006 NHA entered into two concession agreements as follows:

- A concession agreement with IBEX Construction Limited, a special purpose vehicle wholly owned by Frontier Works Organization (FWO) for design, finance, insurance, construction, commissioning, management, operation, maintenance and tolling of Lakpass Tunnel for a period of twenty five years. The Project comprised of a 180 meter long tunnel along with 4.5 kilometers of approach road and the total Project Cost was estimated to be 679 million Rupees
- A concession agreement with Standard Construction Company Limited for design, finance, insure, construct, manage, operate, maintain, toll and transfer of M-9 for a period of twenty five years. The project comprised of 136 kilometers of 6-lane closed highway along with several interchanges, service roads, flyover, and pedestrian underpasses. The total project cost was estimated to be 6.32 billion Rupees.

The concession for M-2 service areas will expire in two years. The construction of Lakpass Tunnel has been completed and it opened for commercial operations in 2009. However, the

M-9 could not be constructed due to termination of the concession agreement. The NHA alleged that the private proponent was unable to achieve financial close within the stipulated period and therefore the concession agreement lapsed, while the private proponent has claimed that the NHA wrongly terminated the agreement. The dispute is currently under arbitration.

Finally, the NHA recently entered into a concession agreement with N. F. Concessions Company Limited—a special purpose vehicle created by Ascent Capital International Limited—for design, finance, constructing, management, operations, maintenance, and tolling of the Shahdara Flyover for a period of 25 years in exchange for availability payments from the NHA.

Table 0.4 below lists the three currently executed concession agreements in the roads sector.

Table 0.4: List of Concessions in the Roads Sector

Project	Contracting Authority	COD	Contingent Liabilities
M-2 Service Areas – BOT – 15 years	NHA	<ul style="list-style-type: none"> ▪ 1997 	<ul style="list-style-type: none"> ▪ Termination Compensation
Lakpass Tunnel – BOT – 25 years – PKR 679 million	NHA	<ul style="list-style-type: none"> ▪ 2008 / 2009 	<ul style="list-style-type: none"> ▪ Development of Alternate Route ▪ Regulatory Risk – NHA Tariff Approval ▪ Subsequent Legislation ▪ Termination Compensation
Shahdara Flyover - BOT-Annuity Arrangement – 25 years – PKR 9.66 billion	NHA	<ul style="list-style-type: none"> ▪ 2013 	<ul style="list-style-type: none"> ▪ Development of Alternate Route ▪ Subsequent Legislation ▪ Termination Compensation

What contingent liabilities exist in the roads sector?

There is no specific mechanism by which the Government accepts contingent liabilities in the roads sector. However, the Government funds the operations of the NHA and currently highway projects are approved by the National Highways Council and the Executive Board of the NHA, which both include members from the Ministry of Finance and the Ministry of Planning and Investment.

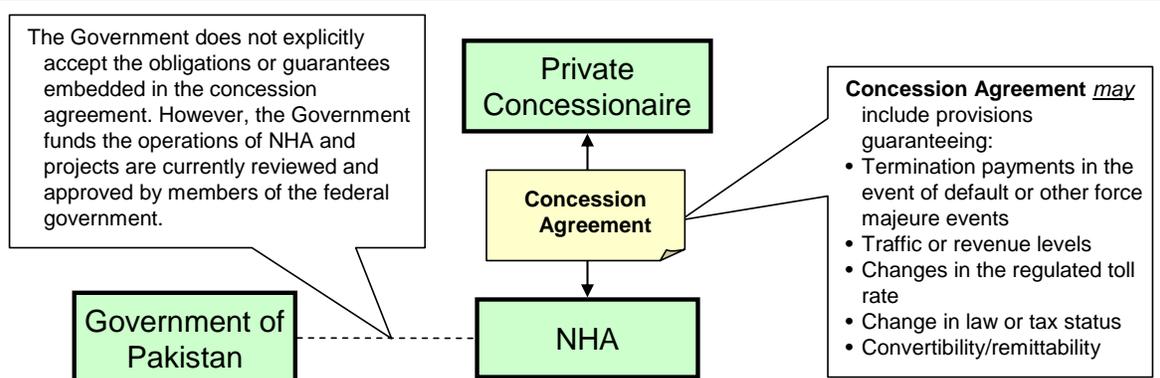
Therefore, contingent liabilities in the roads sector are only explicitly defined in the concession agreement signed between the NHA and private proponent. There are generally four types of contingent liabilities that could be included as provisions in the concession agreement:

- Termination payments triggered by the default of the IPP, default of the Government, or a force majeure event
- Guarantees specifying a minimum level of traffic or revenue for the project when the private proponent is allocated demand risk for the project¹¹
- Regulatory guarantees for any deviation in the contracted toll rate
- Provisions for the convertibility and remittability of foreign denominated funds
- Other guarantees for changes in law and tax status.

The Highways PPP Policy also recognizes the effect of existing or planned non-tolled or partially tolled competing routes on PPP projects whose financial viability depends on toll revenues. The policy states that NHA will endeavor to ensure that competing routes, especially roads of a similar standard, are tolled appropriately. Provisions to compensate the private proponent should competing routes or subsequent legislation affect the financial performance of the project also give rise to contingent liabilities in road concessions.

Figure 0.4 illustrates where these contingent liabilities arise from concession agreements contracted by the NHA.

Figure 0.4: Structure of Concession Agreements and Guarantees in the Roads Sector



¹¹ There are no existing examples of revenue or traffic guarantees, but this is a common contingent liability in PPPs executed in the roads sector in other countries.

The Highways PPP Policy specifically stipulates that escalation of toll rates and toll charges should be permitted, using the formula contained in concession agreement subject to confirmation of mathematical accuracy by the PPP unit with the NHA. The maximum toll escalation factor allowed in any year is directly linked to the annual growth rate in the consumer price index (CPI) as per the Federal Bureau of Statistics. However, the private concessionaire is allowed to apply a lower level of toll escalation, if it considers that it would improve the overall amount of toll revenue. As shown above, this guarantee of the contracted toll rate is one of the key contingent liabilities that arise in road concessions. For example, the Lakpass Tunnel concession includes a toll rate of 13 Rupees per trip; however, the NHA only allowed tolls of 10 Rupees per trip during the first year of operations. Under the terms of the concession agreement, the NHA is obligated to pay the proponent the revenue difference generated by the three Rupee deviation from the contracted toll rate.

Roads sector development pipeline

The National Highway Authority has an ambitious pipeline of projects that it plans to develop as PPPs. Table 0.5 provides a list of 17 projects that are included in the NHA’s PPP development pipeline. The list includes:

- An estimated 96 billion Rupee investment in national highways
- An estimated 1.4 billion Rupee of investment in service areas on national highways
- Operations and maintenance concessions on four major highways.

Table 0.5: Roads Sector PPP Development Pipeline

Project	Contracting Authority	Planned COD
Rawalpindi Flyover – N-5 – 14 km length – 4 Lane Flyover – Rs. 18 billion - BOT	NHA	Not known
Karachi Hyderabad Motorway - M-9 – 136 km – Conversion of existing 4 Lane Highway into 6 Lane Motorway – Rs. 13 billion - BOT	NHA	Not known
Karachi Northern Bypass - M-10 - 50.2 km – Conversion of existing 2 Lane Highway into 4 Lane divided facility – Rs. 4.2 billion - BOT	NHA	Not known
Muzaffargarh - D.G Khan - N-70 – 53 km – Conversion of existing 2 lane highway into 4 lane divided facility including Bridge at Ghazi Ghat – Rs. 5.0 billion - BOT	NHA	Not known
D.G Khan – Rajanpur - N-55 – 106 km - Conversion of existing 2-lane highway into 4-lane divided facility - Rs. 6.5 billion - BOT	NHA	Not known
D.I Khan- Balkasar Interchange - N-120 - 235km – Rs. 11.7 billion	NHA	Not known
Jhang - Chund Bridge – Sargodha – Salam - MB Din –Kharian – 280 km - Upgradation of existing road into 2 lane highway – Rs. 14.0 billion – BOT	NHA	Not known
Realignment of Lahore -Islamabad Motorway at Salt Range - M-	NHA	Not known

