

Managing PPPs for Budget Sustainability

The case of PPPs in Portugal, from problems to solutions

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September 2011

Abstract

Considering that Portugal is currently suffering one of the most severe financial crisis in its history, this paper examines to what extent PPPs have contributed to Portugal's external debt problems and evaluates how Portugal's PPP contracts can be managed in order to contribute to the necessary solution. Although the interests of the various PPP Stakeholders are acknowledged, the focus is on the Government as the public partner, from a sovereign risk and taxpayer perspective. The paper shows how countries like Portugal with large PPP programmes but fragmented PPP institutions and inadequate budget practices can be exposed to greater fiscal risks, leading to the accumulation of PPP liabilities which later contribute to public sovereign debt problems.

Keywords

Public-private partnerships, PPP, concession contract monitoring, toll roads, sovereign debt crisis, contingent liability, public finance, Government guarantees, concessionaire, PPP Agency, renegotiation, capture

1. Introduction

Considering that Portugal is currently suffering one of the most severe financial crisis in its history, and that it is one of the countries that has relied the most on PPP contracts to meet its public service and infrastructure needs, this paper examines to what extent PPPs have contributed to Portugal's debt problems and evaluates how Portugal's PPP contracts can be managed in order to contribute to the necessary solutions.

In the early 1990's, the conversion of traditionally procured public investment to PPPs promised to overcome Portugal's historic infrastructure deficit, despite its tight budget constraint. This was in line with both national and European policies, and was enthusiastically supported by local and international promoters and banks, at least until the first round of the international financial crisis in 2008.

As we enter the 2010's, Portugal is struggling to cope with an extensive and complex portfolio of PPP contracts which presents critical challenges both for public finances and for the local banking system. It is evident now that the prudent management of these PPP contracts will be one of the determinants of Portugal's recovery from the current financial crisis, making it a key component of the Adjustment Programme negotiated with the International Monetary Fund - IMF and the European Union - EU in May 2011.

Although the interests of the various PPP Stakeholders are acknowledged, the focus of this paper is on the Government and public partner, from a taxpayer perspective.

Section 2 describes how PPP projects were contracted in Portugal over the last two decades.

Section 3 highlights the links, and in some cases, the causality, between budget problems and the issues in PPP contract management in Portugal.

Section 4 explores the specific fiscal risks resulting from such practices as availability payments and renegotiations. Section 5 concludes with lessons learned and contributions towards eventual solutions.

2. PPPs in Portugal

Public-private partnerships in Portugal are long term administrative-law contracts under which the public partner (the “*Concedent*” or Grantor) transfers to the private partner or concessionaire the obligation to design, finance and build public infrastructure and/or to operate a public service. The contract may consist of a “public works and public services concession” if the infrastructure is to be built, or simply a “public services concession” if the infrastructure already exists. The concession contract also encompasses the right to receive remuneration for providing the public service, either by charging users, as in cash tolls, or directly from the public partner or *Concedent* itself through volume-based shadow payments or payments for the simple availability of the infrastructure.¹ Some infrastructure-only PPPs, such as schools, are based on long term rental contracts. Under Portuguese law, as in most other civil code countries, public infrastructure is part of the public domain, even if it is financed and operated by the private sector, so the principal asset of the concessionaire is the concession contract itself.

As elsewhere, PPPs are seen as asymmetric contracts, since the *Concedent* reserves the right to impose unilateral changes in the public interest, subject to compensation. In practice, however, once the public partner completes procurement and adjudicates the PPP contract to the private partner, it is placed at an information and bargaining disadvantage.

Portugal has a decades-long history of public service concessions, mostly in water and rail transport. In 1972, Brisa received the first concession to build 390 km of tolled motorways until 1981, mostly the north-south A1 and A2 and the radials A3 and A5. In effect, the A1 connecting the two major cities of Lisbon and Oporto was concluded only in September 1991 (Brisa history). Although originally a private company, Brisa borrowed under Government guarantees and received Government investment subsidies equivalent to 20% of its investments. Brisa was nationalized in 1975, in the post-1974 revolution period, and reprivatized in successive tranches after 1997.

