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# State Guarantees in PPPs

A Guide to Better Evaluation,  
Design, Implementation and Management





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## Introduction

### Purpose of the paper

This EPEC paper sets out the range of State guarantees (“**SGs**”) available to public private partnerships (“**PPPs**”) and considers the policy issues that emerge from their use. It should help governments to evaluate whether SGs are an appropriate policy option and, if so, provide guidance on how to best implement and manage SGs.

### Background

In PPPs, a risk should be borne by the party best placed to manage it, that is, the party that can best understand, control and minimise the cost of the risk. The private sector is generally in a better position than the public sector to handle and mitigate many of the typical PPP project risks (e.g. construction on time and on budget). There are however circumstances under which a “standard” risk allocation may not yield the full benefits of PPPs. This is where SGs may have a role to play.

SGs are a way for governments to incentivise the private sector (e.g. sponsors, banks, capital market investors, equity providers) to participate in PPP programmes or projects. SGs may take various forms and be aimed at an entire PPP market, specific programmes or simply individual projects. They have been a feature of PPP programmes for many years but, with the onset of the credit crisis in 2007, their use has become more prevalent and varied in nature. This paper draws on the now widespread experience of EPEC members in this field.

### Key principles

For the purposes of this paper, SGs are defined as agreements under which a sovereign or assimilated entity (“**Government**”) agrees to bear some or all of the downside risks of a PPP project. An SG is a secondary obligation. It legally binds the Government to take on an obligation if a specified event occurs. An SG constitutes a contingent liability, for which there is uncertainty as to whether the Government may be required to make payments, and if so, how much and when it will be required to pay.

In practice, SGs are used when debt providers (e.g. commercial banks, national and international financial institutions, capital markets, hedging counterparties) are unwilling to lend to a PPP company as a result of concerns over credit risk and potential loan losses. SGs can also be used to benefit the equity investors in a PPP company when they require protection against the investment risks they bear.

### Structure of the paper

SGs raise many questions, such as whether a Government should bear key risks in a PPP project (and if so, which risks), which SG instrument should be used under what circumstances, how should the *value for money* of SGs be assessed and how should SGs be managed and accounted for. This paper is therefore structured in four sections:

- section 1 deals with the main reasons why SGs are used;
- section 2 reviews the types of SGs most used;
- section 3 sets out the main issues that arise when using SGs and provides guidance for their resolution; and
- section 4 provides an overall good practice checklist for evaluating, implementing and managing SGs.

The paper also has an annex containing a basic mapping of the use of SGs across Europe.



## 1. Why State Guarantees Might Be Used in PPPs

This section reviews the reasons why SGs might be used in PPPs. Although Governments will often wish to adopt SGs for a mixture of reasons, we have identified three main sets of drivers: policy, finance and project risks.

### 1.1 Public Sector Policy Drivers

SGs can be used for PPP policy purposes. Some examples are set out below.

- **Building up confidence in a PPP market and demonstrating Government commitment** – In the initial stages of development of a PPP market (or indeed an individual programme within an otherwise mature market), a Government might use SGs to signal commitment to its PPP initiative, build momentum or steer private funds towards PPPs. Emerging PPP markets, or even emerging programmes in established markets, may face particular difficulties in attracting sufficient private sector interest. For instance, the private sector may be unwilling to commit to long-term PPP arrangements with the public sector as it has a limited understanding of the risks involved. There may also be an insufficient number of financiers able to lend on terms (e.g. pricing, loan tenors, local currency) which would make the PPP projects affordable and *value for money*. The use of SGs can encourage private sector participation and help it organise itself to better meet the business opportunities arising out of PPP programmes.
- **Accelerating the implementation of investments** – Even in well-established markets, PPP transactions can entail long and complex procurement, due diligence and negotiation processes; in particular where the funding is provided through *project finance*. By providing SG cover for the elements of risk that give rise to protracted discussion or due diligence issues, the Government can simplify and shorten negotiations and therefore accelerate the commencement of project works.
- **Safeguarding the credibility of a PPP programme** – The failure of a PPP project or the stalling of negotiations on a flagship PPP project can be perceived as the collapse of an entire policy. SGs can be used to avoid this, although this is only relevant if the PPP programme as a whole would be damaged by the failure of a single project and if the programme is of sufficient political importance that protecting its integrity is imperative.

## 1.2 Financial Drivers

Financial issues can also prompt Governments to use SGs. Some examples are set out below.

- **Leveraging additional sources of finance from the private sector** – SGs are often used to attract funding for PPP programmes or projects, in particular for large-scale investments. Putting together lending packages for PPP projects may be constrained by limited financial capacity rather than a PPP-specific problem. By improving the credit quality of a loan, an SG may increase the amounts banks are willing to lend to a given project.
- **Reducing the cost of capital and improving *value for money*** – Occasionally, the stated objective of SGs is to reduce in the cost of capital of PPP projects (and hence improve the *value for money*). It is assumed that this will be achieved by: (i) reducing the cost of debt (which often represents a high proportion of the funding for a project); and (ii) enabling financial gearing to be increased (expensive equity is replaced by cheaper debt).
- **Addressing instability in the financial markets** – SGs have been proposed in order to (i) increase liquidity by lowering the credit risk borne by lenders and (ii) improve funding conditions by encouraging lower pricing and longer debt tenors. This was particularly the case during the recent credit crisis, when a number of European governments set up SG schemes to overcome blockages in the debt markets. Without SGs, the debt market disruptions would have discouraged private sector participation, reduced *value for money* or stopped/slowed down the delivery of individual PPP projects or programmes. The French guarantee scheme adopted in early 2009 (see Annex, paragraph 1) is a typical example of an SG measure aimed at tackling the financial crisis.
- **Getting the asset built without public sector spending upfront** – Governments may be tempted to use SGs to help attract the private sector to finance new projects whilst not making any public fund disbursement at the outset (e.g. capital contributions) for having the asset available. SGs are also perceived as better alternatives to direct grant finance as they have more of a market flavour.
- **Tapping new sources of funds from the private sector** – SGs can be used to encourage new sources of funding for PPPs, such as the capital markets. Capital markets can be a valuable alternative to conventional bank finance for PPPs. They offer an additional source of liquidity, and in some circumstances attractive pricing and long tenors. However, the requirements of capital market investors (e.g. minimum credit quality, simple investor decision-making procedures) may be incompatible with what is required of lenders in PPP transactions. SGs can help bridge this gap. For instance, Governments can use an SG to achieve a target bond rating or facilitate bond issuance. Box 1 below describes two proposals that show how SGs may enable PPP projects to access the capital markets.

### Box 1 – SGs for tapping the capital markets

#### 1. The proposed EU 2020 Project Bond Initiative

The Europe 2020 Project Bond Initiative is currently under development. The objective would be to attract additional private sector financing through the capital markets for individual large-scale infrastructure projects. The Initiative would provide credit support for senior debt in these projects. This support could be in the form of either (i) a subordinated debt tranche or (ii) a guarantee mechanism along the lines of the EIB / European Commission Loan Guarantee Instrument for Trans-European Transport Network Projects (see Box 2). This EU-supported credit enhancement of senior debt would allow PPP companies to source senior debt through bonds placed in the capital markets, possibly resulting in reduced funding costs and/or longer maturities.