Project	Contracting Authority	Planned COD
2 - 15km - Realignment of existing 6-lane facility at salt range(15Km) Concession of full M-2 Motorway 350 kms (15 Toll Plazas) with revenue sharing – Rs. 12.7 billion – BOT		
Link Road Rawat to Thullian - Link between N-5 and M-2 - 28.5 km – New construction of 4 lane divided access controlled Expressway – Rs. 5.15 billion – BOT	NHA	Not known
Kandhkot - Ghotki Bridge at River Indus - Construction of 2-lane concrete Bridge on River Indus - Rs. 6.27 billion – BOT	NHA	Not known
M-1 Service Areas (2 Nos) at River Indus – Rs. 689 million – BOT	NHA	Not known
M-1 Service Areas (2 Nos) at River Haro - Rs. 260 million – BOT	NHA	Not known
N-75 Service Areas (2 Nos) - Rs. 500 million – BOT	NHA	Not known
Peshawar - Lahore - N-5 - 440 km - Operation and Maintenance of 4-lane Highway – Operating Concession – 20 years	NHA	Not known
Lahore-Multan - N-5 - 330 km Operation and Maintenance of 4-lane Highway – Operating Concession – 20 years	NHA	Not known
Multan- Sukkur – N-5 - 455 km - Operation and Maintenance of 4 lane Highway - Operating Concession - 20 Years	NHA	Not known
Faisalabad - Pindi Bhattian Motorway - M-3 & Islamabad - Peshawar Motorway – M-1 - 208 Km - Operation and Maintenance of M-3 (4-lane) & M-1 (6-Lane) Motorway – Operating Concession - 20 Years	NHA	Not known

PPPs and Contingent Liabilities in Other Sectors

There are few PPPs that have been implemented in sectors other than energy and roads. However, the Government has ambitious plans for developing PPPs in Pakistan, primarily through the efforts of the Infrastructure Project Development Facility.

Currently we know of only a small number of specific PPP projects in other sectors:

- The Multan Dry Port contracted by the Ministry of Railway
- At least 11 executed terminal concessions contracted by the port authorities—Port Qasim Authority, Karachi Port Trust, and Gwadar Port Authority—and eight planned terminal concessions.

We requested information from the relevant agencies on these and other possible projects but did not receive sufficient information to make a complete assessment of the existing PPPs or associated contingent liabilities. We have included—in Appendix A—a list of the

executed and planned concessions in ports and shipping. However, we can not be certain that the list is comprehensive. Moreover, while the concessions listed in below are PPPs under a strict definition, because port authorities in Pakistan have historically operated autonomously from the federal government and have not presented fiscal risk, it is unclear whether the Government intends to exclude port authorities from the efforts to strengthen PPP and contingent liability management policies and processes. Notably, IPDF is currently assisting port authorities on implementing some projects. This indicates that ports and shipping should be included in the framework.

In other sectors we expect that there are no major projects that are currently being processed outside of efforts by Infrastructure Project Development Facility. Table 0.6 lists the projects that are currently under development by IPDF. To date, IPDF has not yet completed any transactions and contracted any new projects since its inception. We do not have draft contracts for the projects being developed to assess the contingent liabilities that may arise from the projects under development.

IPDF's current development efforts presented in Table 0.6 and the priorities outlined in the 2010 PPP Policy provide a good indication of the sectors where PPPs are likely to be developed in the future. Box 0.2 describes the sectors that are highlighted in the 2010 PPP Policy.

Box 0.2: Priority Sectors for Developing PPPs in Pakistan

The 2010 PPP Policy states that:

Regardless of sector or level of government, PPPs will be pursued where they represent priority projects, are affordable to the government and consumers, and represent value for money (i.e. provide a better approach than public procurement).

However, the policy identifies the following specific sectors for developing PPPs in Pakistan:

- **Transport and logistics**, including federal, provincial and municipal roads, rail, seaports, airports, fishing harbors as well as warehousing, wholesale markets, slaughter houses and cold storage
- **Mass Urban Public Transport**, including integrated bus systems as well as intra and inter-city rail systems
- **Local Government Services**, including: water supply and sanitation; solid waste management; low cost housing, and healthcare/education and skills development facilities
- **Energy Projects**, including hydroelectric and captive power generation projects
- **Tourism Projects**, including cultural centers, entertainment and recreational facilities and other tourism related infrastructure
- **Industrial Projects**, including industrial parks, special economic zones and related projects
- **Irrigation Projects**, some of these combined with power generation
- **Social Infrastructure**, which includes education, culture, and health infrastructure.

Source: Pakistan Policy on Public Private Partnerships: *Private Participation in Infrastructure for Better Public Services*. Approved by the Economic Coordination Committee of the Cabinet 26 January 2010.

Table 0.6: List of Projects under Development by IPDF

Project	Sector	Value	Status
PSEB IT Park	Office / Industry Infrastructure	120 million Rupee	IPDF assisted Pakistan Software Export Board (the institution) and its transaction advisors in the structuring and implementation of the project. The project is in last stage of the transaction implementation phase with private sector bidder already selected and negotiations are ongoing with selected bidder. At the moment there is also a strong probability that the project may be taken back into the market again given the time it has taken with reference to ongoing negotiations and the rapid change in the business environment
Charsadda Solid Waste Management Project	Municipal Services	20 million Rupee	The project is in the last stage of transaction implementation phase and is in the process of procuring of a private party. Our earlier floatation of request for proposal for the same has not been successful due to security situation in Charsadda. However, another attempt would be made after the security situation issue is resolved
Shaheed Benazir Bhutto CNG Bus Project	Mass Urban Public Transport	50 million Rupee	The project is in transaction implementation phase with the request for proposal already issued to the pre-qualified CNG Bus Operators asking them to submit their technical and financial bids
Establishment of Cool Chain System along National Trade Corridor	Transport & Logistics	150 million Rupee	The project is in the end of the transaction structuring phase with the feasibility report along with the security package for the project already prepared and submitted for approval of the report and the security package
Faisalabad Solid Waste Management Project	Municipal Services	65 million Rupee	The “Needs and Options Report” has been finalized and it was decided in a stakeholder meeting to proceed on DBFO basis. The draft feasibility has been completed for comments. Pre-qualifications have been received from 12 firms
Port Qasim Shipyard Project	Transport & Logistics	500 million Rupee	IPDF is assisting Karachi Shipyards & Engineering Works (KSEW) in the structuring and implementation of the said project as a PPP. The project is in the inception phase of the project development cycle, the RFP has been issued, and transaction advisors are being hired
Gwadar Shipyard Project	Transport & Logistics	500 million Rupee	IPDF is assisting Karachi Shipyards & Engineering Works (KSEW) in the structuring and implementation of the said project as a PPP. The project is in the inception phase of the project development cycle, the RFP has been issued, and transaction advisors

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Project	Sector	Value	Status
			are being hired
PTDC Corporate Complex	Office / Industry Infrastructure	30 million Rupee	IPDF is assisting Pakistan Tourism & Development Corporation (PTDC) in the structuring and implementation of the project as a PPP. The project is in the inception phase and transaction advisors have been short-listed and selected
PTDC-Islamabad Tourist Village	Hotel / Industry Infrastructure	70 million Rupee	IPDF is assisting Pakistan Tourism & Development Corporation (PTDC) in the structuring and implementation of the project as a PPP. The project is in the inception phase and transaction advisors have been short-listed and selected
National Institute of Dentistry	Health	7 million Rupee	IPDF is assisting Pakistan Institute of Medical Sciences (PIMS – the institution) in the structuring and implementation of the project as a PPP. The project is in the inception phase of the project development cycle, the RFP has been issued, and technical advisors have been short-listed and selected
Centre of Liver Disease and Transplant (CLOT)	Health	6 million Rupee	IPDF is assisting Pakistan Institute of Medical Sciences (PIMS) in the structuring and implementation of the project as a PPP. The project is in the inception phase of the project development cycle, the RFP has been issued, and technical advisors have been short-listed and selected
Faisalabad WASA Metering & Billing Project	Municipal Services	10 million Rupee	IPDF is assisting Faisalabad WASA in the structuring and implementation of the project as a PPP. The project is in the inception phase of the project development cycle, the RFP has been issued, and transaction advisors have been selected but not approved
Karachi Circular Railway (KCR)	Mass Urban Public Transport	1500 million Rupee	KUTC (Karachi Urban Transport Corporation) has been setup as an overseeing agency for operation & implementation of KCR. To review the financial viability of KCR the CDWP constituted a committee. IPDF was engaged to prepare a financial model in order to assess the financial viability of the project by the committee with reference to its ability to service debt and generate positive cash flows and to finalize for CDWP & ECNEC its recommendations for their consideration
Electricity Distribution Companies	Energy	unknown	IPDF has been asked by Ministry of Finance to evaluate various options relating to implementation of power distribution functions via PPP mode. Based upon discussions and exchange of information between IPDF and PEPCO, various options have been evaluated to implement power distribution functions through PPP. PEPCO

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Project	Sector	Value	Status
			proposed the future project of advance metering for LESCO. IPDF has explored basic financial and commercial analysis of LESCO The project is in initial inception stage.
Quaid-e-Azam University (QAU) Medical College	Education	5 million Rupee	IPDF is assisting QAU and Higher Education Commission in the structuring and implementation of the project as a PPP. The project is in the inception phase of the project development cycle. IPDF is planning on issuing an RFP for hiring of a technical consultant.
Sheikh Zayed Hospital	Education	5 million Rupee	IPDF is assisting Sheikh Zayed hospital and the cabinet division in the structuring & implementation of the project as a PPP. The project is in the inception phase of the project development cycle. IPDF has sent a comprehensive proposal to the cabinet secretary in which IPDF has proposed that a technical advisor be hired to go forward with this project

A.4 Policies and Processes Governing Contingent Liabilities from PPPs

Finally, it is important to have a clear understanding of **the current policies and processes for managing contingent liabilities from PPPs in Pakistan**. By evaluating how effectively Pakistan is currently managing contingent liabilities—and managing PPPs and other forms of guarantees generally—we can identify the gaps that need be addressed to strengthen the existing policies and processes and achieve the benefits of managing contingent liabilities well.

