

Managing Government Guarantees and Contingent Liabilities*

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*To guarantee or not to guarantee
... is not the question.¹*

PIDS Policy Notes No. 97-11 brought to the public's attention the problem of contingent liabilities arising from the guarantees provided by the government to infrastructure projects. It called on government to establish a policy framework for the provision of guarantees and, more importantly, a system for managing contingent liabilities.

This *Policy Notes* now draws an outline of a risk management approach that deals with expected and unexpected losses from contingent liabilities. The basic requirements are: (a) a risk-sharing arrangement with the private sector, and (b) market-based pricing of the guarantee fee based on relative risks and market conditions.

Demand for government guarantee: the rationale

In the past, the Philippine government was heavily involved in direct financing and provision of public utility services either through government-owned and -controlled corporations or through the direct control of utilities. Thus, power, water and telecommunications, and civil works such as roads, bridges and ports, used to be provided by government under heavily regulated environments. Over time, the deadweight losses created by market distortions such as price controls and subsidies, and the fiscal costs of inefficient public sector delivery of infrastructure services have forced the government to privatize the provision of infrastructure services. The cost of heavy government presence had taken its toll against the boom-bust Philippine economy. Thus, in recent years, the government has spared no effort in trying to attract private sector participation in the infrastructure sector.²

The hard reality, however, is that it is very difficult to encourage the private sector to invest in the infrastructure

**Based on a study conducted by Llanto et al. for the Department of Finance, March 2000.*

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¹*With apologies to the Bard.*

²*The usual example cited to demonstrate government's resolve to let the private sector bear the brunt of infrastructure provision is the amended Build-Operate-Transfer (BOT) Law passed during the Ramos administration.*

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sector when markets are highly regulated, uncertain and distorted by price controls and subsidies. The private sector is all about making profitable investments, generating surpluses and accumulating wealth. In its profit calculus, it leaves no stone unturned in trying to recover costs and generate profits from the business enterprise. When offered the opportunity to participate in infrastructure investments where the scenario's realities, however, involved entering highly regulated and distorted markets for infrastructure and where political patronage could present real constraints to efficient operation and great profitability, the private sector therefore sought government guarantees to cover a wide variety of perceived risks.

The Philippine government has thereupon provided guarantees to encourage private sector participation in infrastructure projects. Government guarantees seek to minimize, and in some cases, eliminate certain risks that discourage private sector participation in financing, building, maintaining and operating public infrastructure projects. A government guarantee was an important feature of the build-operate-transfer (BOT) scheme that helped solve the power crisis in the early 1990s. With the help of a government guarantee, private investors can maximize their return-to-risk ratio in the face of pressure from financiers, investors, shareholders, and others who want to minimize in turn their own risk exposure to the private investors' decision to take on risky infrastructure projects. These guarantees to private investors cover a wide variety of project-specific and general risks.³

Risks in infrastructure projects⁴

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

- * Site availability – the government guarantees right-of-way (ROW) for the project. This involves the purchase of the site for the project as well as the relocation of project-affected personnel;
- * Market risk – if the buyer of the service is a government entity, the government typically agrees to minimum off-take contract purchases and prices (take or pay arrangements). These have the effect of guaranteeing a

market for the output of the proponent such as power, water, and others;

- * Payment risk – if the buyer of the service is a government entity, the government guarantees contractual performance;
- * Change in law risk – the government reassures proponents that changes in the legal framework will not affect contractual agreements; and
- * Foreign exchange risk – the government/central bank agrees to provide forward cover for the proponent which entails either making foreign exchange available for the project or purchasing foreign exchange through a forward contract for delivery at a later date.

Table 1 shows some of these project-specific risks and their bearers.

Guarantees that cover market risks, foreign exchange risks and buyouts in the event of project termination contribute the greatest share to increases in the contingent liabilities of government. The amount of uncertainty inherent in the transition period, that is, from a state of direct government provision to a state of privatization, and the long gestation period of infrastructure projects imply that when such guarantees are provided, the government shoulders a larger proportion of the risk of insufficient market demand, adverse exchange rate fluctuations, and other negative shocks.