After decades of tight financial constraints, Portugal was able to step up its public investment effort after joining the EC in 1986, thanks mostly to EIB-European Investment Bank loans to the Government.

2.1 The precedents set by Lusoponte

The first major concession contract of modern times was the DBFOT contract with Lusoponte for the Vasco da Gama bridge, signed in 1994, which set a number of critical precedents. The project received a Cohesion Fund investment grant of €319 million, but otherwise it was meant to rely exclusively on user tolls, with a variable term defined by the number of cars. The near doubling of the tolls on the existing 25th of April bridge during the construction of the new crossing, resulted in intense protests (*buzi* in June 1994), which led the Government to unilaterally freeze tolls on the existing bridge, and to “rebalance the concession” with a corresponding operating subsidy. Altogether, from 1995 to 2001, Lusoponte had seven renegotiations and rebalancings, known by the Portuguese acronym REF (*Reequilibrio Económico e Financeiro*), totalling €408 million of corresponding compensation (Carmona, Macário & van der Hoofd 2006). Risk allocation was also changed, namely the reduction of the obligation of the concessionaire to maintain the existing 25th of April bridge and conversion from variable to fixed term which added between from 7 to 11 years to the concession.

According to Carmona, Macário & van der Hoofd (2006), several pitfalls triggered rounds of complex renegotiations of this emblematic contract, as identified by the Court of Auditors reports (2005), including misjudging the willingness to pay and protester risk. But the project financing was also waylaid by the financial crisis of 1994, modest by current standards, which caused the Escudo long term fixed interest rates to jump from about 8,5% to 11,5% in the months prior to financial close. Wanting to keep to a tight schedule in order to complete the bridge in time for Expo 98, the Government chose to cover the financing cost difference even though the strict tender procedures assigned interest rate risk to the concessionaire.

Other pitfalls included the absence of a PSC, public sector comparator, which was not surprising at the time for such a large pilot project. A critical and seldom-mentioned pitfall was the poor overlap between the tender management team, GATTEL, Cabinet of the Tagus River Crossing, and highway authority JAE, Autonomous Road Board, which later took over the monitoring the contract. Without the PSC as guidepost, and with an inexperienced contract management team, it was exceedingly difficult for the *Concedent* to defend the original Value for Money optimized at tendering.

2.2 The SCUT shadow toll programme

In 1999, Portugal launched an ambitious road investment programme in the form of shadow toll roads SCUT (*Sem Cobrança ao Utilizador*). Many of the SCUT motorways reached into the sparsely populated interior and thus were expected to have modest

traffic. Nevertheless, traffic was counted and most of the traffic risk was supported by the concessionaire, with the *Concedent* guaranteeing minimum revenues (sufficient to cover debt service) and taking the corresponding upside, in a traffic band risk sharing mechanism. The seven SCUT contracts were signed during 1999-2002. In addition, the Government launched four new cash toll concessions, including ring roads and roads on the more densely populated litoral.

Several of the new road PPPs were troubled by environmental problems post-adjudication and by shifting political decisions regarding the corridors, which complicated expropriations and construction and which resulted in almost immediate claims for rebalancing.

Other PPPs included two urban rail concessions (with mixed user and taxpayer funding) and several port terminal concessions based on user charges adjudicated by individual port authorities. Plans to grant a concession to build the New Airport for Lisbon, and to operate the existing airports, were studied extensively since 2000, but the tender did not proceed.

The ambitious and aggressively innovative hospital PPP programme, launched under Decree Law 185/2002, proved too complex and had to be revised. The Government's intention to transfer clinical risk to the private partners had few precedents internationally, and it significantly restricted the number of interested bidders, since banks were unwilling to take clinical risk and thus required sponsor counter-guarantees. Cascais, the first of four clinical hospital PPPs, was signed in 2008 and the contract entered in arbitration before it opened in 2010. The fourth was signed in early 2011. Tenders for two infrastructure only hospitals were launched in 2008 (Monteiro 2010).

The Regional Governments of Madeira and Azores and many municipalities also undertook a large number of municipal water distribution and waste management concession, car parks, and schools. Nearly all of the water concessions have been renegotiated and water tariffs increased (Oliveira Cruz & Cunha Marques 2011).

