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Enabling Infrastructure Investment

Government Guarantees for Mobilizing Private Investment in Infrastructure

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Acronyms & Abbreviations

BOO	build-own-operate
BOT	build-operate-transfer
BOOT	build-own-operate-transfer
BVGL	business viability guarantee letter
CIRR	commercial interest reference rate
CRPAO	Certificados de Reconocimiento de Derechos de Pago Anual por Obras
DSA	debt sustainability analysis
EAD	exposure at default
EIB	European Investment Bank
EMDE	emerging market and developing economy
EPC	engineering, procurement, and construction
ESC	electricity sales contract
EVN	Electricité du Vietnam
FMO	Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V.
GCA	government contracting agency
GDP	gross domestic product
GGU	government guarantee and undertaking
GoK	Government of Kenya
ICT	information and communications technology
IDA	International Development Association
IDR	issuer default rating
IFAC	International Federation of Accountants
IFC	International Finance Corporation
IIGF	Indonesia Infrastructure Guarantee Fund
IIRSA	Integration of Regional Infrastructure in South America
IMF	International Monetary Fund
IPP	independent power project
IPSASB	International Public Sector Accounting Standards Board
JBIC	Japanese Bank for International Cooperation
KenGen	Kenya Electricity Generating Company
KPLC	Kenya Power and Lighting Company
L/C	letter of credit
LGD	loss given default
LGTT	Loan Guarantee Instrument for Trans-European Transport Network Projects
LOC	letter of comfort
LOS	letter of support
MDB	multilateral development bank
MEF	Ministry of Economy and Finance
MIGA	Multilateral Investment Guarantee Agency
MoF	Ministry of Finance
MRG	minimum revenue guarantee
MW	megawatts
NBET	Nigeria Bulk Electricity Trading PLC
O&M	operations and maintenance
OECD	Organisation for Economic Co-operation and Development
OPIC	Overseas Private Investment Corporation
PAO	Pago Annual de Obras
PAMO	Pagos Anuales por Mantenimiento y Operacion
PCOA	put and call option agreement
PD	probability of default
PFRAM	Public-Private Partnerships Fiscal Risks Assessment Model
PII	Penjamin Infrastruktur Indonesia
PLN	Perusahaan Listrik Negara
PPA	power purchase agreement
PPI	private participation in infrastructure
PPP	public-private partnership
PRG	political risk guarantee
PSO	public service obligation
RPA	Responsabilidad Patrimonial de la Administración
RPICAO	Retribuciones por Inversiones según Certificado de Avance de Obras
SOE	state-owned enterprise
SPV	special purpose vehicle
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

This publication provides guidance to government officials in emerging markets and developing economies (EMDEs) on when government guarantees for public-private-partnership (PPP) projects might be desired; how they could be best utilized; the structure and scope of guarantees and guarantee programs; the costs and risks entailed; and how to manage these risks. This guidance book is not intended to promote PPPs or guarantees, but rather aims to provide a balanced view on how EMDEs can strategically deploy guarantees in limited circumstances to mobilize private financing for their infrastructure needs more effectively.

Traditionally, infrastructure is funded by governments through public budgets. However, many governments of EMDEs do not have sufficient public budgets to fund all of their infrastructure needs. Experience has shown that the private sector can bring in needed financing, technology, expertise, and efficiencies for the construction and operation of infrastructure projects, which can create value for money and improve service delivery.[1] PPP models of developing infrastructure through a long-term, performance-based contract can be an effective method of bringing private sector capital and expertise to the development of certain infrastructure projects.

Governments may be able to help encourage private participation in PPPs by reducing risks through government support instruments such as guarantees. Government guarantees are a sovereign obligation under a binding or potentially binding[2] written document (such as a contract or comfort letter) to satisfy certain obligations of an underlying contract, or to protect the beneficiary from defined losses if specified conditions occur.

Government guarantees are commonly used to make the project more acceptable and financeable to private investors by protecting investors from risks that they have little control over or may not be willing to bear. In this way, a government guarantee can be one of the most critical elements to move a project forward. Even in developed countries, government guarantees have been used to help governments enhance the credit of the underlying project, thus mobilizing private capital or reducing financing costs and passing through a lower cost of services to consumers.

However, government guarantees for PPPs will create contingent liabilities[3] to different degrees and are thus subject to similar risks. Concerns and confusion about contingent liabilities have made many governments hesitant to issue government guarantees even in cases when using government guarantees are necessary and reasonable. To properly address such concerns, it is important to note the distinction between the two fundamental forms of guarantees: financial or credit (debt) guarantees and performance guarantees. Financial or credit guarantees are usually unconditional agreements to service debt obligations of the borrower in case of default. The government guarantees used in PPP projects, on the other hand, are typically performance-based and cover targeted risks. The implications of a financial or performance guarantee for governments' contingent liabilities can be very different, but this distinction is rarely considered when discussing government guarantees for PPPs.

Confusion around the implications of government guarantees has led to delays in infrastructure project development in many EMDE countries. These delays may have enabled governments to avoid any contingent liabilities, but the resulting costs due to infrastructure gaps and subpar service deliveries have severe consequences.