In the guarantee model, an EIB-issued guarantee would be called if the project were unable to generate sufficient cash to service its debt for any reason. It would also apply during the construction period to meet funding shortfalls and thus ensure that the project reaches the operating period. To ensure that the bonds remain at a rating level attractive to investors in most scenarios, it is anticipated that the credit support would amount to a maximum of 20% of the total bond funding of an individual project.

For further information on the EU 2020 Project Bond Initiative, please visit:  
[http://ec.europa.eu/economy\\_finance/consultation/index\\_en.htm](http://ec.europa.eu/economy_finance/consultation/index_en.htm).

#### 2. The French “Fonds Commun de Titrisation PPP” (“FCT PPP”)

The FCT PPP is an initiative currently being developed by the French authorities. The aim of the initiative is to set up a fund (a “Fonds Commun de Titrisation”) which would issue long-term bonds to finance PPP projects. The bonds would be issued on a project-by-project basis. For each project, bonds would be issued at or around financial close. The bond holders would not, however, be exposed to project risk during construction as the financing for the project construction would remain with banks. The bonds would refinance the banks once the project has reached satisfactory completion. The bonds would be backed by the portion of the service charge (payable by the public contracting authority under the PPP contract) that is not at risk of performance under the “cession de créances” mechanism (see Box 3). The risk for the bondholders would therefore essentially be that of the sovereign public contracting authority for the specific PPP contracts. This mechanism is expected to bring long-term funding from institutional investors to individual PPP projects.

### 1.3 Project Risk Drivers

Effective risk transfer is essential to the success of PPPs. Over time, PPP practices across different jurisdictions have developed what might be termed a “standard risk allocation”. Where for some reason this “standard” is not sufficient to satisfy the private sector, SGs can help to tackle specific project issues. In these cases, the aim of SGs is therefore to make PPP transactions bankable and attractive to financial investors. The principal risks that SGs commonly seek to address are reviewed below.

- **PPP company default risks** – Perhaps the most extreme forms of risk coverage are the SGs which protect lenders against the risk of a PPP company default / bankruptcy, irrespective of the reasons for such failure. Interestingly, although the PPP company creditors are most exposed to the insolvency risk of their borrower, the risk also matters to the Government and the taxpayers. The financial distress of a PPP company may indeed lead to an unscheduled increase in user charges / service charges, a taxpayer-funded bailout or a project collapse.
- **Demand / usage risks** – Whilst demand or usage risks are normally considered to be operating risks that should be borne by the private sector, the Government will often have to bear these, at least in part. This is more explicitly the case where forecasting future demand is prone to uncertainties (e.g. a competing road for a toll motorway) or where the Government is the sole or main user of the PPP company services (e.g. schools or hospital projects). The prime objective of such SGs is to make lenders more comfortable with the risks affecting the revenues of the PPP company.
- **Construction risks** – For particularly complex construction projects procured as PPPs, part or all of the construction risk can at times benefit from SGs. Although the private sector is normally prepared to bear the risks of completing an asset on time and on budget, it may be reluctant to accept exceptional risks (e.g. the geology of large tunnel projects, archaeological finds in a location well known for antiquities).
- **Technology risks** – Lenders are often reluctant to accept emerging technologies, high-risk technologies or technology obsolescence risks in PPP projects. They would either refuse to lend or do so only on onerous or inadequate terms. PPP project services may however require a degree of technology risk (e.g. electronic road charging schemes). SGs can facilitate the financing of this type of PPP.
- **Sub-sovereign risks** – Many PPPs are procured by public entities which are not part of central government, and do not have direct or explicit recourse to the relevant ministry of finance. Under these schemes, the private sector is asked to bear the risk of losses arising from a payment default or the non-performance of obligations of sub-sovereign entities. Sub-sovereign risk therefore refers to the credit or payment risk of local government entities (e.g. regions, provinces, cities, municipalities), government agencies (e.g. national road agencies) or public enterprises (e.g. rail infrastructure companies). SGs can be used to tackle sub-sovereign risks.

- **Policy risks** – The so-called policy risks normally fall into the category of risks that the Government should keep for itself. Policy risks arise from unpredictable changes in Government actions. They relate to matters such as: changes to the price the PPP company is allowed to charge for its services; changes to the service charge that the contracting authority is due to make to the PPP company; unexpected changes in laws and regulations; changes to service quality standards; and expropriations without compensation. SGs are sometimes used in jurisdictions where the private sector is particularly concerned about the extent of policy risks.
- **Macroeconomic risks** – Private operators are sometimes provided with SGs which protect them from adverse macroeconomic developments, such as devaluation or depreciation of currencies (e.g. for projects whose revenues are in local currencies whereas the costs and debt service obligations are denominated in a foreign currency) or interest rate fluctuations (typically where the swap markets are not deep/liquid enough to offer adequate hedging).
- **Residual value risks** – These risks relate to the value of the assets handed back to the Government when the PPP contract ends. As explained in section 2.2 below, a Government's undertaking to make payments on early termination or natural expiry of PPP contracts is sometimes akin to an SG.



## 2. Types of State Guarantee Used in PPPs

From a legal viewpoint, SGs can be guarantees in the narrow sense but they may also take the form of contractual undertakings (under the PPP contract or other project agreements), indemnity letters or even letters of intent. Setting aside the legal aspects, SGs can be categorised into types of instrument. This section reviews the most frequently used types of SG and is not intended to be exhaustive. Also, SGs are not necessarily mutually exclusive, they can be blended as part of a support package for the benefit of lenders and/or investors.

### 2.1 Finance Guarantees

Finance guarantees are directly aimed at the lenders to PPP projects. They typically take two main forms which are set out below.

- **Loan guarantees** – These are perhaps the most common forms of SGs. In substance, loan guarantees are instruments under which the Government guarantees the lenders that it will service their debt if the PPP company fails to do so. Three features of loan guarantees are worth stressing:
  - (i) They can be “acceleratable” or of an “instalment” (or “debt service”) type. With acceleratable guarantees, the lenders have the right to require from the guarantor the immediate and full repayment of their debt upon payment default by the PPP company. With “instalment” guarantees, the Government would only pay debt service instalments as and when they are due under the original loan;
  - (ii) They can be “partial” or “full”. With partial guarantees, the Government may only guarantee some of the lenders or a fraction of the debt of the PPP company. With full guarantees, the coverage would encompass all the lenders and/or all of their debt;
  - (iii) The *ranking* of the monies paid by the Government when the SG is called may vary: Government claims may become debt of the PPP company or be treated as non-reimbursable grants. When the claims are debt, they may be super-senior, *pari passu* or subordinated to the debt of other lenders.