2.3 PPPs go into high gear

Already by 2005, Portugal had more than 20 PPP projects contracted or in procurement, with average PPP activity of about 1,3% of GDP, in 2000-2005 period, twice as high as the UK (PWC 2005). The newly elected Government undertook a €25 billion investment programme including new road concessions and the High Speed Rail (TGV) network, leading to a new wave of PPP contracts, in roads and hospitals, but also at the municipal level.

In a unique move, at the end of 2007, Estradas de Portugal, S.A., the State-owned highway company, was granted the global road concession, together with the

consignment of a portion of the fuel tax and the right to grant sub concessions to private partners (Decree Law [380/2007](#)).

According to the EU-DGEFA (June 2011) report , cumulative PPP investments since 1995 amount to almost 10 percent of GDP, which corresponds to an annual average of almost 0,75 percent of GDP. The implicit government liabilities in relation to PPPs – calculated as the net present value of the flow of payments in relation to the contracts already signed in order to be comparable to direct public debt – are “currently estimated at **over** 14 percent of GDP”², or about €25 billion .³ About 80% of the PPP liabilities are in the transportation sector.

3. One hundred PPP contracts in search of a PPP Programme

Although Portugal is estimated to have 116 PPP contracts by last count, about signed since 2005, that is not to say that Portugal has “a PPP Programme” as an explicit component of a centrally managed investment effort. The consensual diagnosis is that there has been “a lack of adequate central control for creating public-private partnerships” based on wrong incentives arising from the fact that they were used to “loosen the budget constraint in the short term as they are recorded, according to existing (European) statistical rules, in the private partners’ balance sheets” (EU-DGEFA 2011).

According to Oliveira Cruz& Cunha Marques (2011), the Portuguese Government went “too far in launching too many projects too quickly” without consolidating know-how in the public sector and applying lessons learned, without the proper legislative framework to guide new contracts and without a structured project management organisation

After the problems with the tendering of the first wave of shadow toll SCUT projects, the new PPP legislation (Decree Law 86/2003) introduced the requirement for Ministry of Finance involvement in the project tender panels. The tender documents, the bid proposals and the final contracts had to be approved by joint tender boards (CAP – *Comissão de Avaliação de Propostas*) named by both the Finance and the sectoral ministries, but these were often political appointees, rather than experienced staff, and often change over the various project phases. The creation of a small but dedicated team in Parpública, a wholly State-owned company, functioned as an internal procurement advisor (agent).

Decree Law 86/2003 also generalized the requirement for a Public Sector Comparator for each project and set guidelines regarding risk sharing and renegotiations. Despite reinforcements of the role of Parpública with revisions to the legislation (Decree Law 141/2006), the institutional arrangements have remained inadequate.

3.1 From individual PPP projects to a PPP Programme

Many of the critical elements needed to transform a set of individual PPP contracts into a PPP programme have been, in practice, missing. As a result, PPP contract management has been weak and fragmented, characterized by policy discontinuities, legal loopholes and even evasion of existing public finance management guidelines.

- The overall ceiling on annual PPP contracting, which has been long required by the Budget Framework Law (LEO *Lei de Enquadramento Orçamental* 91/2001), has never been implemented⁴.
- Clear criteria for selecting projects to procure as PPP rather than as public works contracts. The requirement of a Public Sector Comparator (already implicit in art. 19º of the LEO-Budget Framework law of 2001) has been applied regularly only in the hospital sector.
- Some contracts appear to have been structured so as to overcome existing public finance controls such as the prior approval of the Court of Auditors (*visto do Tribunal de Contas*). Estradas de Portugal argued, albeit unsuccessfully, that the new road sub concessions did not require the usual prior approval of the Court of Auditors. Municipalities used the same argument to sign long term rental contracts for new schools and convention centres outside of the mandated municipal debt limits.
- The definition and staffing up of the *Concedent* role, remains unclear. The creation of a Central PPP Agency, announced at various times, has been held up by disputes between the Finance and the sector ministries over who will have the ultimate authority in transaction and contract management, including the review of service compliance by the concessionaire. Parública has been serving as the Ministry of Finance advisor on PPPs since 2003, and PPP teams were created in the Ministry of Finance itself (GASEPC 2007), in the Ministry of Transport, the Ministry of Health, and the Ministry of Environment, but some have had limited administrative and reporting functions and others been disbanded recently.
- The learning curve in the public sector has not been optimized. There is no effective knowledge centre, with the possible exception of the Court of Auditors which issued in depth reports and PPP guidelines in 2008.

