

# **MANAGEMENT OF CONTINGENT LIABILITIES IN PPP INFRASTRUCTURE PROJECTS: FOCUS ON THE ROAD TRANSPORT SECTOR**

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## **Abstract**

*Policy makers view Public Private Partnerships as a way of reducing the governments' fiscal burden. But government guarantees provided as a part of the privatization process often expose governments to considerable risk which is rarely reflected on the government's balance sheet. The contingent nature of this risk exposes them to the possibility of sudden obligations over a short period of time which can lead to serious fiscal problems. By undertaking a detailed review of literature and review of the projects, this work attempts to understand the nature of contingent liabilities, how they arise, and how they are managed in the public sector. The study of the contingent liabilities arising from the transport sector revealed that based on the experience Canada, the management of contingent liabilities depends on the risk assessment and risk allocation strategy followed by the countries, the strength of their fiscal institutions and legal framework and their budget transparency. By improving these elements, political leaders can increase their financial assistance to targeted infrastructure projects without increasing cost of providing assistance to an acceptable level. The study also concludes that the use of integrated risk management systems will greatly improve governments' ability to manage and control risk.*

*Keywords: Fiscal Risks, Contingent Liabilities, Government Guarantees, Public Private Partnerships, Transport Infrastructure Sector*

## INTRODUCTION

Governments have the challenging obligation of protecting the public interest while meeting the needs of the society. Society's confidence in their government depends on the quality of the services the latter provides. In addition, their expectations continue to rise as they demand more and better government services at a lower cost, and governments are challenged to offer faster, cheaper and better services as well as create new services as a way to develop social progress in their countries (NASCIO, 2006).

Many countries in the world are trying to find newer ways of managing and financing the public assets and services such as roads, airports, telecommunication and power. The traditional way of providing these services to the citizens has been through the use of government, which, in most cases, used to be the sole supplier of these public goods and services. However, due to limited resources and increased financial obligations faced by national governments, another alternative way is emerging and is through the use of and involvement of the private sector in the financing and management of public goods and services. These arrangements can take various forms ranging from full private participation to semi or quasi participation of the private sector. The latter gives rise to an arrangement called Public-Private-Partnerships (PPPs). PPP s are defined as arrangements where the private sector supplies infrastructure assets and infrastructure-based services that traditionally have been provided by the state (Hemming, 2006).

Since the early 1990s, PPP s have become an important tool in the infrastructure service delivery in both developed and developing countries. In fact, the PPP process means that both the public sector and the private sector have certain advantages relative to each other in the performance of specific tasks. It has also been observed that through a partnership arrangement, the public and private sector can merge to provide qualified public services and infrastructure in the most economically efficient manner where the government transfers all responsibilities, risks and rewards for service delivery to the private sector (NASCIO, 2006). With these advantages inherent in the PPP s, governments are turning to public private partnerships as vehicles for delivering high quality services to the consumers. PPP s are also seen as a way of involving the private sector in infrastructure investment in order to utilize the new technology and expertise, shifting some of the risks to the private sector and gaining access to increased capital, and thus contributing to higher operating efficiencies (Polockova, 1999).

PPP s have become intertwined in the design, financing, operation and maintenance of public goods and services. The primary aim for the private sector involvement in the infrastructure programs is to give the taxpayers better value for the money they pay. Brixi and

Schick (2002) discuss that while these may be having benefits, governments may be cumulating significant obligations in the form of contingent liabilities that are neither recorded nor analyzed in the fiscal documents. These hidden costs are not certain when they are going to come due, since the probability of their occurrence is difficult to forecast. Moreover, when it happens they might cause fiscal crises in the economy of the country if no provision has been made for their financing. To prevent this from occurring, the government may find ways to lower either the size or the probability of liability actually being realized and hence reduce the possibility that a fiscal crises will happen.