Costs of bearing risks

In bearing the risks on behalf of the private investors, meanwhile, what are the costs on the part of the government?

In a guarantee agreement, the government promises to absorb certain risks faced by the private investors in uncertain infrastructure service markets. Depending on the state of markets prior to privatization, these risks are the result of uncertainties usually associated with

³Llanto and Soriano (1997).

⁴This section benefited from inputs provided by Prof. Renato E. Reside, Jr., a member of the study team led by Dr. Llanto.

Table 1. Selected project-specific risks and bearer of the risk

Type of Project-Specific Risks	Risk-bearer
Project performance risks High cost of service Bad/inefficient service	Power – power purchase agreements provide for the minimum power plant performance criteria which the proponent has to satisfy. Water – the Metropolitan Water and Sewerage System (MWSS) concession agreement states the minimum criteria for project performance to be satisfied by the proponent. Transport – most toll road concession agreements state the minimum criteria for project performance to be satisfied by the proponent.
Project completion risks Delays Cost overruns Site availability	Power – the National Power Corporation (NPC) normally guarantees right-of-way and site availability for power projects. Water – the MWSS concession agreement stipulates that cost overruns in projects may be passed onto consumers provided they are covered in grounds for extraordinary price adjustments (EPA). Otherwise, such costs are borne by the concessionaires. Transport – responsibility for constructing access and feeder roads necessary for ensuring the viability of many toll roads are assumed by the government.
Fuel and other inputs risk Fuel availability Skilled labor	Power – in many instances, power purchase agreements include commitments by the NPC (also the off-taker) to guarantee the supply of fuel inputs for independent power producers. Water – the MWSS concession agreement transfers input risk to the concessionaire unless there are grounds for extraordinary price adjustments. Transport – inputs for road and bridge construction are usually carried by the contractor.
Market risk User demand for services	Power – at the height of the power crisis, the government agreed to bear significant market risks by adopting minimum off-take contracts with independent power producers. Water – the MWSS concession agreement transfers market risk to the concessionaire. However, a number of bulk water service contracts with pending approvals have minimum off-take provisions with government-owned off-takers. Transport – the MRT-3 contract includes a stipulation of minimum ridership, levels below which the government must compensate the contractor.
Payment risk Creditworthiness of buyers of output	Power – all power purchase agreements stipulate that NPC's commitments carry a full government guarantee for minimum off-take amounts. Thus, the relevant credit risk is that of NPC and the government. All power purchase agreements (PPAs) carry a buyout clause which the independent power producers (IPP) may invoke in case NPC commits a breach of contract or fails to make required payments to IPPs. Water – many proposed service contracts between bulk water providers and off-takers, usually municipal water districts, carry guarantees of payment from the latter. Thus, the relevant credit risk is of the municipal water districts or the municipal government. Transport – there is no off-taker in most transport projects.
Financial risk Debt service coverage Security Ongoing compliance	Power – all PPAs carry a buyout clause which the IPP may invoke in case there is a change in circumstance that materially reduces or prejudices the IPP return and the Parties are unable to agree to a change in the contract after a defined period (guaranteed rate of return risk). In addition, most capacity payments are tailored to cover the project sponsor's debt services plus a fair rate of return. Water – in the MWSS Concession Agreement, the government does not assume financial risk. This is instead passed on to the concessionaires. Transport – debt service coverage is a risk assumed by private operators in the case of toll roads.
Country environment risk Expropriation Regulatory interference Concession revoked Legal framework Environmental approval Foreign exchange	Power – all PPAs carry a buyout clause which the IPP may invoke in case there is a change in law or regulations, and if compliance with such laws results in: a) the power station being unable to operate; b) the interest of the operator in the project and the operator's expectation of its return on investment being materially and adversely affected; and c) the parties are unable to agree to an amendment of the PPA after the defined period of negotiation (legal framework risk). All PPAs carry a buyout clause which the IPP may invoke in case there is a <i>force majeure</i> event that is within the reasonable control of the government or NPC which lasts for a defined period and the

Table 1 (cont'd.)