3.2 PPPs and the Government Budget (OE-*Orçamento do Estado*)

This issue, however, is not necessarily one of missing budget and PPP legislation, but rather one of inadequate implementation, in the rush to sign large number of contracts over short periods.

Although the original 1991 Budget Framework Law (Lei 6/1991) required the budgeting of all public investment projects, under the PIDDAC programme (*Programma de Investimentos e Despesas de Desenvolvimento da Administração Central*), which was included as an annex to the annual budget law approved by Parliament, this has not been applied to PPP projects.

Although the annual ceiling on new PPP liabilities has been required by the Budget Framework Law at least since 2001, but it was never implemented in practice. Analysts even continue to argue that the underestimation of future budget burdens may have been due to the absence of “a legal instrument to incorporate the annual rents for the duration of the contract into the public balance sheet”, Oliveira Cruz & Cunha Marques (2011).

The Budget Directorate (DGO) merely includes a table with the known multi-year PPP liabilities, for information only, in the Budget Report (ROE) which accompanies the annual Budget proposal (*Proposta de Orçamento de Estado*) to Parliament.

When commenting on PPP practices in Portugal, local and international authorities, tended to focus more on issues of individual transaction management and reporting rather than on the cumulative impact of the large number of PPP contracts or the total amount of hidden PPP liabilities.

The Court of Auditors included a section on PPPs in its Opinion on the 2004 General Government accounts again focusing on reporting issues with PPPs: “the Court therefore considered that, for the purposes of budget monitoring, the total public PPP liabilities should be presented, both in the Budget Law and in the Government expenditures accounts in a chart designed to identify and to determine the respective total costs, including those relating to expropriation, changes in contracts, land acquisitions, etc. (Portuguese Court of Auditors, *Parecer sobre a CGE de 2004*). The Portuguese Court of Auditors also raised more specific concerns as a result of its audits (*Tribunal de Contas*, Fertagus 2005 and *Tribunal de Contas*; road and rail PPPs, 2005).

Carmona, Macário & van der Hoofd (2006) stressed that even though “the use the comparison between the PPP and conventional procurement alternatives was required under the Portuguese legal framework) it is actually not yet being applied (in 2006).”

The **World Bank** (2008) estimated that PPP liabilities had reached 10 percent of GDP in 2003 and used Portugal’s experience to draw lessons regarding the need for stronger “institutional arrangements that ensure coordination, technical support “ and the appropriate application of checks and balances”. It considered the “Government PPP Unit suffered from lack of experience with PPP projects and inexperienced staff, and as a result, Portugal’s early PPPs were subject to constant delays and cost overruns”. Thus “weak public sector capacity was evident in insufficient risk transfer to the private sector and in delays in giving essential government approvals”

The OECD (2008) budget review of Portugal cautioned that PPP contracts may “shift too much fiscal risks to future generations”, but its recommendations focused on improving rather than limiting PPP contracting. With regards to PPPs, “summary

information should include risk analysis”, contracts should be carefully reviewed to ensure that they meet efficiency tests and that they do not accept inappropriate risks, “the public sector comparator should be discussed by Parliament”, and the recording of the associated liabilities improved, including those undertaken by State-owned enterprises. , But it appears to have taken the formal arrangements at face value, including the existing requirement for the PSC-public sector comparator that was seldom applied.⁵

Realistically, though, the non-implementation of annual PPP ceilings would have been inconsequential if most projects were user-based, but it has become a critical loophole with the predominance of availability payments.

3.4 PPPs and the IMF in Portugal

In the Article IV consultation (2005), the IMF considered that “private sector involvement in infrastructure investment is welcome”, but recommended that risks should be carefully monitored and any contingent commitments “be recorded with the utmost clarity in the documentation accompanying annual budgets” since future payments to private partners “are akin to debt”.