There is no single, best practice model for managing contingent liabilities from PPP projects: different countries take different approaches. Nonetheless, as described above, good contingent liability management frameworks typically include a set of similar functions, as well as an institutional framework for carrying out those functions. Comparison with these common functions and proven institutional frameworks is a helpful way to evaluate the effectiveness of the existing policies and processes that apply to contingent liabilities from PPPs in Pakistan.

In this section we first describe (in Section 0) common features of good contingent liability management frameworks. We then assess (in Section 0) the extent to which these “good-practice” features are currently apparent in Pakistan.

Good Practice in Contingent Liability Management

We described above the benefits that can be achieved by effectively managing contingent liabilities. We also identified functions, spanning the lifecycle of a PPP project, which are common in effective contingent liability management frameworks. In this section we first review those functions, and provide some examples how they are carried out in other countries. We then briefly describe and provide examples of institutional frameworks for carrying out these functions.

Common contingent liability management functions

The common functions that comprise a good contingent liability management system are listed in Table 0.1. The intended purpose of each function is briefly described—that is, how the function can contribute to the overall objectives of managing contingent liabilities well. Examples are also provided for how each function is performed in other countries.

Table 0.1: Common Contingent Liability Management Functions

What is the Function?	What is the purpose of the function?	How can the function be performed?
Project Development Stage		
Structuring contingent liabilities and designing contractual mechanisms by which the Government bears risks under a PPP contract	To ensure that the risks the Government will bear are consistent with good risk allocation principles, borne at the lowest cost and with minimal fiscal impact	<ul style="list-style-type: none"> ▪ Define principles for allocating risk and structuring contingent liabilities, to be applied when preparing PPPs and draft contracts ▪ Develop tools for practitioners, such as preferred allocation matrices or model contract clauses
Analyzing the	To inform how the project is	Using qualitative and various

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What is the Function?	What is the purpose of the function?	How can the function be performed?
contingent liabilities that will be accepted under a proposed project	structured and approved, and provide a basis for monitoring and budgeting for contingent liabilities	quantitative methods to evaluate the potential cost to Government of accepting the contingent liability
Approving those contingent liabilities, if found to be consistent with structuring principles and good fiscal management	To ensure the use of Government resources in the form of contingent liabilities is focused on policy priorities; represents value for money; and is consistent with good fiscal management.	As part of the overall approval process for PPP projects: <ul style="list-style-type: none"> ▪ Check contingent liability structure ▪ Introduce rules to limit overall fiscal impact of contingent liabilities (such as ceilings or defined budgeting requirements)
Formally accepting the contingent liabilities defined in executed PPP contracts	To clarify the Government’s commitment to its contingent liability obligations, and to ensure the executed contract is consistent with earlier analysis and approval	<ul style="list-style-type: none"> ▪ Require approval of final PPP contracts before signing ▪ Provide a distinct legal agreement, typically signed by a finance ministry, acknowledging the Governments’ contractual commitments (subject to checking the final PPP contract)
Project Implementation Stage		
Monitoring those contingent liabilities while the project is being constructed and implemented	To provide information needed to disclose, act on emerging issues and, if necessary, budget for contingent liabilities	Systematically collect project and other information; periodically re-evaluate contingent liabilities; and make this information centrally available within Government
Regularly and publicly disclosing the contingent liability exposure	To improve accountability for decision-makers, and increase transparency of the Government’s commitments to third parties (such as credit agencies and lenders)	Regularly publish information on contingent liabilities from PPPs, either as part of other public financial management documents, or in a stand-alone report
Taking mitigating action where necessary on emerging contingent liability risks	To help reduce the cost to Government of bearing contingent liabilities by reducing the likelihood or cost of those liabilities realizing	Based on monitoring information, identify and take coordinated action (for example, action by the contracting authority with support from the Finance Ministry) on emerging issues
When necessary, budgeting for and paying for contingent liabilities that have realized	To ensure resources are available to make payments promptly when required—improving credibility and clarity as to how costs of contingent liabilities will be borne, and mitigating the fiscal impact	<ul style="list-style-type: none"> ▪ Set aside funds in advance towards possible future payments ▪ Budget for expected upcoming payments ▪ Create budget flexibility to accommodate payments when needed

As shown Table 0.1, different countries take different approaches to some functions. These approaches depend on the processes for developing PPPs and managing public finances, as

well as on any particular problems the contingent liability management system has been designed to solve. Nonetheless, each function typically serves a common purpose. Above we describe whether and how the existing policies and processes in Pakistan achieve the purposes of these contingent liability management functions.

Institutional frameworks for managing contingent liabilities from PPPs

Institutional frameworks for managing contingent liabilities from PPP projects vary between countries. As for the approaches to the management functions described above, these variations depend on the institutions in place and the challenges faced when the contingent liability management framework was being developed.

Institutions that are typically involved in managing contingent liabilities are:

- **Project contracting authorities**—the agencies that enter into PPP contracts are typically responsible for developing and assessing PPP projects, and therefore also for structuring and analyzing the associated contingent liabilities. As the agency with the direct relationship with the contractor, the contracting authority also typically plays a key role in monitoring and taking action on emerging contingent liability risks. Some countries, such as Colombia, have introduced mechanisms to ensure that contracting authorities must also budget and pay for realized contingent liabilities
- **PPP units**—several countries have dedicated PPP units that support contracting authorities in carrying out their functions in developing PPPs, as described above. Some also play an oversight role by approving PPP projects or overseeing project performance during the implementation stage. For example, the Partnerships Victoria unit in the State of Victoria, Australia, gives substantial support to agencies in structuring PPP contracts and any associated contingent liabilities
- **Finance ministries and other oversight agencies**—PPPs almost always require central approval from finance ministries and other oversight agencies such as planning ministries or agencies. This approval typically covers a combination of consistency with policy priorities and budget resources, and for value for money. In some cases, specific units within the Finance Ministry are responsible for assessing financial commitments under PPP projects, including contingent liabilities. For example, in Chile the contingent liabilities under a proposed project are analyzed by a contingent liabilities management unit under the Budget department. That unit is also responsible for publishing an annual report on the government’s contingent liability exposure.
- **Guarantee fund managers**—some countries have established guarantee or contingency funds from which obligations arising from realized contingent liabilities from PPP projects will be paid. These can be government “accounts” in which budgeted funds are set aside—and which may be managed by a private financial institution—as in Colombia, or legally independent (typically partly or fully government-owned) guarantee companies that assess and issue guarantees to PPP projects in their own right, as is under development in Indonesia.

While the specific roles and responsibilities of different institutions vary, all contingent liability management frameworks require close coordination between different entities, both within and outside government. This means that a common feature of all successful

frameworks is that respective responsibilities, and processes and requirements at each stage—that is, the way those institutions will work together—are clearly defined.

How Pakistan Manages Contingent Liabilities

Pakistan has no specific framework for managing contingent liabilities from PPP projects. However, other policies and processes currently in place may achieve some of the same functions and institutional features as listed above. In this section we first briefly describe the policy areas that are relevant to managing contingent liabilities from PPP projects in Pakistan. We then assess in turn whether these policies adequately define the functions and institutional framework for managing these contingent liabilities, and identify the gaps that an improved system should address.

What policies are relevant for managing contingent liabilities in Pakistan?

In Pakistan, the key relevant policy areas for managing contingent liabilities from PPP projects are those for:

- Developing and implementing PPP projects in general
- Managing similar types of contingent liability.

We describe each of these briefly in turn.