The Loan Guarantee Instrument for Trans-European Transport Network Projects (“LGTT”), set up jointly by the EIB and the European Commission, is an example of a structured loan guarantee (see Box 2 for further details on the LGTT).

- **Refinancing guarantees** – These are used when lenders are unable to supply reasonably priced finance for a duration compatible with the profile of the PPP cash flows or the PPP contract life. These SGs, therefore, help address the concern that the financial crisis and the new banking regulatory requirements will make long-term commercial funding more expensive and scarce. With these instruments, the Government undertakes to repay the lenders if the PPP company cannot refinance its debt when it comes close to maturity. Equally, if the PPP company manages to refinance its debt, but on more onerous terms, the Government is committed to pay the difference. As with loan guarantees, the issues of fullness and ranking of the claims are important design features. Refinancing guarantees have become important as a result of the emergence of the so-called “mini-perm” financing during

the financial crisis. In a “mini-perm”, the tenor of the PPP project’s senior debt is significantly less than the duration of the PPP contract. This means that refinancing will be necessary at a relatively early stage. The refinancing guarantee scheme introduced by the Flemish Government in 2009 is an example of such SGs (see Annex, paragraph 4).

### **Box 2 – The Loan Guarantee Instrument for Trans-European Transport Network Projects**

The LGTT was set up in 2008 with the aim of attracting greater private sector participation in the financing of revenue-risk TEN-T projects. The instrument enables the transfer of some important elements of demand risk inherent in a concession-based PPP project during the early years of operation. The LGTT improves the ability of the PPP company to service senior debt during the initial operating period or “ramp-up” phase of the project. Its design substantially enhances the credit quality of the senior credit facilities, thereby encouraging a reduction of risk margins applied to senior loans to the project.

The LGTT is an EIB instrument, the risk capital for which is jointly provided by the EIB and the European Commission. The guarantee works as follows. In an LGTT project, commercial banks (not necessarily the project lenders) provide a stand-by facility (“SBF”) which is available in addition to the usual *project finance* funding instruments. The SBF can be drawn by the PPP company in the event of unexpected shortfalls in traffic income during the initial ramp-up period of operations. The proceeds of the SBF may be used to cover the debt service of the project’s senior credit facilities – in other words, to prevent the project going into payment default under the loan agreements. It is important to note that the SBF may be drawn down only in the initial traffic ramp-up period (i.e. after construction of the project is completed). The LGTT does not cover construction risks.

Once drawn, the SBF is serviced, and repaid, on a cash sweep basis, subordinated to the senior loans but ranking ahead of equity. If at the end of the availability period there are still amounts outstanding under the SBF, the LGTT guarantee can be called upon by the SBF providers. At this point, the EIB would pay out the SBF providers and become a subordinated creditor to the project. Once the EIB becomes a creditor to the project, amounts due under the LGTT still rank junior to the debt service of the senior loans and would be repaid either on a cash sweep basis or on a fixed reimbursement profile for the LGTT debt.

For further information on the LGTT, please visit:  
[www.eib.org/attachments/press/2008-005-fact\\_sheet\\_en.pdf](http://www.eib.org/attachments/press/2008-005-fact_sheet_en.pdf).



## 2.2 PPP Contract Provisions

SGs are often granted through provisions of the PPP contract between the Government and the PPP company rather than as separate Government undertakings to lenders and/or investors. The typical PPP contract SGs are set out below.

- **Revenue or usage guarantees** – These SG mechanisms are common in transport PPPs. Under these SGs, the Government, as PPP contract grantor, guarantees the PPP company a certain level of usage (e.g. traffic level in a toll road project) or revenues (e.g. if traffic revenues fall below a certain level, the Government makes up the shortfall). These SGs offer less protection than outright loan guarantees as (i) the primary beneficiary of the guarantee is the PPP company and not the lenders and (ii) should the PPP company's costs not be managed properly, there would still be a risk of payment default on the loan because of insufficient cash flow<sup>1</sup>.
- **Guaranteed minimum service charges** – Under these mechanisms, the Government guarantees that the service charge it has undertaken to pay on a regular basis to the PPP company during the operational phase of the PPP contract will not fall below a certain threshold, irrespective of the performance of the PPP company. The PPP company's lenders usually secure this Government commitment to ensure that their debt, or a portion of it, is *de facto* guaranteed even if the PPP company performs poorly or if the PPP contract is terminated. The French "cession de créances" and the German "Forfaitierungsmodell" presented in Box 3 are variants of this form of SGs.
- **Change of law/regulation undertakings** – In countries with a regulatory framework which is not yet fully developed, the Government may need to provide contractual commitments, or protection, in respect of future regulatory policy. This may also be true for public procuring authorities without an established track record. Policy risks can be allocated to the Government via the provisions of the PPP contract, provided that the contract is binding upon the Government and cannot be changed unilaterally<sup>2</sup>.
- **Termination payments** – Termination payments are a feature of many PPP contracts. They often cater for the legal principle that there should be no "unjust enrichment" when a contract ends. SGs can be found in PPP contract provisions that deal with the compensation owed to the PPP company when the PPP contract is terminated prematurely following default of the PPP company. Standard termination provisions normally provide for Government payments that reflect the value of the terminated contract or of the assets that are handed back to the Government. There are SGs where the contract provisions go beyond this norm and, for instance, ensure that the lenders will be paid the full amount or a pre-agreed proportion of their outstanding debt. The PPP contracts granted in the early 2000s for the maintenance and renewal of the London Underground are an example of this (see Annex, paragraph 2). Even where termination provisions ensure that the PPP company will be paid by reference to senior debt outstanding these SGs are less straightforward for lenders than outright loan guarantees. This is because (i) the primary beneficiary of the guarantee is the PPP company and not the lenders and (ii) the lenders have to wait until the PPP contract is terminated before being repaid, which can be a complex and lengthy process.

<sup>1</sup> The cash flow is the difference between the revenues of the PPP company and its operation, maintenance and tax costs.

<sup>2</sup> Policy risk is also often allocated by law, particularly in civil law countries (e.g. impartial arbitration, regulatory independence).

### Box 3 – Guaranteed minimum service charges

#### 1. The French “cession de créances”

A “cession de créances” is an assignment of receivables in which a creditor transfers the benefit of certain receivables directly to its banks. The “cessions” are regulated under the “Loi Dailly” of 1981, which was aimed at providing a clear framework for simplified commercial mortgaging techniques. Under the “Loi Dailly”, a creditor may raise money from its bank by transferring the benefit of amounts due to it. These amounts are collated on a “bordereau Dailly”, which in turn serves as security for the loan. One of the advantages of the mechanism is its bankruptcy remoteness. In the event of bankruptcy, a liquidator cannot reintegrate the funds subject to the “cession” into the common debt for the benefit of all creditors.

The principal aim of the “cession” is to secure a portion of the debt repayment to the banks. To avoid bearing a performance risk, the bank has to ask for the “cession” to be “accepted”: by accepting a “cession”, the debtor undertakes to pay the amounts due under the assigned receivables whatever happens under the underlying contract. This acceptance creates a very strong direct payment obligation from the public procuring authority to the bank.