Type of Project-Specific Risks	Risk-bearer
	<p>parties are unable to agree to a contract revision. In a few cases, this applies to all <i>force majeure</i> events (<i>force majeure</i> risk). Many PPAs carry a buyout clause which the IPP may invoke in case the NPC is privatized wherein it effectively results in a real or purported assignment of rights or assumption of obligations under this agreement or wherein it materially and adversely changes its net assets, projected profits, projected net cash flow from operations, prompting a reasonable person to conclude that the ability of NPC or its successor entity to duly perform its obligations under the PPA on a timely basis has been materially and adversely affected.</p> <p>Water – in setting the concession fee equivalent to the annual debt amortization payments of MWSS, the MWSS concession agreement effectively transfers the responsibility for paying MWSS loans to the concessionaires. Since these loans have been contracted in foreign currency, the concessionaires bear the risk. However, the concessionaires have cited the devaluation of the peso in their latest petition for EPA before the MWSS Appeals Board. There are no automatic adjustment mechanisms for passing these risks to consumers.</p> <p>Transport – in toll road agreements, most of the country environment risks are assumed by the government.</p> <p>Note: The Philippines no longer guarantees foreign exchange rates at the time of conversion. What is more prevalent is a guarantee of convertibility of domestic currency into foreign exchange.</p>
Sources: International Finance Corporation (1996) and Llanto et al. (2000)	

market demand, legal structure, political regime and foreign exchange during the transition period from public to private sector provision. Bearing these risks at the outset does not seem acceptable to the private sector. Thus, to attract private investments, most, if not all, of these risks will be passed onto the national government. Leaving such risks to the government invariably creates contingent claims on the government which can be triggered by certain events.⁵

Policymakers, multilateral institutions and academics have expressed concern about the impact of contingent liabilities on the fiscal position of governments. Failure by the government to charge risk-adjusted prices for guarantees implies inadequate compensation for the risks shouldered by the public sector. Comprehensive guarantees expose taxpayers to potentially huge fiscal burdens that are not necessarily justified especially if the risks covered by the guarantee are commercial in nature. In addition,

the contingent nature of these liabilities is such that governments which rely on cash budgeting do not provide for them in their budgets. They become actual obligations of the government when the private investor calls on the guarantee. But since there is no or inadequate provision for future calls in the budget, the guarantee call creates undue problems on the government's fiscal position. To satisfy an unforeseen guarantee call, certain budgetary items, e.g., expenditure for health, nutrition, and others, may suffer. Table 2 shows the largest sources of contingent liabilities in terms of size of exposure in various sectors.

For sure, there are trade-offs in resource allocation which involve the way public resources are spent. However, it is the accumulation of large contingent liabilities and a lack of awareness of these that the national government should avoid in the future. And should it really be necessary to encourage investment in a key area through a guarantee, the potential government exposure to contingent liabilities must be properly accounted for, covered by adequate reserves and properly priced to reflect the scarcity value of government guarantees.

⁵In 1997, Llanto and Soriano pointed out that government guarantees have generated huge contingent liabilities which the government should manage very well, otherwise, the government will be exposed to substantial payment burdens once a guarantee call is triggered.

Framework for managing guarantees and contingent liabilities

The comprehensive guarantees provided by the government to the power sector in the early 1990s created a huge risk exposure for the public sector in terms of contingent liabilities that become due once trigger events lead to guarantee calls. Of course, it should be stressed that said guarantees were deemed necessary at that time to be able to bring in private investments to solve the crippling power crisis during the closing months of the Aquino administration. However, there is now a realization that future government guarantees should be provided for more efficiently.

In view of this, there is a need to formulate a framework that would help manage guarantees and contingent liabilities.

Basic requirement: appropriate policy environment

A prerequisite for a good framework is the presence of an appropriate policy environment. Certainly, macroeco-

nomics stability characterized by low inflation and low interest rates will enable projects to have more certain cash streams and a positive rate of return on investments. An appropriate and transparent regulatory and legal framework that safeguards public welfare and safety, upholds contractual obligations and ensures adequate returns to the investor will likewise support the enabling macroeconomic environment fostered by government. Among the critical areas that will require impartial and transparent rules and procedures are the following: arbitration procedures, enforcement of contractual obligations, competitive bidding for supplies and equipment, tariff adjustment, and repatriation of capital.