In the 2009 Consultation, concluded in January 2010, the IMF suggested that “greater involvement of the Ministry of Finance in public-private partnerships, especially early in the design stage, will also help improve results and contain fiscal risk,” continuing to focus on individual tender management.

By 2011, the IMF concluded that “there are significant fiscal risks associated with SOEs and PPPs, not all of which have yet been identified. Materialization of these contingent liabilities can pose a serious challenge for debt management and require close monitoring.” PPPs merited a special chapter in the ensuing Economic Adjustment Programme IMF (2011).

At the European level, the Maastricht criteria focused attention on the internal imbalances, budget deficit/GDP<3% and Sovereign debt/GDP<60%. The tight expenditure and debt criteria combined with soft Eurostat national accounting rules to create accounting and budgetary incentives to transform traditional public investment projects into PPPs. ESA 95 norms and Decision 18/2004 allowed PPP projects to be excluded from public expenditure and public debt if the private partner bore the construction risk and either the traffic or the availability risk. In retrospect, this has strongly encouraged the trend towards availability payments, which involve considerably more fiscal risks than the original user-paid toll roads.

A recent UK Parliament report on the PFI, considers the divergence between the European Standards of Accounts (ESA) and the International Financial Reporting Standards (IFRS), which “require that most PFI projects be scored in an organisation's

financial accounts, is confusing, and creates “incentives to use PFIs, rather than direct capital investment by departments”.

4. The fiscal risks in PPP

Far from the promise to resolve Portugal’s various deficits, in infrastructure, in financing and in management resources, the large number of poorly structured and managed PPP contracts became another source of financial distress.

Although borrowings by concessionaires are not included in public debt, they are certainly included in external debt, to the extent that projects are financed by international banks, or by local banks dependent on cross-border funding. While public debt reached €160 billion (93% of GDP) at the end of 2010, gross external debt reached €405 billion (235 % of GDP at end 2011), “extremely high” by IMF standards (IMF June 2011). After enjoying an AA rating for more than a decade from 1998 to March 2010, Portugal’s long term sovereign rating has been cut sharply to BBB- in 2011 (Fitch).

4.1 The fiscal risks in availability payments

Much of the Portuguese PPP problem has to do with increasing prevalence of availability contracts where the traffic risk remains with the *Concedent*. Unlike the case of user-based PPPs, the concessionaires and the banks have little need to scrutinize traffic studies, because project revenues are independent of actual traffic. This may place Governments at greater risk of undertaking marginal projects, leading to overinvestment in infrastructure and painful macro corrections.

With the recession and the introduction of tolls in three of the former SCUT shadow toll roads in October 2010, there are reports that traffic has declined by 20% to 50% in various corridors in the first semester of 2011, versus the year earlier figures. Several projects report traffic volumes of less than 50% of base case. This may be evidence of, both, the traffic diversion caused by the introduction of tolls, and of the income-elasticity of traffic demand as Portugal enters the 9th consecutive quarter of negative GDP growth.

4.2 Fiscal risks in renegotiations and rebalancings

As shown above, Lusoponte set a number of unfortunate contract management precedents that have continued to hobble the Portuguese PPP projects since, namely the absence of a PSC, the weak contract management team on the public sector side, and the high frequency of bilateral renegotiations and rebalancings.

The critical issue in PPP programme sustainability is getting and maintaining good Value for Money for the taxpayers over the 20-30 year duration of a PPP concession

contract. FIDIC and EU public procurement rules all focus on procurement, but in PPP the focus has to be on contract management post-adjudication.

By signalling its readiness to renegotiate contracts, even accepting the ex-post reallocation of key risks such as traffic, interest rate and major maintenance, the Portuguese State may have encouraged sponsors in subsequent projects to undertake strategic behaviour, bidding aggressively in the conviction that the tables could be turned in their favour in post-signing renegotiations.

According to Oliveira Cruz & Cunha Marques (2011), renegotiation of contracts has been the Achilles heel of PPPs in Portugal. With international tendering, bidders “compete for the market” but then “settle into the good life”, no longer having to “compete in the market”.