The “cessions” and the acceptance mechanism have been used for the financing of French PPPs. The public authority granting the PPP contract (and hence liable for a stream of service charge payments to the PPP company over the life of the contract) can decide in advance to accept the transfer of the benefit of a portion of those payments to the lenders, under certain conditions provided for in the PPP contract. The main conditions under which this acceptance becomes valid are that (i) construction must be complete and the project in operation and (ii) only a portion of the part of the service charge corresponding to the investment and financing costs can be transferred. A law of 2008 caps this portion at 80% of the investment and financing element of the payment. The benefit of the transfer then becomes irrevocable, irrespective of whether the services under the PPP contract are being rendered or not. The economic rationale of this system is that the loans backed by the “cession Dailly” will be considered as public borrowing by the lenders and as such will attract low interest payments, resulting in a lower service charge for the authority.

The system has proved to be efficient in optimising the cost of financing PPPs, without significantly limiting the risk transfer.

#### 2. The German “Forfaitierungsmodell”

Germany makes extensive use of the “forfeiting” model at the municipal level. In this model, the public contracting authorities and the lenders enter into a side agreement. Under this agreement the public authority waives its right to reduce or suspend the payment of the element of the service charge that covers the debt service in the event of poor performance or non-performance by the PPP company. In certain cases, the “forfeiting” covers only 80 to 95% of the debt service obligations (as in the case of the “cession de créances” in France), leaving the “non-forfeited” portion of the debt exposed to project risk. Typically, “forfeiting” is only applied post project completion, with the lenders assuming project risk during the construction phase. As a result, lenders treat the proportion of debt subject to “forfeiting” post completion as a public sector risk and price it accordingly.

- **Debt assumption undertakings** – Some Governments (for example Turkey - see Annex, paragraph 7) have used, or are planning to use, debt assumption undertakings to provide guarantees to the lenders in some of their PPP projects. These PPP contract undertakings require the Government to assume the debt obligations of the PPP company should the PPP contract be terminated. Often, this is achieved through novation of the financing agreements to the Government upon termination. In simple terms this means that the Government becomes the borrower, replacing the PPP company. Whether this is acceptable to the lenders will depend on the credit status of the Government entity that will assume the debt service obligations.
- **Residual value payments** – Residual value provisions are sometimes used in PPP contracts whose duration does not allow the PPP company to fully amortise its debt or remunerate investors. In these cases, the Government undertakes to pay the PPP company, upon contract expiry, a pre-defined amount which generally reflects the residual value of the underlying asset. Residual value provisions are used for instance in the Italian motorway sector, where a number of concessions granted some time ago have a short remaining life but significant investment requirements.

### 2.3 Sub-sovereign Creditworthiness Guarantees

Sub-sovereign creditworthiness SGs are used to enhance the creditworthiness of non central government grantors of PPP contracts. With such SGs, the quality of the payment obligations of the sub-sovereign entity becomes equal to that of the central government guarantor.

Sub-sovereign guarantees may vary in form, but they are often structured as direct undertakings by the central government to the lenders to PPP projects. These undertakings require the central government to intervene if the sub-sovereign defaults on its obligations towards the PPP company. This intervention may vary from making payments on behalf of the sub-sovereign entity to undertaking to ensure that the sub-sovereign will be put in a position to meet its obligations. In some cases, the central government may try to achieve this through non-contractual means, such as “comfort letters” or “letters of intent”. In other cases, the lenders will insist on formal contractual commitments.

The credit enhancement brought about by sub-sovereign SGs can improve the terms of the financing for the PPP company. The debt pricing should indeed reduce with the credit rating improvement. This can therefore improve the *value for money* of the underlying PPP projects although this has implications for the fiscal situation of the sovereign guarantor (see section 3.3).

The Italian “Fondo di Garanzia per le Opere Pubbliche” is a good example of an attempt to formally credit enhance the financial obligations of sub-sovereign entities (see Annex, paragraph 3). In contrast, the UK PPP hospitals programme of the 1990s is an example of soft sub-sovereign support. At the outset of the programme, potential lenders collectively expressed concerns about the ability of hospital trusts (“NHS Trusts”) to meet their financial obligations as they fell due. The “National Health Service (Residual Liabilities) Act” passed in 1996 gave the lenders certain protections, but these fell well short of a commitment that Government would stand behind the debts of

NHS Trusts. The UK Government was unwilling to make such a contractual commitment. Eventually, the Secretary of State for Health issued a letter of explanation to lenders. This indicated that it was “untenable”, given the statutory responsibilities of the Secretary of State for Health, that the Government would stand by in circumstances where an NHS Trust was unable to meet its obligations (and thus be unable to meet its commitments under a PPP contract) and do nothing. This letter explained the powers and duties of the Secretary of State but stopped short of giving comfort to a specific group of lenders. It proved sufficient for lenders to lend to the PFI programme. By 2001/2002, lenders had become more comfortable with PFI in health and dropped their requirement for this letter of explanation, despite there being no change in legislation.

In this section 2, we have reviewed the three main categories of what can straightforwardly be defined as SGs. Governments sometimes also use debt instruments to support PPPs. Being loans (i.e. the Government lends to PPP projects alongside existing lenders to address market failures or specific project risks), these instruments are not considered as SGs *per se*. Box 4 provides two examples of Government debt instruments used in PPPs. To avoid accounting and other regulatory issues (see section 3.3 below), debt instruments often work on a commercial, “gap filling” basis alongside other commercial lenders until market conditions become more favourable, or the project circumstances change.

#### **Box 4 – Debt instruments**

The Infrastructure Finance Unit (“TIFU”) was created by the UK Treasury in March 2009 to make Government loans, on market terms, to PFI projects that could not access finance in the market. Its objective was to provide liquidity to enable PFI projects to reach financial close on a timely basis. Government lending via TIFU was always intended to be both temporary and reversible. Following the 2010 “Comprehensive Spending Review”, TIFU has ceased to offer Treasury loans to projects (see Annex, paragraph 2).

In contrast to TIFU, the French “fonds d’épargne” is only a liquidity product and requires an SG of some sort to support it (see Annex, paragraph 1).

### 3. State Guarantee Issues and Suggested Guidance

SGs give rise to a series of issues which need to be carefully thought through before they are implemented. The issues are often instrument-dependent and should therefore be assessed on a case-by-case basis. This section highlights the main issues SGs raise and suggests guidance for dealing with them.

#### 3.1 Value for Money and Risk Allocation Issues

SGs inherently raise *value for money* and risk allocation issues. The most significant ones are reviewed below.

##### Value for money of SGs

Being a form of Government intervention, SGs should demonstrate that they are in the public interest. Political motives (e.g. election timing, fiscal targets) will often encourage Governments to take on more risk than is appropriate, or prefer bearing risks over the long-term to spending cash in the short-term. This can lead to sub-optimal decisions about SGs.