The encouragement of solicited over unsolicited bids for the implementation of infrastructure projects is crucial in signaling that the government wants competitive forces to come into play in the market. This will help government to ward off potential political pressure and lobbying behind unsolicited bids.

A consistent macro-micro environment will thus help minimize the risks of guarantee calls. Moreover, a growth economy will shield the government from the risk of buyout clauses or similar undertakings that are normally demanded by private investors in uncertain and weak markets. The end result is an overall reduction in risks, making fewer guarantee calls more likely.

Things to consider

What are the factors that need to be considered? *First*, the government should recognize that a guarantee cover is not a free resource which it can grant at will. Without making an efficient allocation of this resource and in the face of budget constraints, the government can find itself saddled with a fiscal shock once private investors call on the guarantee. A contingent liability becomes an actual claim on government's fiscal resources once certain events trigger a call. Thus, as a scarce resource, a guarantee should be efficiently allocated and its correct pricing ensures, to a large extent, its efficient allocation. Pricing of the guarantee should therefore consider market conditions and relative project risks.

Table 2. Largest sources of contingent liabilities in selected sectors

Item Guaranteed	Cost
Power sector^a Buyout clause or termination Buyout Force majeure	Buyout or termination price Buyout or termination price Buyout or termination price
Transport sector Buyout Force majeure	Buyout or termination price Buyout or termination price
Water sector MWSS to assume loans being paid by concessionaire MWSS to pay early termination fee Loser of appeal to pay total cost of appeal process for both parties Force majeure	Cost of principal and interest on old MWSS loans Early termination amount Cost of appeals process Early termination amount
^a Note that the annual capacity payments by NPC to IPPs are guaranteed, however, they do not give rise to contingent liabilities since the payment schedule has already been predetermined in the contract.	

Second, the government should determine the amount of guarantee cover that it can prudently provide in any given year subject to a hard budget constraint. This amount should cover not only guarantees to infrastructure projects but also other guarantee programs implemented by various government agencies, especially those that have the nature of sovereign guarantees. In some instances, the government only gives an indirect guarantee since the first recourse of the private investor is the balance sheet of the sponsoring agency. However, since this also exposes the government to contingent liabilities, indirect guarantees should thus be likewise considered in the totality of the guarantee cover which the government can provide at any given time.

Operationally and for practical reasons, it may be hard to arrive at a "global amount of guarantee" that the government may provide at a given year as suggested by this *Notes*. The second-best approach might be to ensure that all national government agencies involved in the grant of guarantees should be conscious of this principle whenever they consider the grant of guarantees and report to the Department of Finance the amounts of guarantee that they have provided, including the sector covered.

On this note, it is worthy to mention that the government implements various guarantee programs through several agencies such as the Quedan and Rural Credit Corporation (QRCC), Small Business Guarantee and Finance Corporation (SBGFC), Guarantee Fund for Small and Medium Enterprises (to be merged with SBGFC), Comprehensive Agricultural Loan Fund (CALF), Trade and Industry Development Corporation (TIDCORP), Industrial and Guarantee Loan Fund (IGLF) under the Development Bank of the Philippines, and the Home Guaranty Corporation. The guarantees they provide are nontrivial; yet, there is no one agency in the governmental bureaucracy that has information on the global amount of guarantees provided, much less an appreciation of the associated contingent liabilities. In this respect, therefore, there is a critical need for a very serious study of the pricing, allocation and management of guarantee schemes.

Third, the government should rank infrastructure and other projects to be given guarantee cover in accordance with their net social and private benefits. This will require a thorough inter-agency discussion and if possible, calculation of the relative social and private benefits as well as corresponding costs of projects. The Medium-Term Philippine Development Plan and the annual budgetary deliberations can provide initial guidance on the relative ranking of projects.