### **Statement of the Problem**

As the government's role is transforming from financier to guarantor of services and projects the contingent liabilities that they face are becoming a serious issue that needs a particular attention. As Irwin (2003) claims, contingent liabilities are the obligations of the governments to make payments if a particular event occur. He further argues that the existence of these liabilities brings to the government's fiscal instabilities for these reasons: First their values are difficult to determine therefore policymakers may have poor information about their cost when they make decisions about such liabilities. Second, because these obligations come due only if particular events occur and involve no immediate cost to government, budgeting and accounting rules do not require disclosure of contingent liabilities. Third, the existence of contingent liabilities makes it more difficult for governments to evaluate or measure their fiscal position, so fiscal surprises are more likely to occur.

### **Aims of the Study**

The main purpose of this study is to gain an understanding of international good practices in the management of contingent liabilities related to infrastructure projects. By analyzing the practices of a developing country, this study will review good practices which will form the basis for policy recommendations for governments on how to manage their contingent liabilities effectively.

### **Research Approach and Organization**

By undertaking a detailed survey of literature and review of the Canadian project, this research attempts to understand the nature of contingent liabilities, how they arise, and how they are managed in the public sector. Basically, this research will focus on the contingent liability management in the transport infrastructure sector.

## CONTINGENT LIABILITIES

### Introduction

Recently, governments' exposure to fiscal risk and their propensity to incur hidden deficits has increased (Brixi and Schick, 2002). At the center of this phenomenon, is the increased volumes and volatility of international private capital flows which have increased domestic funding through the applications of PPPs. With declining fiscal resources, governments now are concerned to allow these private capital flows to be invested in various sectors of the economy in infrastructure projects. These projects expose the private sector to major risks because firstly, after these investments are made, they are largely sunk costs so they cannot be used elsewhere without incurring great costs and secondly they are often politicized as they provide essential services previously provided by monopolistic entities in the economy (Au-Yeung, 2006).

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Therefore, as Brixi (2004) shows, the private sector requires governments' commitments to protect them from these major risks which can be either political or nonpolitical based risks. The political risk, Irwin et al (1999) points out, arises from the uncertainty that the performance of the project is not assured due to unpredictability of the rules governments impose in law, regulations, contracts and the way the governments choose to apply those rules. One major source of political risk is the uncertainty that the politicians will keep the prices too low to allow an adequate rate of return to the private investors. Other sources of political risk can be changes in tax rules, or even breach of contract. In addition, Brixi (2004) discusses that exposing the private investors to political risk increases the risk premium required by the private investors on their investments. The more they are exposed to this kind of risk the more governments have to pay for them, therefore, the politicians should be cautious of how they are to formulate and sustain good policies in the country. In some instances the governments have to also assume nonpolitical risks, risks which by they have minimum or no control at all. For instance, nonpolitical risk may arise from the uncertainty about the cost of construction, instability of the local currency, fluctuating future demand for the project's services and the failure of the owner to pay back the loan. In this case, the more is the risk borne by the government the less is the rate of return that the private sector should expect.

In PPP arrangements, when governments provide support to private investors they implicate themselves into explicit and implicit commitments that they would bear the responsibility if the private sector fails to deliver the predicted project outcomes. In the case of

failure, the commitments of the governments will lead to a contingent liability on their side as they will have to take care of the negative outcomes of the failure.

In this chapter the study looks at the contingent liabilities. Firstly, contingent liabilities are defined and thereafter the rationale for governments' use of guarantees will be discussed. The study will continue to look at various forms of guarantees that are provided by the governments. Later, the study discusses various fiscal risks and how contingent liabilities are managed.

Contingency is defined by the International Accounting Standards Committee as "A situation or condition whose ultimate outcome is determined only by the occurrence or non-occurrence of one or more current events". Within the framework of this definition, the government promised support is met only if this event actualizes and therefore, when that happens, the government's liability is not contingent anymore but it becomes factual indeed, representing a financial burden on the fiscal budget (Almeyda and Hinojosa, 2001).