Policies and processes for developing and implementing PPP projects

As described in Table 0.1 and illustrated in Figure 0.1 above, the contingent liability management functions are usually integrated into the overall policies and processes for developing and implementing PPP projects. In Pakistan, PPPs have in the past been developed by contracting authorities, following their own processes, which are specific to each authority and include limited external approval. An updated PPP Policy—briefly described in Box 0.1 below—was introduced in January, 2010. This replaces the 2007 PPP policy, which was the first attempt to adopt formal processes for developing PPP projects across infrastructure sectors, and includes some provisions that are relevant for contingent liability management.

Box 0.1: Content of the PPP Policy (2010)

The current PPP Policy was approved by the Economic Coordination Committee (ECC) of the Cabinet in January, 2010. This policy includes descriptions of :

- The background, objectives and scope of PPP in Pakistan, including the types of support the Government may provide to PPP projects
- Institutional roles and responsibilities for developing and implementing projects, which comprise roles for the contracting authorities (which may be federal or local Government departments, or state-owned enterprises), the Planning Commission, and several entities under the Ministry of Finance (MOF)
- The (forthcoming) legal framework for PPPs
- Principles for allocating and managing risks through PPP agreements
- Processes for developing and implementing PPPs, including recommended steps in the PPP development process, the Government’s approach to unsolicited proposals, and some information on project approval requirements.

Source: PPP Policy (2010)

A PPP Bill, intended to set these policies in law, is yet to be finalized and enacted. We understand the draft PPP Bill is undergoing a third-party legal review before it will be approved within the Ministry of Finance and ratified through the parliamentary process.

Policies and processes for managing similar types of contingent liability

A second policy area that may have implications for managing contingent liabilities from PPP projects is the policy and processes for managing similar types of contingent liability. These include the policies defined in the Fiscal Responsibility and Debt Limitation (FRDL) Act (2005) with regard to the provision of debt guarantees to private parties, and the processes set in place by the Debt Policy Coordination Office (DPCO) to implement those policies. As explained in Box 0.2, while the provisions of the FRDL Act do not currently apply to obligations under PPP projects, they could reasonably be extended to do so.

Box 0.2: The Implications of the FRDL Act (2005) for PPP Contingent Liabilities

The implications of the Fiscal Responsibility and Debt Limitation (FRDL) Act (2005) for management of contingent liabilities under PPP projects depends on the interpretation of “guarantee”, as defined in the Act. Under the FRDL Act, “guarantee” is defined as follows:

“Guarantee” includes any obligation undertaken to make payments in the event of the profit of an undertaking falling short of a specified amount

A later clause, setting a cap on new guarantees, elaborates on this definition, specifying that the cap applies to “guarantees, including those for Rupee lending, bonds, rates of return, output purchase agreements”.

Good practice in structuring PPP projects in general would avoid providing explicit rate of return or debt guarantees. However, some types of contract clause—such as termination payments in the case of contractor default, or minimum demand guarantees—do achieve a similar result. The FRDL Act is not currently understood to apply to these types of contingent liabilities, but a new contingent liability management system could draw on these provisions of the FRDL Act.

Source: Fiscal Responsibility and Debt Limitation (FRDL) Act (2005) Chapter 1, clause 2 (definitions) and Chapter 2, clause 3(d)

Do these policies achieve the contingent liability management functions?

Table 0.2 describes the extent to which these policies and processes address each of the contingent liability management functions described in above. Since the current policies make limited explicit reference to managing contingent liabilities, there are several gaps in Pakistan’s current contingent liability management framework with respect to these common functions.

Table 0.2: Contingent Liability Functions in Pakistan

Function	Relevant Policies in Pakistan
Project Development Stage	
Structuring contingent liabilities	<p>A principle for allocating risk is defined in the PPP Policy 2010: that “[each] risk will generally be borne by the party best able to manage it at minimum cost”.</p> <p>This principle is in line with international good practice, and provides a basis for managing contingent liabilities. The PPP policy also states that the</p>

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Function	Relevant Policies in Pakistan
	concession contract will specify how risks have been allocated. However, no further policy or guidance is provided on how these contractual mechanisms should be designed, to achieve the best risk allocation and to manage fiscal impact
Analyzing contingent liabilities	No requirement or approach to analyzing contingent liabilities is defined
Approving contingent liabilities	<p>There are no specific requirements or rules for taking the contingent liabilities to be accepted under a proposed project into consideration when approving a PPP project. The requirements and process for PPP project approval in general are not clearly specified, as described below.</p> <p>The FRDL Act limits the issue of new guarantees during a fiscal year to two percent of the estimated GDP for that year. As described in Box 0.2 above, this limit does not currently apply to contingent liabilities accepted under PPP projects, but could feasibly be extended to do so. Checking consistency with that limit would then form part of the process of approving a proposed PPP project.</p>
Formally accepting contingent liabilities	<p>PPIB signs Implementation Agreements to contractually define the extent of the Government’s obligations, including contingent liabilities, to Independent Power Producers. In other sectors, there is no formal mechanism by which the Government Accepts Contingent Liabilities.</p> <p>The Debt Policy Coordination Office currently certifies that new debt guarantees are compliant with the FRDL Act and in some cases the Ministry of Finance issues a comfort letter to formally acknowledge the issuance of a guarantee.</p>
Project Implementation Stage	
Monitoring contingent liabilities	<p>The PPP Policy (2010) specifies that contracting authorities are responsible for monitoring PPP projects. The PPP Policy also states that the DPCO is responsible for “ultimate management” of any contingent financial obligations, including PPPs, arising from the PPP program. This follows the FRDL Act (2005), which specifies that the DPCO is responsible for monitoring the Government’s guarantee stock.</p> <p>No requirements or guidance are provided for the nature of this monitoring, or for how DPCO and contracting authorities should work together during the project implementation stage</p>
Disclosing contingent liability exposure	The FRDL Act (2005) requires “consistent and authenticated information” on guarantees, including their budgetary impact, to be included in an annual debt policy statement. This is included among the responsibilities of the DPCO
Taking mitigating action on emerging contingent liability risks	As described above for monitoring contingent liabilities, the PPP Policy (2010) suggests that responsibility for actively managing those liabilities would be shared between contracting authorities and the DPCO. No further guidance is provided.
Budgeting and paying for realized contingent liabilities	No approach to budgeting and paying for contingent liabilities from PPP projects is defined

Is the institutional framework for managing contingent liabilities well-defined?

To date, responsibilities and processes for developing PPP projects in Pakistan have been fragmented, with agencies following their own processes, and without well-defined or centralized approval requirements. Both PPIB and NHA—two agencies with experience with private sector participation in Pakistan—follow internal approval processes. For example, the final approval of a new IPP is made by the PPIB Board, which includes the Secretary of Finance and Secretary of Planning, and PPIB has authority to sign Implementation Agreements codifying the Government’s obligations to an IPP.

The Ministry of Finance and IPDF are actively developing policies and guidelines to develop PPPs in sectors that have had limited experience with PPPs to date. This assignment draws from and supports those efforts, particularly the new PPP Policy approved in January 2010.

The PPP Policy clarifies responsibilities for managing contingent liabilities

The PPP Policy (2010) is part of the Government’s efforts to rationalize and strengthen the institutional framework for developing PPPs in general. The PPP Policy defines responsibilities for various aspects of developing and implementing PPP projects, and provides a basis for an institutional framework for managing contingent liabilities. For example, it is clearly stated that the DPCO is responsible for managing all contingent liabilities of the Government, including those from PPP agreements. The policy also requires the Ministry of Finance to approve any financial commitments under PPP projects.

However, in some cases (and reflecting the relatively unclear processes, as described below) the interactions between entities are not clearly defined. For example, the relative responsibilities of the contracting authority and the DPCO for managing contingent liabilities during the project implementation stage would need to be more clearly defined under an improved contingent liability management framework. The applicability of the PPP policy’s requirements to entities such as the PPIB and port authorities, which have developed their own processes as described above, has also not been clearly defined.