Fourth, the government should disaggregate and assign risks to the party most capable of managing them or whose actions have a direct bearing on their outcome. Thus, a risk-sharing arrangement with private parties shall reduce the demand for government guarantee and minimize its exposure to contingent liabilities as well as reduce the moral hazard problems in implementing projects.⁶ The sharing of risks has to be reflected in the contracts to be executed between the contracting parties.

Fifth, the government should consider giving only a set of core guarantees to BOT projects as well as to concession arrangements,⁷ covering only (a) fundamental risks, e.g., uninsurable political risks; (b) fundamental rights; and (c) foreign exchange convertibility. Fundamental rights bind the BOT proponent to undertake the project in full accord with the terms of the contract. As such, the government will grant the BOT proponent the exclusive right to the project and will guarantee it against direct or indirect government takeover unless there is a separate agreement or buyout provision in the project agreement. Foreign exchange convertibility guarantees the BOT proponent's right to (a) purchase foreign exchange in the open market; (b) transfer its foreign currency funds abroad; and (c) maintain foreign currency bank accounts in the Philippines or abroad. To be neutral, the core guarantees should be applicable across sectors and impartial to all types of projects.⁸

⁶*Llanto and Soriano (1997).*

⁷*ICC Policy Workshop on BOT and Related Policies, Tektite Building, Pasig City, May 14, 1999.*

⁸*Ibid.*

Sixth, the government should adopt an explicit exit strategy for government guarantee in its contracts with private investors, thereby minimizing the government's risk exposure and potential burden on its fiscal position. The exit strategy will prevent perverse incentives and moral hazard in project management and implementation. For example, the government can include a provision for a fall-away of government guarantee for foreign exchange convertibility once the country attains an investment grade rating in international capital markets.⁹

This is similar to the position taken by the NEDA-Investment Coordination Committee to adopt a selective and reasonable set of performance undertakings that are subject to a fall-away clause. More specifically, commercial and market risks that appropriately belong to the private sector should no longer be covered by government guarantees. Fall-away clauses were included in the 1200 MW Ilijan Natural Gas Power Plant wherein the performance undertaking for the availability fees shall fall away when the Philippines achieves an investment grade rating for its Philippine peso debt for two consecutive years from Standard and Poor or Moody's or other internationally recognized rating agency of comparable standing.

Seventh, the government should include the duration of the guarantee cover or the period of cooperation between the sponsoring agency/national government and the project proponent in pricing the guarantees. A recent analysis for the power sector shows that the greater the time period within which the guarantee call can be exercised, the more likely it will be exercised by the project proponent. Thus, a higher guarantee fee or premium could be required.¹⁰

Eighth, the government, together with the sponsoring agency and the private investor, should review the guarantee fee annually in the light of changing business and economic conditions, to give the Department of Finance the opportunity to charge market-based guarantee fees.

The pricing of the guarantee fee is an important consideration. In the absence of a first-best actuarial basis,¹¹

the guarantee fee should be related to the market price of a long-term government security or bond. Since the guarantee cover constitutes an allocation of government resources to the project, the premium or fee for that cover should be based on the opportunity cost of the allocated resource. There is also a great advantage in calibrating the guarantee fee according to the relative risks in infrastructure projects. In this regard, government should identify all the possible risks that can affect the project, rank them according to their weight and probability of occurrence, and make a judgment on what specific risks the government is willing to cover. Thus, having a risk-adjusted and market-based guarantee fee will enable government to provide adequate guarantee cover and create the proper incentives for private demand for that cover.

An approach to contingent liability risk management

A contingent liability is one whose value is uniquely dependent on states of nature that will occur in the future. The timing of the occurrence of these states is unknown. Because the government exercises a limited amount of control over many activities, it is not aware of how much it can lose when events trigger payment or service obligations.

Using the present value approach to estimate contingent liabilities, one can take the present value of total future payments to be made within the next ten years to all BOT operators with known take-or-pay contracts, and then compute government's total exposure as, say, a range of one-to-three percent of this value.

The estimated amount of contingent liabilities is only indicative and clearly a more refined estimation is needed. The approach is likewise inadequate since the present value approach does not take into account the following:

⁹Llanto and Soriano (1998).