Guidance: Based on the issues outlined in this paper, decision-makers should have an appropriate framework in place for judging when an SG is likely to be justified as part of their PPP programme. Sound decisions are more likely if the Government carefully considers the full costs and benefits of SGs. Appointing specialised advisers can help decision-makers understand the exposure to risk, assess the benefits and estimate the “whole life” cost of an SG. In the context of the cost-benefit analysis, SGs will need to be assessed against other forms of Government intervention (e.g. grants, interest rate subsidies, tax breaks).

##### Value for money of the PPP projects benefiting from SGs

Optimising risk transfer is fundamental to a successful PPP project. By issuing an SG, the Government is altering the PPP risk allocation and may therefore affect the *value for money* of the PPP solution. The business case for a PPP may no longer stand up against a more conventionally procured project where the public sector takes most of the project risks.

Guidance: SGs should preserve the private sector’s incentives to manage the risks it can best manage. Prior to an SG being considered for a PPP project, the Government should verify the *value for money* model which justifies PPP as a procurement method for the specific project.

## **Moral hazard**

SGs involve the Government bearing some or all of the risks associated with a PPP project. Although potentially attractive for bringing the private sector in on PPPs, this redistribution of risks and rewards can jeopardise the private sector's incentives to perform. Maintaining these incentives is arguably the key to a well structured PPP. For instance, the lenders to a PPP project, when guaranteed, may not be sufficiently incentivised to perform a detailed appraisal of the project, to structure their financing in a way which adequately manages risks and rewards and to monitor the project performance throughout the life of their loan. At the wider programme level, SGs can create moral hazard as the market may get used to SGs and expect them regardless of individual project circumstances. Additionally, SGs can create two tiers of projects, those that benefit and those that do not. The latter may find it more difficult to attract private sector interest and/or financing.

Guidance: To avoid moral hazard, it is fundamental that the design of SGs should leave the private sector with sufficient risk at the margin. Partial guarantees can limit moral hazard. This can be achieved in many ways, such as (i) setting ceilings on Government exposure, (ii) restricting the SG coverage to specific events or specific project phases, (iii) limiting the guarantee coverage to a sub-group of lenders, (iv) requiring the Government claims to rank above those of the lenders or the investors in the event of a default and (v) once an SG is called, requiring Government payments to become loans rather than grants.

## **Implicit liabilities**

Implicit liabilities may arise when the market expects the Government not to allow certain projects to fail and to take on a payment obligation despite the absence of a legal commitment to do so. Although a Government may not have given any undertaking to protect the lenders from insolvency of the PPP company, it may consider the prospect of a project failure unpalatable. Often, the bigger the investment or political profile of the project, the greater the temptation to sacrifice long-run objectives and market reputation for an immediate bailout. Likewise, providing SGs for certain projects may be perceived by the market as a signal that Government would support all PPP projects should they run into difficulties.

Guidance: Governments should avoid incurring implicit liabilities or promoting a guarantee culture. This can best be achieved through clear statements to the market and ensuring that actions are consistent with those statements. Where Governments offer SGs, what is guaranteed and what is not should be made clear. Governments also need to recognise that they may come under pressure from lenders and sponsors to act beyond these boundaries when projects run into trouble. Governments should have a clear strategy for this eventuality. *Ad hoc* policy-making may result in bad precedents<sup>3</sup>.

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<sup>3</sup> The actions of the UK Government in the case of the failure of an important contractor in its PPP schools programme in 2004 could be regarded as a model. The insolvency of Jarvis plc threatened to place a number of PPP projects in default. The UK Treasury made it clear to lenders that no additional Government support would be forthcoming. As a result, funders were forced to deal with the consequences of the failure. The risk transfer worked, and although a number of funders lost money, all schools were ultimately completed and the programme was maintained.

## 3.2 Implementation and Management Issues

SGs raise a series of implementation and management issues which Governments will need to address in the early stages of designing a PPP programme or project.

### **Managing conflicts of interest**

SGs can expose Governments to delicate conflicts of interest throughout the life of the PPP contract. With SGs, Governments may be *de facto* potential creditors of the PPP companies (e.g. by standing behind certain lenders). On the other hand, Governments often are, or control, the PPP contract grantors. The interests a Government may have as a PPP contract grantor may run against its interests as a guarantor to the lenders. For instance, as a PPP contract grantor, the Government may wish to terminate the PPP contract following a major event of default, while, as a guarantor, it will be unwilling to terminate the contract to avoid a call under the SG. The lenders to PPP projects will look very closely at the conflict of interest that arises for the public sector on a given project. They are likely to request a robust governance structure that separates and clarifies the roles of the Government. If this conflict is not properly addressed, the lenders may be unwilling to lend to the project.

Guidance: Conflicts of interest can be complex matters. They should be evaluated case by case as every form of SG will imply specific issues. The interests of lenders and investors and what they are prepared to accept will need to be taken into account when devising an SG structure.

### **Designing the key SG features**

When designing SGs, the Government will need to reflect on a number of fundamental features such as:

- (i) whether the SG should produce its effects before the underlying PPP contract is terminated or once termination has occurred;
- (ii) if calls are made under the SG, whether the Government will want to be a creditor of the PPP company and what level of seniority (*ranking*) the Government will wish to have for its claims compared to those of other lenders or equity investors;
- (iii) which *loss-sharing* mechanism to apply. For partial SGs, the sharing of the financial losses between the Government and the guaranteed parties (e.g. the lenders) can take several forms. For instance, a *pro rata* basis will mean that the Government and the lenders will share losses on an equal footing according to agreed percentages. In a “first loss” SG, the Government will cover 100% of the losses until the maximum guaranteed amount has been exhausted. Lenders will only start incurring losses beyond this amount;
- (iv) if calls are made under the SG, whether the payment obligations of the Government should be on an “accelerated” or an “instalment” basis.

Guidance: Designing the SG features adequately will drive their effectiveness. Regarding (i) above, a Government can use an SG to step into a distressed project before it fails. This would allow the Government to work with the lenders and the equity providers towards a satisfactory outcome for the PPP project. SG instruments that are triggered upon termination of the PPP contract (e.g. debt assumption undertakings) lack this important lever.

As for (ii), it is advisable to structure guarantee payments as loans rather than grants.

Deciding on the *ranking* of the claims and on the *loss-sharing* mechanism in (iii) will depend on the incentives the Government wishes to provide and on the negotiations with the senior lenders.

Finally, the “acceleration” issue raised in (iv) requires careful consideration. Lenders will generally wish to have the option to accelerate the SG, in particular where they are concerned with the credit standing of the Government entity providing the SG. Governments may want to resist acceleration, not least because of the need to raise a large capital sum at the point of termination.