Experience suggests that contingent liabilities are naturally very costly when governments' obligations fall due at some point of time; and hence they turn to aggravate the fiscal risk and cause country fiscal crises (Brix, 2004). Brix and Mody (2000) explain that when governments assume the contingent liabilities they shift the risk from private sector to themselves. By doing so, they expect to create financial incentives for policy priorities without any immediate financial outlay. Therefore, for those governments who are fiscally constrained, the contingent liabilities offer an easy mechanism to provide financial assistance or subsidy. On the other hand, there exists a rationale for governments to entangle themselves in contingent liabilities, despite their potential adverse effects on the resources of the country. The next section outlines some of the reasons.

## **MANAGEMENT OF CONTINGENT LIABILITIES IN ROAD SECTOR**

### **Introduction**

The rapid rate of urbanization is accelerating the demand for transport infrastructure in most of countries of the world. Urban transport systems in particular, call an integrated package of solutions such as: effective management of existing infrastructure, accurate pricing, and urban growth management (Menckhoff, 1999). Within these circumstances, Estache (2001) explains that, many countries in the world are turning way from the traditional public sector development of roads and have started entering into partnerships where the private partner builds and operates the road, in return for long-term revenues. A common reason for this increasing trend of Public Private Partnerships in the provision of transport infrastructure is that governments do not have the financial resources to carry out all that is needed for the future development of road systems (Poole and Samuel, 2006). As Estache (2001) adds, this applies not only to

construction but also to operation and maintenance of the system, which may require substantial amounts of funding. But there are other good reasons for involving the private sector in the road infrastructure such as: to increase the efficiency of operations, and the need to provide a service that is responsive to the needs of the citizens (European Commission, 2003).

## **CASE STUDY**

### **Highway 407 Express Toll-Route, Canada**

407 Express Toll-Route is located in southern Ontario, Canada's Greater Toronto area. The highway is connected to six interchanges on the 400 series of highways: 400, 401, 403, 404, 410, 427 and Queen Elizabeth Highway. The purpose of building the highway was to relieve the congestion on the existing highway 401 which is considered to be the busiest highway in North America, used by more than 400,000 vehicles per day (Mekky, 1998). The highway width of the 407 varies between 4 and 6 lanes and it has the capacity to expand up to 12 lanes wide.

Highway 407 uses advanced tolling technology, therefore it has become a model for all electronic toll highways around the world. Unlike the other toll roads where drivers wait at a toll booth to pay the toll to a machine, 407 roadway uses an all- electronic toll system that eliminates the traffic queues.

The 407 uses a system of cameras and transponders that charge each vehicle automatically. A radio antenna detects when a vehicle with a transponder has entered and exited the highway calculating the toll rate. For vehicles without a transponder, an automatic number plate recognition system is used. In this case the system records video images of the vehicle and then sends the signal to a central processing computer where the information about all the Canadian and US vehicles is provided through a database system. After the information is known and the toll rates are calculated, the bill statement is sent to the users on monthly basis.

This system comprised of electronic sensors, automatically records the transactions at entry and exit of each trip. The toll system is composed of five components: vehicle transponders to read the bar code sticker of each passing vehicle, a vehicle classification system, a roadside toll collection system, a toll transaction processor and a revenue management system. The cost of each trip is based on the time of day one uses it, the distance traveled and the vehicle class.

For those drivers traveling on 407 ETR without transponders there are extra charges imposed on them to help cover the cost associated with tolling and collecting from these individuals.