S. Ping Ho (2006), who studied PPP renegotiations in the context of game theory, warned that PPPs are incomplete contracts and that “Governments should expect and prepare well for renegotiations, establish early warning systems, keep enforcement costs low, and secure alternate sources of reliable information to minimize impact of opportunistic behaviour on the part of concessionaires”.

However, Engel, Fischer & Galetovic (May 2009) argue, from the Chilean experience, that when the renegotiations occur during construction,⁶ these cannot be said to result from the “incomplete” nature of PPP contracts. Instead, they note that the renegotiations and rebalancings of PPP deals in Chile were bunched in certain years and mostly (65%) paid future Government administrations. In contrast, the awards of arbitration panels were mostly (61%) paid by the administration who faced the disputes. They also conclude that pre-determined renegotiation caps are substantially exceeded and are thus ineffective.

The actual frequency of arbitration payments, renegotiations and rebalancings of PPP contracts in Portugal is difficult to quantify since there is no single published list⁸, but it is estimated to be greater than in other PPP markets. The current IMF mandated reviews are likely to shed new light on the impact of bilateral negotiations and of independent arbitration. Arbitration may involve less fiscal risks, because it is done under formal international rules, and the outcomes are binding on all parties, the *Concedent*, the concessionaire, and most importantly, the creditor banks. Arbitration awards are usually less than 20% of the compensation requested by concessionaires (Portuguese Court of Auditors 2008).

4.3 Regulatory capture in PPPs

One way to understand the “*Concedent* performance risk” in the post tender monitoring and renegotiation phase would be to apply the concept of “regulatory capture”. Normally, regulatory capture is said to occur when a government regulator

bends to the interests of those it regulates. But a “private partner may also capture the procurement process by side-contracting (colluding) with the government” (Maskin & Tirole 2007). *Concedent* capture can also occur if there is a small group of possible bidders, as in a smallish market like Portugal.

To Fourie & Burger (2000), the “problem of regulatory capture also stems from the information asymmetry, and this risk is higher if the regulator (or *Concedent*) is constrained in terms of management and analytical capacity.”

According to Irwin (2007), politics can encourage governments to bear more risk than is in the public interest, since successful claimants “tend to have opaque costs and to come with a rationale explaining how they are good for the country” especially if the “government’s accounting and budgeting fail to recognize their costs”.

4.4 PPPs and the Portuguese banking system

Portugal’s excessive external debt reflects, in part, the external funding of the local banking system which became highly leveraged. Liabilities to non-residents rose from € 155 billion at the end of 2008 €171 billion at the end of 2010 (including €41 billion of emergency funding from the ECB), 42.2% of the Gross External Debt.

Portuguese banks were enthusiastic about project financing, which promised stable long term income for manageable risks, provided that long term funding could be secured. Before the Euro was introduced in 2000, the EIB provided the long term Escudo funding needed and local and international banks took project and construction risk by issuing payment guarantees in favour of the EIB. Later, Portuguese banks continued heavily involved in project finance, even when credit spreads dipped below one percent.

When foreign banks retracted sharply after 2008, local banks stepped up their underwriting. But when bank ratings were cut below the levels required by the EIB for its guarantors, bank guarantors had to pay additional fees to the EIB

As Portugal and its banking system faced ever rising funding costs and eventually lost access to the international financial markets, the large portfolio of thinly-priced project finance loans caused serious asset-liability and earnings problems, leading banks to sell some PPP loan assets at deep discounts in order to deleverage. Net interest margins on the project finance loans have become negative and a few PPP project have become distressed, although others have benefitted from the generous renegotiations mentioned above. In the future, the IMF will require that the annual review of PPPs and concessions be “accompanied by an analysis of credit flows channelled to PPPs through banks by industry and an impact assessment on credit allocation and crowding out effects” (IMF Update 1-September 2011).

4.5 . Fiscal risks, PPPs and Portugal severe external debt crisis

According to IMF-FAD (2009) “A survey of selected countries confirms the transmission mechanisms from the financial crisis to PPP programmes”. However, there is no mention of the reverse causality between excessively large PPP programmes and a country’s sovereign rating.