### **Managing financing documentation and inter-creditor issues**

When SGs are set-up to benefit the lenders to a PPP project, they can have a significant impact on the financing documentation and, in particular, the decision-making arrangements of the creditors of the PPP company. Put simply, as a result of its potential financial exposure to the PPP company (i.e. should the SG be called), the Government may face a series of choices when designing an SG, such as:

- (i) whether the Government will want to have a say in the decisions made by the lenders before the SG is actually called, and if so, what sort of say;
- (ii) what level of control the Government will want to have on the lenders' decisions once the SG has been called;
- (iii) whether the Government will want to favour or to constrain the lenders' right to step into a non-performing project;
- (iv) whether the Government will wish to participate in the security package (i.e. the rights over the assets of the PPP company) which the lenders to a PPP company normally have;
- (v) when it guarantees the lenders, the Government should consider the position of the hedging counterparties<sup>4</sup> providing interest rate or exchange rate protection to the PPP company. Hedges are prevalent in PPP transactions and can give rise to significant financial exposures when they need to be unwound.

The Government will therefore often need to be involved in long and intricate negotiations with the private sector.

Guidance: Integrating SGs into the typical *project finance* documentation can be complex. It is important that the Government mobilises competent staff and possibly advisers (e.g. legal and financial) when devising SG instruments and negotiating with the SG beneficiaries and other parties to the PPP contract. Such staff will need to follow clear governance rules and be able to make important decisions in short time frames. The interests of the hedging counterparties should be adequately taken into account as these can lead to serious bankability issues. Finally, when SGs are devised on a scheme basis, their terms and conditions should be sufficiently flexible to allow specific PPP transactions to benefit from them. Devising SG schemes too restrictively will compromise their application to the individual PPP project.

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<sup>4</sup> Typically the financial institutions which provide instruments that insulate the PPP company from the risks of interest rate variations or exchange rate fluctuations.



## **Assessing the set-up and monitoring resources and costs**

Devising, implementing, managing and monitoring SGs will require significant resources and involve costs for the Government. Setting up an SG for a PPP transaction will require experienced negotiators with a deep understanding of *project finance* and negotiation. If this resource cannot be found within the Government, it will need to be secured from the private sector at an additional cost. SGs also need to be monitored during their life-time as they entail risk management and additional responsibilities. For instance, SGs will often require the Government to make important decisions (e.g. calling an event of default on a project, making budgetary allocations that will need to be processed internally). Finally, a call under an SG will imply treasury operations to make and receive payments.

Guidance: Prior to committing to an SG, the Government should ensure that clear governance rules are adopted and that it has the necessary resources and skills to manage the SG and monitor the PPP project during their lifetime. In particular, staff should have a framework for making important and rapid decisions. Appropriate legal and financial advice will also be needed if the SG is called. As noted above, following a call on an SG, the Government may assume additional rights and obligations under the project documentation. It will need to ensure it has sufficient qualified staff and access to advisers to address this matter appropriately.

## **Charging for SGs**

Charging for issuing SGs will be relevant to Governments for several reasons:

- (i) Through SG pricing, the Government (acting as an insurer) can provide financial coverage for the risks it takes on under the SG. If these risks materialise, the Government will have to meet the SG payment obligations and could fund such calls from the fees earned;
- (ii) Pricing will provide incentives for project procuring authorities to consider the costs of SGs and seek other options. For instance, if the Government is to guarantee the obligations of a sub-sovereign entity, the latter should bear this cost. This will incentivise the sub-sovereign to improve its credit standing, internalise its cost within Government, help meet part of the cost of any call on the SG and improve the quality of monitoring;
- (iii) The price charged for an SG will be an important determinant of the *value for money* of the SG. This is principally because the price should cover the fair value of the risks being covered but also because charging can help the Government to cover the administrative costs of implementing and running SGs;
- (iv) Charging for an SG can provide the right incentives to the market. The private sector should be made aware that there is a cost related to a guarantee and be incentivised to require it only when absolutely necessary;
- (v) Charging for the payments made under an SG call can incentivise the PPP company to restructure its financing package to enable the SG to be reimbursed as soon as possible;
- (vi) Charging is required for State aid purposes (see section 3.3 below).

Before issuing SGs, the Government will be faced with a number of key decisions regarding pricing, such as:

- (i) Who to charge: although common sense dictates that the beneficiary of the SG should be paying for it, SGs are likely to be borne by the PPP company and eventually charged back to the public procuring authority;
- (ii) When to charge: charging for a SG can be made upfront (i.e. at financial close), over the life of the SG (i.e. as a risk margin payable on the guaranteed amount), once calls are made under the SG or as a share of the PPP project upside;
- (iii) How much to charge: deciding on the quantum of the SG fee will need to take into account the original motivation for charging and therefore the desire to recover costs, make suitable provision for risks and comply with regulation. It will however be constrained by what the market is prepared to pay for the SG.

Guidance: Charging for SGs is often complex. Pricing for risk according to the expected losses requires specific expertise. Pricing can also have unintended consequences on the behaviour of the parties to the PPP project. Appointing specialised advisers should be considered.

### **Preparing the exit**

SGs are likely to be more efficient in achieving their goals if they are limited in scope and duration. The need for SGs will change over time:

- (i) At SG programme level, a Government may need to provide wide ranging SGs to support a PPP initiative in its early stages. As the initiative matures and uncertainties are reduced, SGs may no longer be necessary or could be confined in scope;
- (ii) At PPP project level, not all the project phases necessarily require Government support. For instance, the LGTT protection set out in Box 2 is limited to the traffic risk in the critical initial operating period of eligible transport projects.

Guidance: SGs should therefore ideally be temporary and reversible. At PPP programme level, the Government should clearly state the features of the SG scheme at the outset in order to guide the market and manage expectations. Ideally, the Government should indicate a start date and an end date for the granting of the SGs and indicate the circumstances under which it envisages that an SG will no longer be necessary. At PPP project level, the SG structures should address the periods of the project cycle that require Government support. SGs should contain provisions for the expiry of the cover once the critical project phase is over. Financial benefit sharing mechanisms can incentivise the PPP company and its lenders to step down an SG when it is no longer needed for the economics of the project.

### 3.3 Budgeting, Accounting and Regulatory Issues

Due to their contingent nature, SGs can have a significant impact on future public finances. The potential fiscal cost associated with SGs means that they should be carefully designed, accounted for and their issuance controlled. SGs will also often be constrained by legal requirements such as national or European regulations.

#### Accounting issues

The contingent nature of SGs makes their valuation and accounting challenging. The public accounting standards in place in a given country drive the way SGs will be accounted for. Where public accounting standards are not well developed, the financial impact of SGs tends to be recorded in the Government accounts only when the contingent obligation materialises (i.e. the SG is called). The principle of “cash accounting” may encourage Governments to ignore the cost of SGs as they generate no immediate expenditure. “Accrual accounting” standards require the immediate recognition of at least some obligations to make payments later. Current international accounting standards require that a contingent obligation be recognised as a liability when the probability that a payment will be made is considered to exceed 50% and when a reasonably reliable estimate of the payment can be made. The most advanced standards require the recognition and the disclosure of the obligations created by SGs.