Processes for developing and approving PPPs remain unclear under the PPP Policy

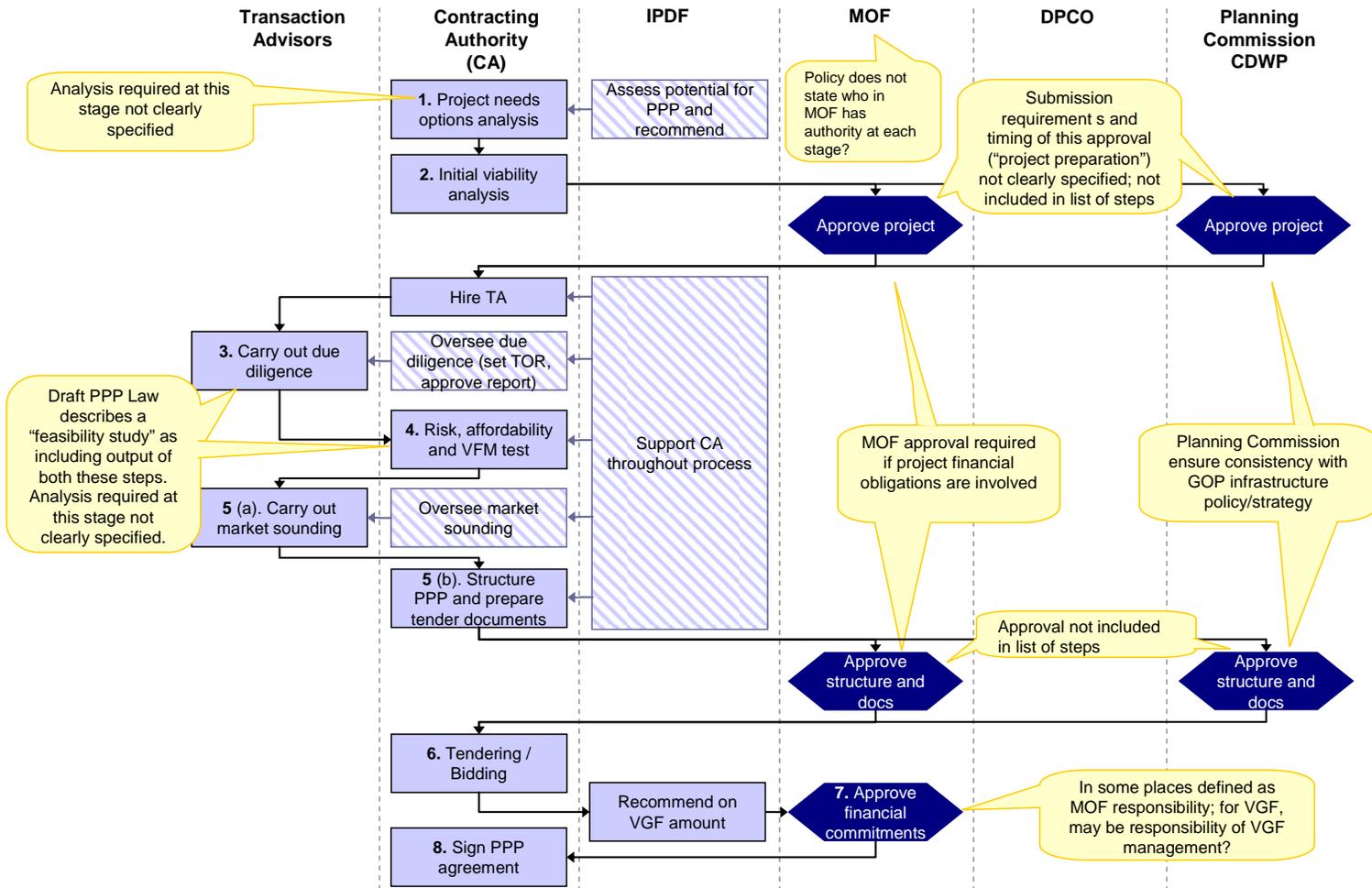
The main shortcoming of the 2010 PPP policy is that the processes for developing PPPs are not clearly and fully specified. The PPP Policy describes an eight-step process for developing PPPs—the “PPP Lifecycle”: from project identification (needs and options analysis) to tendering, closing and monitoring a PPP contract. The component steps of developing PPPs are broadly in line with international good practice and some guidelines have been issued by IPDF to carryout specific functions. However, the requirements for project assessment—including the process by which projects are evaluated and approved at each stage—are not clearly specified.

Figure 0.1 shows the PPP project development process as currently specified in the 2010 PPP Policy, including the eight-step PPP Lifecycle. As highlighted in Figure 0.1, the PPP policy does not specify clearly how the required project approvals fit among the project development steps¹², or the kind of analysis and assessment that is required at every stage.

¹² The exception is the “approval of viability gap funding”, which is specified as following the completion of the bidding process. Requiring this formal approval only at this late stage, however, risks undermining competition in the bidding process: private contractors may be discouraged from bidding if the project may ultimately not be approved.

Many countries strengthen their contingent liability management frameworks by integrating the contingent liability management functions (particularly at the project development stage) into the overall process for developing and approving PPPs. In Pakistan, to do so successfully would first require that overall process to be clarified and strengthened by addressing the gaps highlighted in Figure 0.1.

Figure 0.1: Map of PPP Project Development Process in 2010 PPP Policy

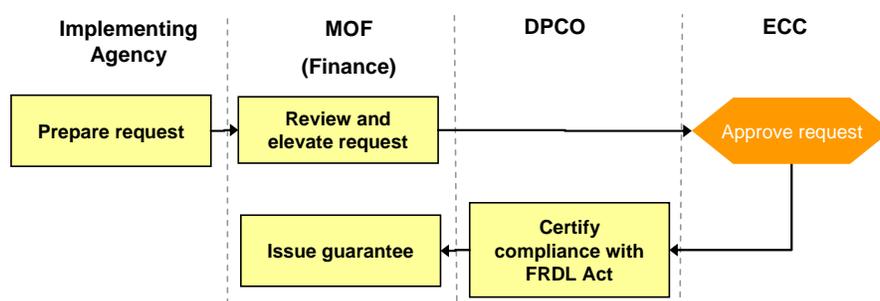


Processes for approving and issuing other forms of guarantee are also unclear

In some countries, contingent liabilities under PPP projects are formally accepted through a legal agreement (sometimes called a guarantee or comfort letter), distinct from the PPP contract, and typically signed by the Ministry of Finance. This allows a distinct approval process for obtaining that agreement letter can be put in place—this is often comparable to the process for issuing other forms of guarantee such as debt guarantees, and could be an alternative approach in Pakistan to integrating contingent liability approval into the overall PPP approval process.

However, as with the development of PPPs, the process that is in place for issuing or managing debt guarantees in Pakistan is also not clearly defined or consistently followed. Figure 0.2 illustrates the general process that we understand is generally followed to review and approve a request for a debt guarantee. Most significantly, DPCO is tasked with reviewing the request for a debt guarantee and certifying that it is compliant with the Fiscal Responsibility and Debt Limitation Act after it has been approved by the Economic Coordination Committee (ECC). Once DPCO has certified the request, MOF issues the guarantee. In most cases the guarantee is formally issued with a comfort letter from MOF.

Figure 0.2: General Process for Approving Debt Guarantees



The process illustrated above has not been consistently followed in the past, however. As a result, data on what guarantees had been issued were not compiled or systematically monitored and managed. In 2009, DPCO responded to this lack of information by collecting and collating information on debt guarantees for the first time. DPCO identified a total of 994.7 billion Rupee of outstanding guarantees, including US\$2,799 million in foreign denominated loan guarantees.

Appendix B: Stakeholder Workshop

This Appendix provides information on the one-day stakeholder workshop held in Islamabad on 21 July, 2010. The objectives of the workshop were to:

- Identify and understand the benefits that can be achieved by managing contingent liabilities
- Present Castalia’s specific recommendations on how to manage contingent liabilities and how roles and responsibilities should be allocated
- Collect feedback on the recommendations
- Discuss how the recommendations could be adopted and implemented.

Given the limited engagement of the Ministry of Finance and other stakeholders during the early stages of this assignment—due in part to the departure of the Director of DPCO—and the diversity of participants, much of the time during the workshop was spent clarifying the purpose and benefits of managing contingent liabilities and providing background on the assignment. This prevented detailed discussion on the specific components of the recommendations. Nevertheless, there was open dialog among the participants and many constructive comments were given.

In general, participants expressed enthusiasm about the proposed contingent liability management framework. However, there was notably some question as to how all of the ongoing PPP related initiatives fit together (including contingent liability management, viability gap funding, the 2010 PPP Policy, the project development process, and the development of a financing facility) and whether contingent liabilities is a high priority or if other efforts might be more important. Based on this observation, we believe that it would be a worthwhile effort to undertake a project that aims to: (1) clearly show how all ongoing initiatives should be integrated, (2) prioritize and create a timeline and milestones for moving the integrated initiatives forward, and (3) identify any additional gaps or capacity building constraints, would be very fruitful and well-received by the Government. This need aligns with our suggestion that pilot-testing a project would be an effective way to carry out an assessment of Pakistan’s PPP program while simultaneously providing training and guidance moving a project toward closing a transaction.