The causal relationship between PPPs and Portugal’s external debt problem can be described as one of quantity and also of quality. In quality terms, the trends towards availability payments and frequent renegotiations damaged the Value for Money and the productivity due to over investment in costly infrastructure now plagued with excess capacity. But sometimes traffic takes years to ramp up and one or two weak projects need not be a cause for alarm.

The critical problem has more to do with the sheer quantity of PPP transactions and with the negative synergies and duplication which have now lead the Government to cancel plans for a third north-south motorway nearly parallel to the A1. In addition, the increasing reliance on PPPs promoted the illusion of budget discipline that was in fact achieved by removing a sizable portion of public investment from the visible direct public expenditure and direct public debt.

5 PPPs as part of the solution

Portugal’s Economic Adjustment Programme focuses special attention on PPPs, with a freeze on new tenders until a full review of the portfolio is carried out by March 2012, in order to quantify the fiscal risks in each PPP contract and in the PPP portfolio overall, and to assess the scope for renegotiating some PPP contracts so as to reduce government liabilities and also to define annual ceilings on new PPP liabilities (IMF Update 1-September-2011). An assessment of the 30 most significant PPP contracts is underway (August 2011).

In its response to the IMF and the EU, the Portuguese Government agreed to forego contracting any new PPPs at the national, regional or local level until it takes measures to:

- Enhance monitoring and control of capital expenditure decisions with the implementation of a public investment information system
- Set indicative expenditure ceilings and a medium-term budget framework for 2012 Budget
- Revise the Budget Framework Law (LEO)
- Publish a comprehensive report on fiscal risks as part of the annual budget, consistent with international best practices, including all PPPs

The Adjustment agreement also calls for strengthening of the management of PPPs including the project selection, assessment, approval and tendering, the contract

monitoring framework and reporting standards, under supervision of the Ministry of Finance and in consultation with EC and IMF staff by end-2012.

The solution to the debt crisis includes deleveraging the Government, the public sector, the banks and the country as a whole, so PPPs must become part of that deleveraging. Some of the measures include:

- Increasing user fees in order to reduce reliance on the over-burdened Portuguese taxpayer, such as the introduction of tolls in the former SCUT shadow toll roads. Since Portugal has no through transit traffic, affordability and willingness to pay are real constraints, resulting in traffic diversion.
- Extending the concession periods could help to reduce the annual payments, but this would require finding a new, non-commercial, source of very long term funding since it is not available in the market. One solution would be for the EIB to release bank guarantees on all projects which have reached completion. Another initiative would be to create an EU-wide official infrastructure investment fund along the model of the Infrastructure Crisis Facility created in 2009 to help projects nearing financial close in developing countries.
- 3. Cancelling marginal projects and problematic contracts that have been subject to too many renegotiations, and which may present the greatest fiscal risks over the next 20-30 years. Contract resolution or buy-back possibilities are complex and will vary project by project, but should be carefully investigated and executed.
- 4. Restricting bilateral renegotiations of PPPs as much as possible⁹, ensuring that all rebalancings are subject to the intervention or review by an independent third party as in the case of arbitration. Publication of all contractual changes and their budget impact is essential in order to demonstrate that the *Concedent* is not caving unjustifiably in to concessionaire and bank claims. Rigour and transparency are key in order to recover credibility. Although some PPP contracts are considered armoured (*blindados*) in favour of the concessionaire, it is possible to enforce penalties and remedies in cases of non-compliance
- 5. Implementing the annual budget limit for new and existing PPP liabilities, as required by the Budget Framework Law since 2001, so that PPP projects and the resulting PPP liabilities are subject to the same budget discipline and procedures as other public investment and direct public debt.
- 6. Creating and maintaining a Central PPP Agency in the Finance Ministry with executive rather than merely advisory powers, to monitor manage the financial aspects the PPP portfolio as a whole and the resulting PPP liabilities, in much the same way as the Ministry manages the public debt.

- Creating and maintaining PPP units in each of the sector ministries to assume the permanent role of *Concedent* in all phases of PPP projects. Ensuring that the Net Present Value of all PPP liabilities, revised annually, are included in each department's annual budget, alongside the traditional capital investments. Monitoring and setting caps on the total PPP liabilities per ministry.