Guidance: The accounting for SGs should recognise the cost of the risks covered by SGs. This implies in particular an assessment of the probability of the SGs being called at some stage. Governments should have a framework for evaluating such probabilities and specialised advice may be needed for this. Best practice transparency principles suggest full disclosure of SG obligations in public sector accounts.

#### Budget issues

Budgeting procedures are designed for planning and controlling the allocation of public resources for capital investment programmes and operational expenditures, in line with national budget laws. Budgeting procedures do not necessarily replicate accounting rules although they are often influenced by them. In contrast to modern accounting standards, budget procedures can often be cash based and would therefore tend to disregard commitments entered into under SGs.

Guidance: Sound budget rules should be such that Governments examine SG proposals (i.e. exposure to risk) in the same way they consider spending proposals (i.e. cash disbursements). Incorporating the cost of bearing risk into budgets is advisable. If budget rules require governments to take account of the cost of an SG when it is issued, the temptation to use SGs unwisely will be much reduced. Governments should also reflect in their annual budgets the expected cost of meeting calls under their SGs, an allowance for administration costs and a margin to cover uncertainties.

## **Controlling SG exposure**

SGs entail a fiscal risk which should be managed. In particular, sub-sovereign government entities or agencies will often be willing to grant SGs or make use of central government SGs whilst underestimating the potential cost of SGs for central government.

Guidance: A proper decision-making framework for granting SGs should be adopted. Information on SGs should be centralised. The ministries of finance should play an active role in developing and reviewing SG proposals. As the issues involved in evaluating, designing and valuing guarantees are complex, it will often be necessary to appoint financial and legal advisers. Governments should also consider limiting their exposure by setting quantitative ceilings for SG programmes and caps for specific SG instruments. This can be achieved, for instance, by using a fund to manage liabilities arising from SGs.

## **Eurostat statistical treatment of SGs**

Fiscal stability in the EU is preserved under the Maastricht Treaty through the “Excessive Deficit Procedure” of the “Stability and Growth Pact”. Under the European System of Accounts (ESA 95), the general rule is that a Government should report in its national accounts those assets for which it bears most of the risks. As a general statistical principle under ESA95, SGs are considered to be contingent liabilities that are not normally accounted for by Governments unless and until they are called. However, in cases where it is known with certainty or judged that the SG will be called, the debt which is guaranteed by the SG will be considered Government debt<sup>5</sup>.

Guidance: Prior to committing to an SG programme or an individual SG, the Government should assess its statistical classification.

## **Eurostat statistical treatment of a PPP project benefiting from an SG**

Eurostat’s ESA95 Manual on Government Deficit and Debt contains statistical rules for the assessment of the risk distribution in long-term projects between Government and commercial partners (PPPs and concessions)<sup>6</sup>. As SGs alter the distribution of risks in a project, they may influence the statistical classification of PPP assets on a Government balance sheet. In substance, Eurostat considers that SGs covering more than 50% of the capital cost of a given PPP project have a significant impact on the distribution of project risks between the parties to a contract. In such cases the PPP assets should be recorded on the balance sheet of the Government, which means that the project-related debt will be accounted for in full by the Government<sup>7</sup>.

<sup>5</sup> For further information, please see “Manual on Government Deficit and Debt, Implementation of ESA95, 2010 edition” at [http://epp.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-RA-09-017/EN/KS-RA-09-017-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-RA-09-017/EN/KS-RA-09-017-EN.PDF).

<sup>6</sup> For further details, please see “Accounting and Statistical Treatment of Public-Private Partnerships: Purposes, Methodology and Recent Trends”, European PPP Expertise Centre (2010), at: [www.eib.org/eppec/resources/eppec-eurostat-statistical-treatment-of-ppps.pdf](http://www.eib.org/eppec/resources/eppec-eurostat-statistical-treatment-of-ppps.pdf).

<sup>7</sup> It is important to note that if, in addition to SGs, the Government also provides financing to the PPP project, both the tests for majority financing and for SGs must be performed simultaneously. It is thus necessary to establish whether or not the total value of SGs and government financing exceeds 50% of the project’s capital cost.

In Eurostat's view, when classifying PPP assets it is necessary to look at the individual and aggregate impact of SGs in order to test whether these cover more than 50% of the capital cost of the project. Such analysis needs to take into account all types of guarantees provided to the PPP company, such as:

- (i) partial or total loan guarantees;
- (ii) minimum revenue guarantees;
- (iii) minimum demand guarantees.

The aggregate impact of these SGs will determine whether the related PPP assets should be recorded on the Government balance sheet, irrespective of the probability of an SG being called.

The same rule applies where Governments undertake to reimburse all or part of a project's debt service through direct or indirect contractual provisions. For instance, where the PPP contract has an excessively lenient regime of service charge deductions (i.e. the PPP company will *de facto* rarely be liable for deductions as a result of the asset unavailability), Eurostat treats these provisions in the same manner as it treats guarantees.

As far as PPP contract termination provisions are concerned, Eurostat considers that, depending on their features, these may also have an impact on the risk allocation and should be considered when determining the statistical asset classification. Compensation may constitute legitimate reparation for the PPP company but it may also have economic effects similar to SGs where the PPP company (or its lenders) would recoup its investment under all circumstances. This will therefore have an impact on the risk distribution between the parties. Termination provisions which provide that, following a PPP company default, the Government is liable for compensation sums calculated on the basis of the capital or operation costs of the PPP assets (rather than the market value of the assets at termination) imply that most of the project risk is borne by the Government. Therefore, for statistical purposes, these termination provisions should be treated as guarantees. Equally, contractual obligations which provide that, following a PPP company default, the Government is liable for the payment of all or part of the debt outstanding, should be treated as partial (or full) credit guarantees by the Government.

Guidance: Prior to committing an SG to a PPP project, the Government may wish to assess whether the statistical classification of the PPP project asset has not changed as a result of the SG. In the event of doubt, Member State's statistical authorities can seek advice from Eurostat.

### **State aid issues**

State aid is regulated by the Treaty on the Functioning of the European Union ("TFEU") and by other regulations, communications, notices and guidelines adopted by the European Commission. It refers to measures involving a transfer of resources granted (directly or indirectly) by the State to an undertaking engaged in an economic activity and operating in a market in which there is trade between EU Member States. The general principle is laid down in Article 107 of the TFEU. There is State aid when the financial support in question meets all the following conditions:

- (i) it is granted by the State or involves State resources;
- (ii) it favours certain undertakings or the production of certain goods;
- (iii) it distorts competition, and
- (iv) it affects trade between Member States.

EU Member States cannot grant any State aid unless (i) it has been notified to and authorised by the European Commission or (ii) it falls within the application of authorised exemptions.

As far as SGs are concerned, the basic EU law provisions on State aid apply to all guarantees under which a transfer of risk takes place. An SG will not constitute State aid if it does not bring any advantage to a commercial undertaking. The main test applied in this respect is the “market economy investor principle”: an SG is free of aid when the State obtains remuneration equivalent to the premium a market economy operator would charge an equivalent company for an equivalent guarantee. Where an SG does not comply with the “market economy investor principle”, it is deemed to entail State aid. The State aid element will then need to be quantified in order to check whether the aid may be found to be compatible with the internal market rules.