B.1 Workshop Attendance

Table 0.3 below lists the individuals that attended and participated in the workshop.

Table 0.3: List of Workshop Participants

Sr. No.	Name	Designation	Organization
1	Ms. Sumaira K. Aslam	Joint Secretary (Investment)	Ministry of Finance
2	Mr. Haq Nawaz	Joint Secretary (Budget Implementation)	Ministry of Finance
3	Mr. Momin Khan	Deputy Secretary (Investment)	Ministry of Finance

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4	Mr. Mahmood Ahmed	Section Officer (Investment)	Ministry of Finance
5	Ms. Mehwish Ashraf	Financial Analyst (DPCO)	Ministry of Finance
6	Mr. Raghuv eer Y. Sharma	Lead Pakistan Energy and PPP Program	The World Bank
7	Mr. Anjum Ahmad	Senior Energy and PPP Specialist	The World Bank
8	Dr. Rashid Aziz	Senior Energy Specialist	The World Bank
9	Ms. Saadia Razaqat	Economist	The World Bank
10	Tasneem Alam	Economist	IMF
11	Chaudhary M Anwar	Deputy Chief (Physical Planning and Housing)	Ministry of Planning and Development
12	Mr. M. Hussain Malik	Deputy Chief (Transport)	Ministry of Planning and Development
13	Mr. Irfan Ismail	Additional Director (Banking Surveillance Department)	State Bank of Pakistan
14	Mr. Usman Shaukat	Deputy Director (Infrastructure and Housing)	State Bank of Pakistan
15	Mr. Abdul Karim Nayani	Consultant	Privatisation Commission
16	Mr. Shah Jahan Mirza	Director (Finance & Policy)	PPIB
17	Mr. Sabir Ali Khan	Director General (CPCC)	PEPCO
18	Mr. Najam Javid	Director Finance (IESCO)	PEPCO
19	Mr. Anwar ul Haq	Director Finance (PESCO)	PEPCO
20	Mr. Muhammad Jawad Anwar	Dy. Director (CPCC)	PEPCO
21	Mr. Afzal Masood	Manager (Finance)	National Transmission and Despatch Company
22	Mr. Muhammad Sohail Noman i	Section Officer (Coord)	Ministry of Ports and Shipping

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23	Syed Mohammad Ali Shah Lakiary	XEN (Civil)	Port Qasim Authority
24	Mr. Mumtaz Alam	D.M. (Finance)	Port Qasim Authority
25	Brig. Syed Jamshed Zaid	General Manager (P&D)	Karachi Port Trust
26	Mr. Muhammad Hanif Abdullah	Project Manager (East)	Karachi Port Trust
27	Mr. Khizer Javed	Deputy Director	Ministry of Communications
28	Mr. Arshad Chaudhry	G.M. (BOT)	National Highway Authority
29	Mr. Azeem Tahir	Director (BOT)	National Highway Authority
30	Ms. Sehrish Jamil	Assistant Director (Planning)	National Highway Authority
31	Mr. Mir Muhammad Khaskheli	Director Planning	Ministry of Railways
32	Mr. Khizar Saleem Khokhar	Section Officer (Works)	Ministry of Housing and Works
33	Mr. Fayyaz ul Haq	Section Officer (Policy)	Ministry of Housing and Works
34	Mr. Shahnawaz Mehmood	Head Projects	IPDF
35	Mr. Ali Malik	Advisor Projects	IPDF
36	Ms. Saadia Hassan	Advisor Projects	IPDF
37	Mr. Kevin Richards	Project Manager	Castalia - Strategic Advisors
38	Mr. Ahmad Waqar	Chairman	PanGro - Development Advisors
39	Mr. Aamir Qawi	Chief Executive Officer	PanGro - Development Advisors
40	Mr. Arsalan S. Vardag	Chief Financial Officer	PanGro - Development Advisors
41	Mr. Junaid Jadoon	Senior Associate	PanGro - Development

			Advisors
42	Mr. Majid Baig	Deputy Chief (Planning)	Ministry of Railways
43	Mr. M. Ikram	Assistant Economist	Ministry of Finance
44	Mr. Tariq Farooq	Procurement Specialist	Ministry of Finance
45	Mr. Aamir Butt	Assistant Director	Alternate Energy Development Board

B.2 Workshop Presentation

The following pages include the presentation that was delivered by Castalia during the stakeholder workshop following an introduction by Mr. Raghuvveer Y. Sharma from the World Bank and Castalia team member Ahmad Waqar, former Secretary of Finance.

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Managing Contingent Liabilities and Fiscal Risk from Infrastructure PPPs in Pakistan



Funded by the World Bank

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Outline

- Introduction and Objectives
- Session 1: What are “contingent liabilities” and where do they occur in Pakistan?
- Session 2: How can managing contingent liabilities improve Pakistan’s infrastructure and fiscal management?
- Session 3: What should Pakistan do to manage contingent liabilities?
- Session 4: Who should manage contingent liabilities in Pakistan?
- Session 5: How can Pakistan implement a contingent liabilities management system?

Introduction and Objectives

- **The Government of Pakistan and the World Bank has asked Castalia to recommend how the management of contingent liabilities (CLs) from PPP projects can be improved**

- **So far we have:**
 - **Evaluated the existing policies and institutional processes governing contingent liabilities in Pakistan**
 - **Assessed some of Pakistan's existing contingent liabilities**
 - **Developed recommendations and options to strengthen the institutional framework in Pakistan**

- **The objective of this workshop is to:**
 - **Identify and understand the benefits that can be achieved by managing contingent liabilities**
 - **Present Castalia's specific recommendations on how to manage contingent liabilities and how roles and responsibilities should be allocated**
 - **Collect feedback on the recommendations**
 - **Discuss how the recommendations could be adopted and implemented**

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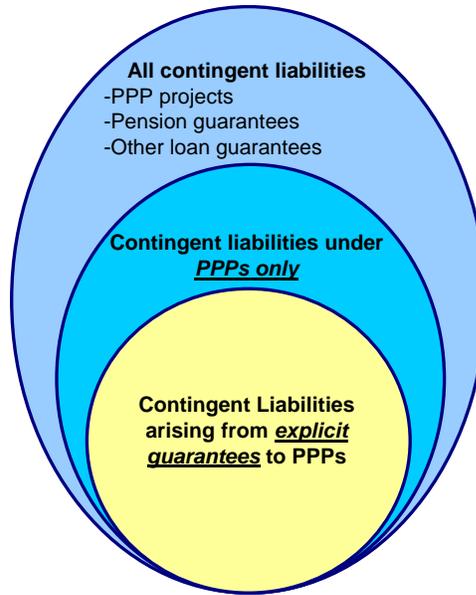
Session 1: What are “contingent liabilities” and where do they occur in Pakistan?

First, what do we mean by a “public private partnership”?

- **Pakistan’s 2010 PPP Policy defines “public private partnership” as follows:**
 - *A public private partnership (PPP) is any arrangement involving the financing, development, operation and maintenance of infrastructure by the private sector which would otherwise have been provided by the public sector. In a PPP, instead of the public sector procuring a capital asset and providing a public service, the private sector creates the asset through a dedicated standalone business (usually designed, financed, built, maintained and operated by the private sector) and then delivers a service to the public sector entity or consumer in return for payment that is linked to performance.*
- **PPPs exist in the following sectors:**
 - **Energy**
 - **National roads**
 - **Ports and rail**
 - **Others?**
 - **The 2010 PPP Policy also renews Pakistan’s commitment to developing PPPs**

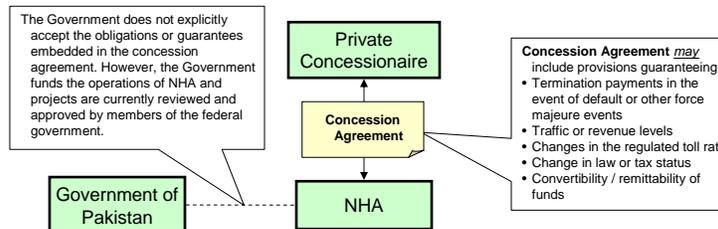
What are “contingent liabilities”?