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1 Value for money means achieving the optimal combination of benefits and costs in delivering services users want. Further information can be found at: https://pppknowledgelab.org/guide/sections/54-assessing-value-for-money-of-the-ppp

2 Some forms of government guarantees, such as comfort letters, may or may not be binding, depending on the drafting, jurisdictions and/or outcome of a dispute resolution process. See Section 3.1 for further discussion on this topic.

3 Contingent liabilities are obligations whose timing and magnitude depend on the occurrence of some uncertain future event.

This is especially true in countries with high infrastructure deficits, where underinvestment in infrastructure has led to slower economic growth and poor quality of life for the communities. In Sub-Saharan Africa, for example, it was estimated that if the infrastructure gap were closed relative to the median of the rest of the developing world, gross domestic product (GDP) per capita for the region would increase by an estimated 1.7 percent per year.[4] Such economic progress resulting from improved infrastructure has tangible benefits for human capital development and poverty alleviation.

Government guarantees, when used in a strategic and prudent manner, can be a powerful tool to help close infrastructure gaps. It is important to note, however, that a guarantee will not turn a “bad” project into a good one. Not all projects are suitable for PPPs, and not all projects that are suitable for PPPs would require or should be considered for government guarantees. Furthermore, government guarantees may be structured in many ways, with different legal and financial implications. Therefore, careful consideration should be given to the benefits and costs of government guarantees before they are deployed. The best way to mitigate the risk from issuing a guarantee is to ensure that the project meets best practices in how it is selected, prepared, and structured. Projects shown to be economically viable are much less likely to fail. The challenge for governments is to determine where and what kind of guarantees are necessary or cost effective. The rest of this guidance book seeks to answer these questions. The book is organized into five chapters, as summarized below:

Chapter 1: Overview of Government Guarantees introduces the different types of guarantees and reviews the benefits and risks of guarantees and other forms of government support. This chapter notes that the decision to issue a government guarantee for a PPP should begin early in the project preparation and development cycle. Once a project has been identified as providing value for money—that is, it is found to be in line with the government’s development priorities and is economically and financially viable and affordable—the next decision is whether there is a role for the private sector, and whether the project should be procured as a PPP. Guarantees should be considered during this initial development phase, when the PPP structure and the project’s fiscal-support requirements are being determined. It is important for the Ministry of Finance (MoF) to be actively involved in the decision making, including as a “gatekeeper” or ultimate approver, given the fiscal implication of the PPPs. The benefits of a government guarantee can include increasing investor confidence in a PPP project; demonstrating government support; increasing the amount of financing and sources of financing available to a project; reducing the cost of debt service; and reducing the returns investors require by enabling a lower risk profile. However, overly broad guarantees that transfer risks to the government that should have gone to the private investor can create moral hazard and potentially lead to larger government payouts than necessary.

Chapter 2: Scope of Government Guarantees examines the risks involved in a PPP project, appropriate risk allocation among different parties and the common types of guarantees used to address these risks. This chapter notes that government guarantees are often requested when the risks are either within the government’s control or not acceptable by the market. Risks commonly associated with government guarantees include political and regulatory risk; revenue and demand risk; foreign exchange risk; uninsurable force majeure events; and payment and early-termination risks associated with the underlying contract with non-creditworthy counterparties. In certain cases, there is an important role for international financial institutions, such as multilateral development banks, to further enhance the credit strength of a sovereign guarantee.

4 World Bank 2017b.

Chapter 3: Structuring and Negotiating Government Guarantees first discusses the different forms of government support, from comfort letters to guarantee agreements, and their legal enforceability, before describing the common issues encountered when negotiating a government guarantee, including its scope, term, cure periods, dispute resolution mechanism, waiver of sovereign immunity, and the role of government advisors. More so than what a document is called, it is the language of the document that will determine whether a comfort letter or letter of support (LOS) is treated as a guarantee in a dispute resolution. The benefit of a guarantee is that it is a precise document that makes explicit the obligations of the guarantor. Like any contract, the specific provisions are important to ensure that the guarantee provides the coverage needed, while still giving the guarantor time to remedy the issue.

Chapter 4: Managing Fiscal Risks from Government Guarantees discusses how governments can manage the contingent liabilities that arise when government guarantees are called. This requires adequate assessment, approvals, accounting, disclosure, and monitoring throughout the life cycle of a project. This chapter also discusses how to budget for and fund guarantees, as well as costing and pricing estimation for guarantees. Estimating government's exposure under the issued guarantees is required in order to manage appropriately the risks associated with these guarantees. Budgeting and accounting standards are evolving to allow for more transparency in government guarantees, although measuring contingent liabilities still requires complex estimations of the probability of default and the size of the payout. Another path to managing the fiscal risks of government guarantees for PPPs is through transparency and disclosure of the key elements of PPP contracts, including guarantees.

Finally, **Chapter 5: Guidelines for Governments** summarizes the key takeaways from this guidance book—from project preparation to managing contingent liabilities—to ensure that governments use guarantees effectively and prudently to attract private investment in infrastructure while managing their own exposures and risks.

Additionally, case studies are referenced throughout the document to highlight specific points and provide real-world examples.