The major lesson learned from the Portuguese PPP experience is that countries which exclude PPPs from the normal budget discipline procedures and constraints, do so at their peril, since these complex, opaque and very long term contracts carry greater fiscal risks than traditional procurement and require more, not less, scrutiny and monitoring and limits.

NOTES

1. In the Eurostat European glossary, concessions refer only to contracts which transfer the right to collect user charges on existing Infrastructure.

Government liabilities with a given PPP contract may be less than the concessionaire debt and shareholder investments, to the extent that the project relies directly on user charges such as cash tolls. But Government liabilities with a PPP contract which depends on taxpayer funds exceed the concessionaire debt and shareholder investment to the extent that future Government payments have to cover eventual operating deficits and major maintenance, as well as profit margins, and risks assumed by the Concedent.

2. The varying estimates of total PPP liabilities result from the application of different methodologies as well as the lack of consolidated data. In order to be comparable to direct public debt, the estimates of PPP liabilities should be based on the Net Present Value of future payments to be made by units of Public Administration (including regional and municipal governments) discounted at the Government bond interest rate. Estimates may differ depending on the institutional perimeter considered (including deficit-prone State and Municipality owned companies), the nature of the PPP contracts (including long term rentals as well as concessions), accounting for fiscal risks assumed (adding probable downside scenarios, not just the base scenarios) and the discount rate used (set at 6,08% in years past). Total public PPP liabilities may be less than the amount of total investment financed, and of the respective project debt, to the extent projects may benefit from investment grants and user charges such as cash tolls, or may be more than total investments to the extent the Government payments also have to cover future operating deficits.

2. Under the usual arbitration clause, the Arbitral Tribunal is composed of three members, one appointed by each party and the third chosen jointly by the other two arbitrators and its decisions, which have to be rendered within six months, cannot be appealed.

3. In comparison, PFI liabilities estimated at GBP 35 billion in the UK (UK Parliament Report 2011).

4. Law 91/2001 of 20 August, *Lei de Enquadramento Orçamental*, Budget Framework Law, article 28, clause (I) required that the annual Government budget include "The determination of the maximum possible commitments to incurred with contracts to provide services under private finance or other form of partnership of public and private sectors" (*A determinação do limite máximo de eventuais compromissos a assumir com contratos de prestação de serviços em regime de financiamento privado ou outra forma de parceria dos sectores público e privado*).

5. "Public-private partnerships: In Portugal, PPPs are subject to two reviews: a budgetary quasi-appropriation and a methodology assessment to check for efficiency and sustainability. For each project, there is an inter ministerial steering committee including representatives of the MFAP and a PPP expertise centre housed in Parpublica SA. Each central government PPP project is subjected to a gateway process at the points of preparation, negotiation and renegotiation. This gateway process allows the Minister of Finance to stop the project and gives

him/her veto power if the project does not provide efficiency or could endanger fiscal discipline. The project team prepares an initial feasibility study and undertakes a public sector comparator (PSC) analysis – an analysis of the expected cost of the project if it were developed under procurement with no resource to private finance. Tender boards are required to consider the PSC value as a limit-value for establishing a contract, while reserving the right to cancel the call for bids if the proposals are lower than the PSC” (OECD 2008).

6. In Portugal, the Ministry of Transport considered it inevitable that requests for reequilibrium also occur in the first years of the concession contracts (Portuguese Court of Auditors, 2008, 1.4.3)

7. Under the usual arbitration clause, the Arbitral Tribunal is composed of three members, one appointed by each party and the third chosen by the other two arbitrators, and its decisions, which have to be rendered in six months, are binding on all the parties and cannot be appealed.

8. In a unique case, the concession for the Alcantara container terminal in Lisbon, due to terminate within 7 years, was extended by another 27 years in direct negotiation and traffic risk was shifted to the Concedent, in order to finance the near tripling of capacity.

9. In the UK, renegotiations occurred in 33% of Central Government Departments PFI projects signed between 2004 and 2006. The changes amounted to a value of over \$4m per project per year equivalent to about 17% of the value of the project (NAO, 2007). Considering data on nearly 1,000 concessions granted during 1985 - 2000, Guash(2004) showed that 30 % of the concessions were renegotiated (see also Guash, and Straub,2008)

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