### ***Development of Highway 407***

The need for Highway 407 was recognized in early 1950s, but, the plan for building it was implemented later on. In 1987, the province of Ontario started building the first section of nine kilometers with the cost of 1,806 million US dollars. In 1989, the province was in an extremely weak financial position, a feasibility study for the development of the 407 as a toll road was undertaken (Mylvaganam and Borins, 2004). A traffic consulting team was hired to prepare a traffic forecast report, and their results made the province confident enough to develop the highway through the private sector financing with a build-operate-transfer concession (Mendoza et al, 1999). Hence, in spring 1993, the Ontario Ministry of Transportation, issued a Request for Qualifications for constructing and financing, and they received the proposals from two consortia. The successful bidder would be the one that presented the best overall proposal for the project in terms of the overall plan viability, the bid price and the length of the concession (Poschmann, 2003). The conditions were that the private sector would be rewarded with the toll revenues but they would not receive any guarantee on the demand and traffic revenues, which would leave them highly exposed to the demand and the traffic risks (Vining, 2006). Consequently, they required significant financial support from the province, given the high risk of constructing a new toll road. This was against the province attempts to shift the financial risk to the private sector, so they thought, instead of providing support to a costlier financing provided by the winning bidder, they would better provide the financing themselves (Mylvaganam and Borins, 2004). Thus the province financing of the construction substituted for the planned private financing. In 1994 the winning bidder was Canadian Highway International Corporation (CHIC) which started the construction of the first thirty six kilometer section. Mendoza et al (1999) point out that the province financed this construction with five hundred million Canadian dollars and by June 1997, construction of the first section was finished so the road was opened to the public. For the first months, while the toll system was being debugged, the road users were not charged and the average weekly trips were 300,000, but then, when the operational problems were solved, the tolling began. But now the trips dropped to 100,000 but in a year they climbed to 200,000 (Mylvaganam and Borins, 2004).

The next section to be built consisted of a twenty-four kilometer section to the west of the existing road and fifteen kilometer section to the east (Poschmann, 2003). This time the province was intending to increase the private participation. Between 1996 and 1998 the province commissioned additional studies to evaluate different options such as: *Retain and Improve, Not-for-profit, BOT and Full Equity Sale* (Mendoza et al, 1999). After many detailed analysis the governmental province concluded that the option of the Full Equity Sale would give the best value for money to Ontario taxpayers and would provide the necessary financing for the

construction of the west and east section (Mendoza et al 1999). Thus in summer 1998 the province announced that it was willing to embark into a partnership for the development of Highway 407 (Trottier and Maguire, 2006). In this privatization process many advisors such as traffic consultants (Wilbur Smith Associates), engineering consultants (Dillon Parsons and Douglas), legal consultants (Goodman, Philips, Vineberg and Godfrey) were employed to analyze and prepare the terms for the construction and the bidding process. Given the time constraint the concession process had to be carried out at the same time with the bidding process. The first step in this dual process was to send a Request for Expressions of Interest to potential bidders. Bidders who responded the Request and fulfilled the financial and technical requirements, received a Confidential Information Memorandum in which the bidding terms were explained in detail and from this moment the candidates would have access to database enclosing information on the highway (Mendoza et al, 1999).

Thus in January 1999 bidders went through the bidding process of 407 ETR privatization where the winner was going to be chosen only on the base of the bid price (Mylvaganam and Borins, 2004).

The Highway 407 express toll route was “entrusted” to a conglomerate of private companies: Gruppo Ferovial, the Spain’s second largest construction company, SNC-Lavalin Group and Caisee de depot et placement du Quebec which paid 3.1 billion dollars for owning the highway for 99-years.

(Mendoza et al 1999) recognized that some of the challenges faced during the process of privatization of 407 toll road were:

1. The fear that the serious bidders would stay away because of the previous unsuccessful attempt to attract bidders in the first privatization process.
2. Uncertainty whether the privatization would meet the province’s primary objective of ensuring that the fair value was received for Ontario taxpayers. If this was to happen, it would make it difficult to engage in a privatization of highway 407 again
3. There was a fear arising from the use of a new unproven toll technology system. This system was the first one in the world and there was no certainty whether the bidders would perceive it as adding to the roads value or the opposite.
4. The fear that the private company would operate like a monopoly and set its price higher than what the provincial government expected. Again, by imposing a toll minimum rate, that would divert the traffic from other congested roads, the bid was going to be unattractive to the private sector.