- A contingent liability is a payment obligation whose **occurrence, timing** and/or **amount** depend on some uncertain future event or circumstance
- This project focuses primarily contingent liabilities arising from explicit guarantees to PPP projects
- An explicit guarantee is a contractual or legal commitment from the government to make a payment to a private party, incur an expense, or forego revenue if a certain event occurs



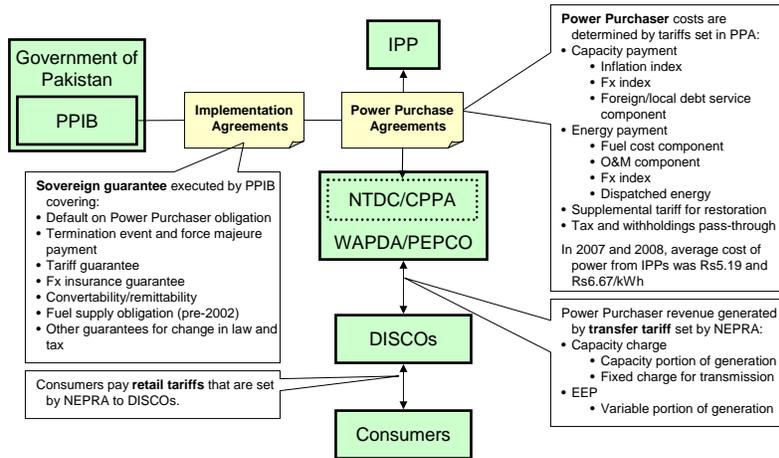
Contingent liabilities in Pakistan—direct guarantees

- Example: NHA has signed concession agreements for road and tunnel projects which include contingent liabilities



Contingent liabilities in Pakistan—3rd-Party Guarantees

- Example: PPIB has been given the authority to sign Implementation Agreements on behalf of the Government, which include guarantees to Independent Power Producers



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Why are contingent liabilities necessary?

- By providing guarantees, the government is exposed to the possibility of sudden and substantial **unexpected payment obligations**, which could lead to **fiscal instability**
- But, guarantees are needed to mobilize private investment in infrastructure
- And structured appropriately, they can maximize value for money
- This creates a need to establishing a systematic process for managing contingent liabilities



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What general types of contingent liabilities are common in infrastructure PPPs?

- Guarantees on particular variables that affect project performance:
 - Demand guarantees (specifying a minimum level of demand)
 - Exchange rate guarantees
- Termination payments or arrangements
 - If the private party defaults
 - If the Government defaults
- Compensation or termination arrangements covering damage due to some *force majeure* events
- Guarantees on Government behavior
 - Guarantee of regulator decision-making
 - Guarantee of availability of land, permits
- Government bearing project commercial risk

•What triggers each of these contingent liabilities? What are the underlying risks?

•What information is available for each:

•During project development?

•Once a project has been implemented?

•What are the implications on:

•The justification for the Government accepting risk?

•The ability to manage risk?

Session 2: How can managing contingent liabilities improve Pakistan's infrastructure and fiscal management?

What benefits can be achieved by managing contingent liabilities well?

Objective of managing CLs	How it can be achieved	Benefit
<p>Improve the ability to close PPP transactions based on sound risk allocation and management</p>	<p>By establishing a systematic process that:</p> <ul style="list-style-type: none"> • Helps the contracting agencies identify, structure and implement transactions well • Gives investors confidence in project structuring and the provision of guarantees 	<p>Better infrastructure:</p> <ul style="list-style-type: none"> • More projects closed • Greater value for money achieved on closed transactions
<p>Improve accountability and decision making</p>	<p>By ensuring decision makers :</p> <ul style="list-style-type: none"> • Accept risks and approve projects that maximize value for money • Make regulatory and policy decisions that reduce risk and improve value for money 	<p>More value created with limited resources through:</p> <ul style="list-style-type: none"> • Better project screening • Good regulatory and policy decisions
<p>Reduce fiscal risk and instability</p>	<p>By controlling the fiscal cost of accepting risk:</p> <ul style="list-style-type: none"> • Reducing the uncertainty of payment obligations • Minimizing the cost of payments on realized contingent liabilities 	<ul style="list-style-type: none"> • Better fiscal and budgetary planning • Lower burden on Government's balance sheet and budget
<p>Increase credibility</p>	<ul style="list-style-type: none"> • By making the Government's exposure transparent and signaling a commitment to manage risks • By increasing investors' confidence in how payment obligations will be met 	<ul style="list-style-type: none"> • Improved sovereign credit rating • Lower borrowing costs over time

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What are other countries doing to manage contingent liabilities?

- There is limited experience, but growing interest internationally in managing contingent liabilities

See handout on International Approaches to Managing Contingent Liabilities

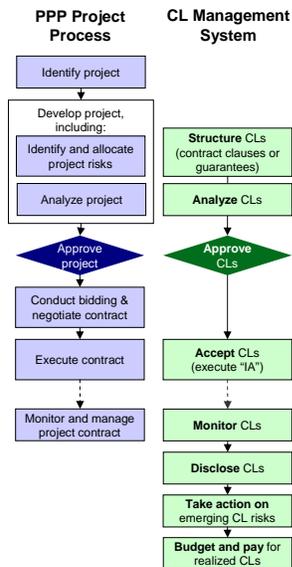
- Countries have focused on establishing frameworks that:
 - Define acceptable risks and structures for contingent liabilities
 - Establish a standard approach to valuing contingent liabilities
 - Define decision rules for assessing and approving contingent liabilities
 - Monitor and disclose contingent liabilities routinely
 - Budget or set aside funds to cover expected or actual costs (that is, realized costs, which may exceed expected cost) of contingent liabilities
 - Establish a systematic process to meet payment obligations.
- International experience also suggests it is important to:
 - Clearly assign roles and establish mandate to centrally administer the policies
 - Develop specialized knowledge on risk management principles.

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Session 3: What should Pakistan do to manage contingent liabilities?

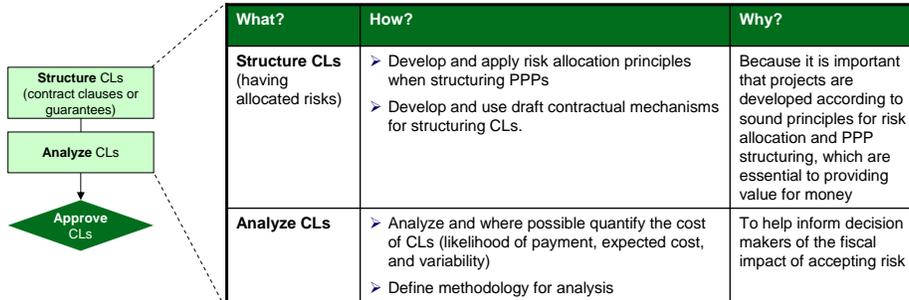
What should Pakistan do to manage contingent liabilities?



➤ Pakistan should adopt policies and processes for performing eight key functions:

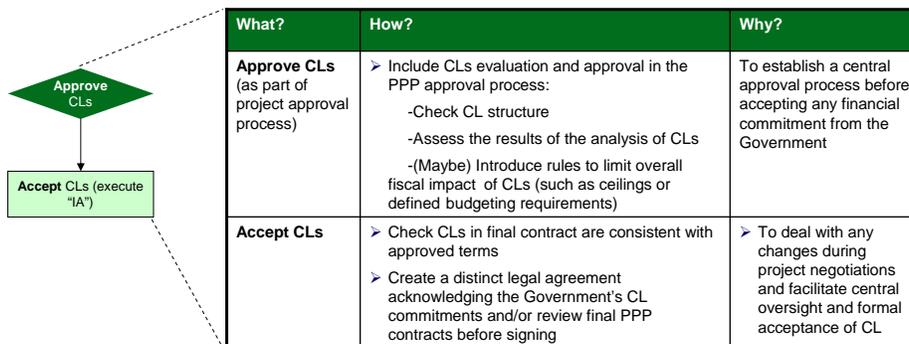
- **Structuring** contingent liabilities and designing contractual mechanisms according to good principles for risk allocation
- **Analyzing** contingent liabilities that will be accepted under a proposed project
- Establishing a central process for **approving** contingent liabilities
- **Formally accepting** contingent liabilities
- **Monitoring** contingent liabilities while a project is being implemented
- Regularly and publicly **disclosing** contingent liabilities
- **Taking mitigating action** on emerging risk
- **Budgeting and paying** for realized contingent liabilities