¹⁰See Llanto et al. (2000).

¹¹There has been no history of guarantee calls which is, in a way, fortunate for the economy. Option pricing techniques seem relevant for pricing guarantees given to the power sector.

- * estimates of past and future expected market demand when estimating exposure to market risk;
- * while take-or-pay contracts insure private operators against market risk, the government has a larger exposure to contractual buyouts and termination payments which are triggered by *force majeure* and other events; and
- * the exposure to risks may actually be higher than the 1 to 3 percent range.

The contingent liabilities should be carefully monitored and managed in order to minimize the costs of actual calls on the government. An appropriate contingent liabilities management framework could therefore inform government's decision on providing guarantees, expectation of guarantee calls in the future, and the setting of reserves for the contingent event.

The underlying rule is to identify first, the different types of risks and second, the best way to improve their management, whether by insuring, transferring, mitigating or retaining the risk. This approach, when adapted to the public sector, takes into account the government's budgetary processes, the legal environment and the type of risks being evaluated. The approach has six steps, described as follows:¹²

Identifying risk exposure and sharing risks with the private sector

To determine the government's risk exposure, there is a need to first identify all types of risks in a given infrastructure project. Then, the cost and loss implications of the identified risks have to be assessed. The government should then evaluate which party (public or private) has the best access to the information needed to most accurately assess the underlying risks of the project. The specific risk should be assigned to the party that has the best information, and the ability to monitor, control and service the risks.¹³ In the case of market risks, it is the private investor that is more capable of monitoring, controlling and servicing the risk while the government is the appropriate party to assume right-of-way, political, and other fundamental risks.

Quantifying risk exposure and budgeting for expected costs

It is not feasible to account for every source of risk in projects and the pragmatic approach is thus to identify risks and rank them in order of highest probability of occurrence. Quantification of risk exposure can be done through valuation techniques, depending on the availability of data, e.g., data on the performance of a project or program, the quality of data and others.¹⁴

With a quantification of its risk exposure, the government can start budgeting for expected costs. Information on expected costs will be based on the government's review of the project situation, including performance of the project proponent, which can be done on annual basis during the cooperation or guarantee agreement period.

Budgeting for the expected costs will have as a main impediment the simple cash-based budgeting system of the government.¹⁵ Because guarantees translate into actual costs only when a guarantee call is made, they remain as contingent liabilities. The government's cash-budget accounting system does not normally carry this as an expenditure item and so, contingent liabilities do not appear in the government's accounts. No funds are therefore budgeted to cover them.

In this regard, the NEDA-ICC has recognized the need to include in the financial analysis of BOT projects the accounting of contingent liabilities¹⁶ so that it can have benchmarks on the number of BOT projects or the magnitude of contingent liabilities that may be programmed in a given

¹²This draws on Lewis and Mody (1998).

¹³*Ibid.*

¹⁴Lewis and Mody (1998) list several techniques, e.g., those used to value options in financial markets. A technique called stochastic simulation was used to quantify net expected loss in their study of Colombian contingent liabilities.

¹⁵Originally pointed out by Mody and Patro (1996).

¹⁶Draft highlights of the Investment Coordination Committee Workshop on BOT and Related Policies, Tektite Tower, Pasig City, May 14, 1999.

year. The ICC has thus proposed that the national government should integrate contingent liabilities accounting into its budgeting and financial programming framework and process. To accomplish this, the government should first develop a database of national government exposure to contingent liabilities which can be based on a review of all contractual provisions that have contingent liability implications.¹⁷

Providing reserves against unexpected losses

In addition to budgeting for expected costs, the government should also make reserves against unexpected losses. The reserve policy depends partly on how often the government wants to approach the legislature for funds. If government has a good sense of the expected and unexpected losses, then frequent funding requests may be avoided. The advantage of having a reserve fund is that the liquidity, value and credibility of the guarantee cover is enhanced, making it a potent tool to influence private sector investment decisions. Investing the reserve assets will maximize the value of the reserve fund thereby creating a hedge for future guarantee calls.¹⁸