## ***Lessons Learned from Highway 407 Express Toll Road***

### *Risk Allocation*

In the first attempt to privatize the province was trying to transfer all the risks to the private sector and it failed. But when the province started the construction and the development of the work, this time the private sector was ready to take on risks such as financing, construction and traffic risks. This experience was a good lesson for all the other governments to learn in that it is more efficient for the government to take some risk before the private sector comes in. In this case, the private firm acquired a road that had been proved to be successful in terms of the traffic level and the technological performance. This explains why there was a sharp rise in the value of the highway between the first attempt to privatize and the second one.

### *Concession Term*

The long term nature of the concession (99 years) was a positive factor for the privatization of the highway 407 in the sense that it gave the private owners a greater financial flexibility than a shorter term concession would have given.

### *Regulatory Structure*

In highway 407 the owner was legally allowed to charge a market oriented toll rate, unlike some other cases where there is restriction on the toll charged by the road owners.

### *Government Commitment*

The 407 toll road was a good example of high coordination among the governmental units involved in this project, which presented a good image to the bidders who had the conviction that the governmental units were serious and supportive to the 407 privatization.

### *Bid Process*

In this particular project there were no cases of complaints about unfairness during the bidding process. The selection process was clear, fair and free of political pressure.

### *High Quality Traffic Study*

One of the key factors for the success of the privatization of highway 407 is the comprehensive traffic and revenue study done by an internationally recognized traffic firm. The fact that another reputable party was involved in the process gave bidders high level of confidence about the future performance of the road.

## CONCLUSION

The construction of Highway 407 toll road came at the time when the province of Ontario was facing budget fiscal constraints. Therefore the best thing to do, given the circumstances was to involve the private sector into the development of the highway. Thus, it was necessary that the governmental province take the efficient measures to avoid any disruption on their budget expenditures and contingent liabilities that would arise from the private sector's failure to financially and physically complete the project. However, the story of 407 toll road proved to successfully pass all the anticipated difficulties and emerged as a model for all other major toll roads projects all over the world.

The success of the 407 Highway project can be mostly attributed to the government's preparedness and effective public administration to bring in the private sector and ensure that the road project succeeded. In addition, the Province of Ontario established an effective project management team with appropriate skills which were outsourced from the private sector as a part of governance structure for the project. Note that this is one of the key requirements for the success of the public private partnership. Also, there was a full support from senior management including the minister which effectively put pressure on the contractors to meet their financial and schedule obligations. Another element that contributed to the success of this project was the fact that the governmental province of Ontario pursued an efficient risk analyses that continually identified the risks the project was exposed to, their probability of occurrence, their consequences as well as the risk mitigating strategies. These actions taken by the public sector were the key strategy for managing contingent liabilities prior to their occurrence. Moreover the success of the highway 407 can be accredited to the way the concession contract was designed. Its long term nature gave the private sector the incentive of financial flexibility which allowed them to borrow on the long term basis and thus meet the financial requirements of the project. It must be pointed out that the government had gained considerable experience from the first attempt to attract the private sector and there was more care taken in the way they transferred the risk to the private sector. For instance the government did not leave the financial risk on the private sector's shoulders, but assumed that risk itself at the most critical time, when the toll road was at its first stage of development and when its success was uncertain yet.

Ensuring the safety of the road was another critical point that the province achieved successfully by commissioning the professional engineers of Ontario to carry out a safety analysis which prevented accidents that would have otherwise occurred. This eliminated the insurance premiums that government would have paid due to road accidents.

All these actions taken by government are an illustration of a good practice followed by the governmental province of Ontario aiming to prevent any possible occurrence of the

contingent liabilities coming up from the toll road project. Different governments have got different approaches in managing and controlling the contingent liabilities arising from the road projects. Highway 407 case demonstrates a very adequate contingent management strategy that was based on preparing all the grounds to prevent the possible risks affecting the project. Avoiding the contingent liabilities from occurring in fact made the Highway 407 project a success story and a good model for other projects to come.

## SCOPE FOR FURTHER RESEARCH

A further research can be done on this issue in terms of “should the governments continue to keep these guarantees (where contingent liabilities derive from) off balance sheet or should they start reflecting them in their balance sheet? How this action could affect the fiscal risk currently present due to these guarantees?

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