Contingent liability management functions—project development stage



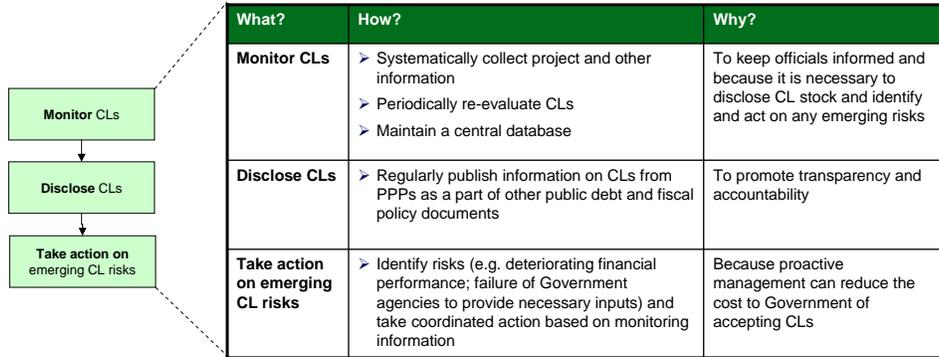
Review DRAFT Procedures Manual for Managing Contingent Liabilities

Contingent liability management functions—project approval stage



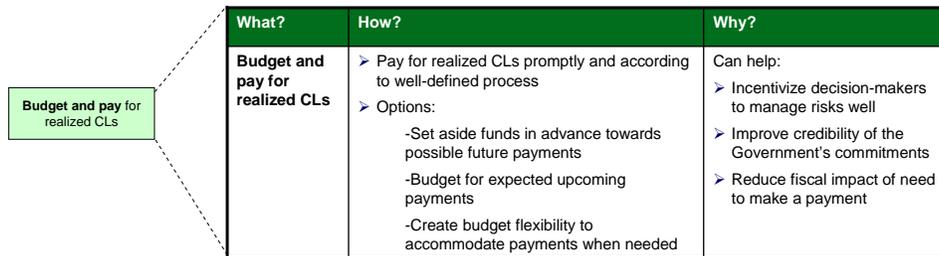
Review DRAFT Procedures Manual for Managing Contingent Liabilities

Contingent liability management functions—project implementation stage



Review DRAFT Procedures Manual for Managing Contingent Liabilities

Contingent liability management functions—project implementation stage cont...



Discuss preferred approach to budget and pay for contingent liabilities

Session 4: Who should manage contingent liabilities in Pakistan?

Who should manage contingent liabilities in Pakistan? Two options...

Option 1: Integrate contingent liability management into existing institutions

- **Contingent liability management functions carried out by a combination of:**
 - **Contracting Authority**—as the agencies with the responsibility for developing and implementing projects
 - **DPCO**—as the division within MOF responsible for providing administrative leadership at the central level (defined as CL manager in 2010 PPP Policy)
 - **IPDF**—as support to contracting authorities in all aspects of PPP development and contract monitoring/management
 - **MOF**—as the oversight agency responsible for approving financial commitments to PPPs
- **Allocation of functions should consider capacity of different agencies**
- **Possibly use a contingency fund or account within Government to set aside funds towards future payments; could involve charging guarantee fee (as in Colombia)**

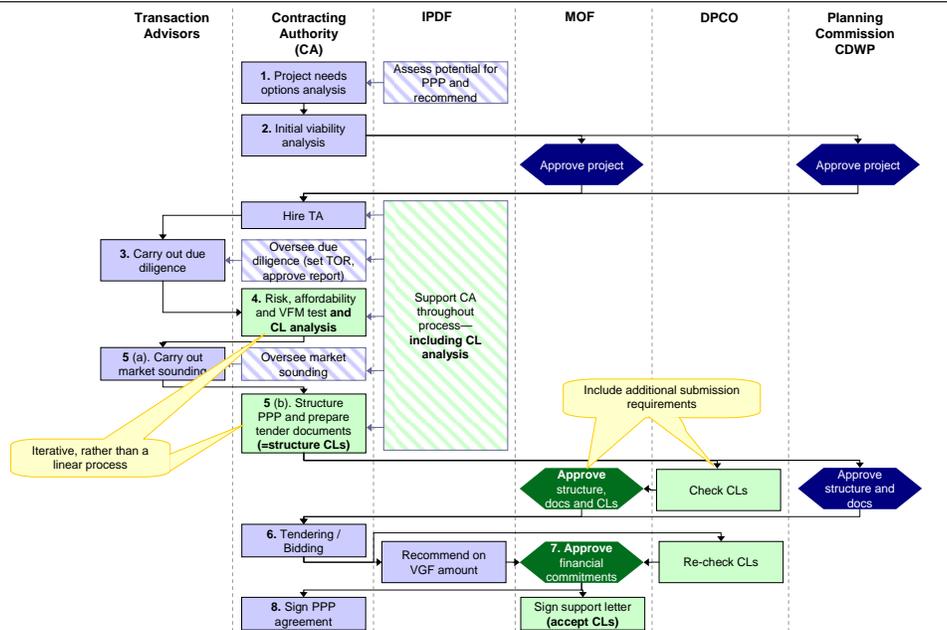
Option 2: Create an independent Guarantee Fund

- **Government could create a legally-distinct Guarantee Fund to issue guarantees in its own name, in place of the Government (as in development in Indonesia, Brazil)**
- **Guarantee Fund could operate as a commercial guarantee fund / insurance company, charging for guarantees based on fund capital provided upfront by Government—could attract capital from other sources**
- **Guarantee Fund would be responsible for:**
 - **Structuring CLs** (by defining what types of guarantees it will offer—possibly following Government-specified restrictions or policies)
 - **Analyzing and approving CLs** (defining a price and offering guarantee at that price for decision by private contractor)
 - **Accepting CLs** in its own name
 - **Monitoring, disclosing, taking action on and paying for CLs** when realized
- **Government would effectively budget for CLs at the point of the initial transfer to the Fund; a mechanism should be defined for recovering the cost ex-post of any adverse Government behavior**

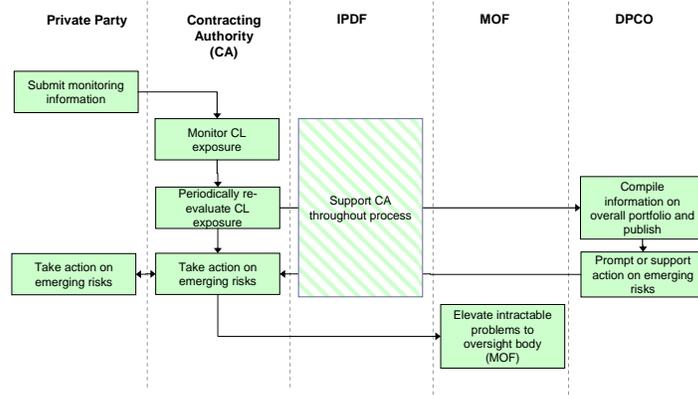
Why it is better to strengthen existing institutions

- Is the solution consistent with the existing mandates of each agency and the basic policy and regulatory framework laid out in the 2010 PPP Policy and draft PPP Bill?
 - Pakistan has limited experience with PPPs outside of the energy sector (and roads to some degree), and therefore limited exposure to contingent liabilities
 - The main problem the Government needs to address is strengthening the incomplete and unclear policies and processes that are currently in place
- Is the solution appropriate for the size of the problem?
 - Complex and sweeping reforms would likely be less flexible, take longer to implement, and the benefits would be more uncertain
 - Establishing sound policies and practices, and building strong capacity among existing agencies more quickly, is also more likely to create an environment that is attractive to private and multilateral investors
 - Incremental reform also facilitates learning by doing

How can CL management be integrated into PPP development process?

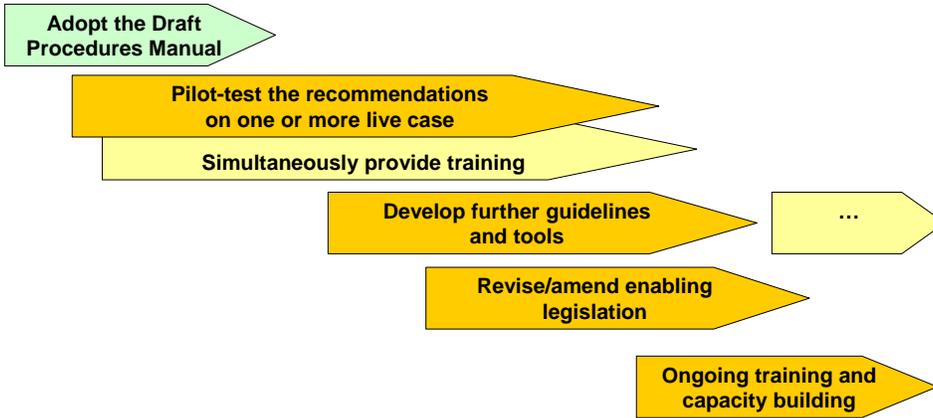


How will CL management work during project implementation?



Session 5: How can Pakistan implement a contingent liabilities management system?

What steps are needed to adopt and implement these recommendations?



Questions and Closing Comments