Government's tolerance for risk bearing

The main idea behind government's tolerance for risk bearing is to find out just how much losses arising from guarantee calls the government can absorb in a given time period. Based on an annual review of the guarantee cover given and the implied contingent liabilities, the performance of the project and the project proponents, and the macroeconomic and microeconomic conditions, the government should be able to develop a pattern of probable defaults. There are two general approaches for this, namely:¹⁹ (a) establish the probability of default in each specific project; or (b) determine the probability of default of the government's portfolio of guarantee cover. The latter is a portfolio value-at-risk approach that takes into account portfolio diversification. Having an understanding of the pattern of probable defaults, the government can then determine how much guarantee calls it can absorb, given other competing demands for scarce resources.

Risk mitigation and control mechanisms

A vital component of a risk management framework is the risk mitigation and control mechanism. This is the first barrier of defense of the government against moral hazard problems that are ever present in guarantee arrangement. One way to develop this is to require the guaranteed party to hold a certain amount of capital or collateral as a first-loss protection barrier.²⁰ Government can also place restrictions on the use of the reserves set aside for future guarantee calls to assure itself that funds will be available for unexpected costs. Another way of doing it is to have proper pricing of guarantee fees to create the proper incentives for parties requiring them. Finally, risk-sharing between the government and private proponents is an effective firewall against moral hazard and incentives problems in infrastructure projects.

System for monitoring and evaluating government's risk exposure

A fundamental aspect of accounting for and monitoring exposure is the establishment of a standard reporting format for contingent liabilities. This will be important in monitoring exposure and other implications of the contractual arrangements. Conditions that may trigger payment obligations on the part of government, the performance of sponsoring agencies and other support agencies in limiting exposure, risk, and actual payments, should be monitored. Contingent liabilities should also be regularly reported to the public or at least to Congress.

Conclusion and recommendations

Government guarantees can be effective tools to encourage private sector participation in infrastructure development. The past experience with comprehensive guarantees, however, shows that the government now faces a substantial amount of contingent liabilities. Actual guaran-

¹⁷The case study of the contingent liabilities in the power sector is an example of this important exercise. See Llanto et al. (2000).

¹⁸Lewis and Mody (1998) from which most of the ideas are taken, provide an extended discussion of the problem of provisioning for expected and unexpected costs and creating a reserve fund.

¹⁹Ibid.

²⁰These suggestions come from Lewis and Mody (1998).

tee calls convert these liabilities into real costs which will have serious fiscal implications for government. The government should thus review the guarantee contracts, particularly those with IPPs to find ways to mitigate its risk exposure and payment for guarantee claims.

In this light, it is important to regularly report to Congress the extent of guarantees provided by the government and the associated contingent liabilities. Likewise, disclosure of contracts and guarantee agreements should be part of the regular information-sharing with the public and Congress.

This *Policy Notes* shows how critical it is for government to have an appropriate framework for the grant of guarantee cover, a credible risk and contingent liability management approach.

In conclusion, the following recommendations are hereby presented:

* ***The government should develop a framework for providing guarantee cover to infrastructure projects***, the elements of which are:

- treatment of guarantee cover as a scarce resource that should be efficiently allocated,
- pricing of a guarantee according to market conditions and relative risks,
- risk-sharing between project proponent and government,
- core guarantees for selected risks and applicable across sectors and projects,
- exit strategy or fall-away clause in guarantee contracts'
- guarantee fee based on the duration of cooperation between government and investors, and
- annual review of guarantee fee based on project performance and business and economic conditions.

* ***The government should develop a contingent liability risk management approach*** whose elements include:

- identification of the government's risk exposures by reviewing existing contracts and trigger events,
- measurement or quantification of expected and unexpected exposures,
- provisioning for expected costs in the budgetary process,
- assessment of government's tolerance for bearing risk,
- use of government's risk tolerance as a basis for establishing policies and procedures for structuring reserves against unexpected losses,
- implementation of risk mitigation and control mechanisms to prevent unintended losses on those risks, and
- establishment of systems to continually monitor and reassess the government's risk exposure over time. 

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