Certain individual SGs and SG schemes may be exempt from notification requirements.

For individual SGs, the European Commission considers that the fulfilment of all the following conditions will be sufficient to rule out the presence of State aid (although failure to comply with them does not mean that the SG is automatically regarded as State aid):

- (i) the borrower is not in financial difficulty;
- (ii) the SG must be linked to a specific financial transaction, for a fixed maximum amount and be limited in time;
- (iii) the SG does not cover more than 80% of the outstanding loan or other financial obligation. Losses and recoveries resulting from performance of the relevant secured obligation have to be shared proportionally between the lender and the guarantor;
- (iv) a market-oriented price is paid for the SG.

For SG schemes, the European Commission considers that the fulfilment of all the following conditions will rule out the presence of State aid (although failure to comply with them does not mean that the SG is automatically regarded as State aid):

- (i) the scheme is closed to borrowers in financial difficulty;
- (ii) the SGs must be linked to specific financial transactions, for a fixed maximum amount and be limited in time;
- (iii) the SGs do not cover more than 80% of each outstanding loan or other financial obligation;
- (iv) the terms of the scheme are based on a realistic assessment of the risk so that the premiums paid by the beneficiaries make it, in all probability, self-financing;
- (v) the level of the fees has to be reviewed/adjusted at least once a year to ensure that the scheme is self-financing;
- (vi) the fees charged have to cover the normal risks associated with granting the SG, the administrative costs of the scheme and a yearly capital remuneration;
- (vii) the scheme must provide for the terms on which future SGs will be granted.

Guidance: State aid requires forethought in the early design stages of individual SGs or SG schemes. This will enable potential issues to be identified and addressed. Specialised advice should be sought in particular on matters related to the compliance of SGs with EU State aid rules and on financial matters to assess the compatibility of SG structures and pricing. Where doubts emerge, it is advisable to consult or notify the European Commission (Directorate-General for Competition).

## 4. Good Practice Checklist

The “good practice checklist” proposed below builds on the findings of this EPEC paper. It is intended to support Governments when considering the use of SGs. The checklist identifies the typical issues Governments should address when evaluating, designing, implementing and managing SGs.

### Initial decision-making

- Establish an appropriate framework for assessing when an individual SG or SG programme may be justified, instead of waiting for a specific PPP project to require one;
- Identify the precise issues that the SG intends to address;
- Establish a framework for evaluating the risks to be covered by the SG;
- Carry out a *value for money* analysis of the proposed SG (advisers may be needed);
- Check that SGs are the right form of Government intervention (for example, by comparing them to investment grants, credit lines, tax breaks, insurance schemes);
- Adopt a decision-making framework for the granting of SGs that will limit political interference;
- Check that the SG does not alter the *value for money* of the PPP solution for the project.

### Setting the rules

- Clearly explain the SG objectives, rules and features to market participants;
- Set the eligibility criteria that the PPP projects must meet to be granted an SG;
- For SG programmes, set the basic terms and conditions for the granting of the SGs but leave enough flexibility to ensure that individual PPP projects can be catered for.

### Designing SGs

- Ensure that the Government team setting up SG programmes or individual SGs has the right skills;
- Involve relevant Government stakeholders at an early stage and ensure they are aware of their roles and responsibilities;
- Ensure that the provider of the SG is a Government entity acceptable to lenders and investors;
- Identify the beneficiaries of the SG and structure the SG to address those beneficiaries only;
- Ensure that the SG is designed to cover only the targeted risks;
- Limit the SG protection to the project phases that require it;
- Ensure that the SG preserves the investors’ incentives to manage the risks they can best manage;
- Limit moral hazard by leaving sufficient risks with the lenders (what is sufficient will need to be assessed on a case by case basis);
- Ensure that the Government’s conflicts of interest are properly managed and acceptable to lenders and investors;
- Ensure that the claims paid out under the SG are reimbursable (this will often create better incentives);
- Share the project upside if any;
- For SG programmes, ensure that there is a proper exit plan.

### Negotiating SGs

- Ensure that skilled resources or advisers are available for negotiating individual SGs;
- Ensure that the Government negotiating team has a framework for making important and rapid decisions;
- Carefully consider inter-creditor issues;
- Carefully address financing issues such as the impact of the specific SG on the lenders step-in rights, the sharing of the security package with the lenders, the *ranking* of the Government claims under the SG compared to lenders' claims;
- Ensure that the needs of the hedging counterparties are taken into account in an appropriate manner.

### Charging for SGs

- Appoint advisers as pricing matters can be complex and affect behaviours;
- Ensure that the SG pricing contains appropriate remuneration for the risk and covers administrative costs;
- Consider who to charge and when to charge;
- Ensure that the SG pricing meets State aid and other regulatory requirements.

### Budgeting and accounting for SGs

- Ensure that SGs are accounted and budgeted for in accordance with modern standards;
- Ensure that the SG obligations are properly disclosed and make this information available to audit bodies;
- Ensure that SGs are controlled centrally and approved by the ministry of finance (in particular for SGs granted by sub-sovereign entities);
- Set overall caps on the risks to which the Government is exposed;
- Assess whether the SG changes the Eurostat classification of the PPP project;
- Check that the SG is consistent with national budget constraints.

### Laws and regulations

- Ensure that the SG complies with existing laws and regulations;
- Check at an early stage whether the individual SGs or the SG programme comply with State aid regulations;
- Make sure that the possibility of an SG is referred to in the PPP project procurement documents.

### Managing SGs once they are in place

- Ensure that skilled resources are available to manage and monitor the SGs and the underlying PPP projects;
- Ensure that the ministry of finance has an active role in monitoring and managing SG programmes;
- Ensure that a team is in place to deal with the commercial and financial issues that will arise once an SG is called;
- Ensure that treasury capacity is available to make and receive payments if the SG is called;
- Evaluate the success of SGs on a regular basis.



## Conclusion

SGs can be used for many purposes. They have proved valuable instruments to address market imperfections that may hold up the delivery of PPP programmes and/or projects. However, they raise many issues and can create perverse incentives. As a result, Governments need to dedicate efforts and resources to evaluating, designing and implementing them, and managing them once they are in place.

This paper stresses that for SGs to help, they need to be tailored to the specific issues and circumstances and their consequences need to be fully understood. Above all, it is worth bearing in mind that an SG has real resource consequences for both the Government and the PPP projects. SGs may have an important role to play in making good projects bankable. They can never make a poor project good.



## Annex: Summary of State Guarantees Among EPEC Members

### Introduction

This Annex provides a brief overview of the use of SGs among EPEC members. It is not intended to be all-encompassing mainly as this area is constantly evolving and as information is difficult to gather.

### 1. France

**Loan guarantees / Refinancing guarantees** – In early 2009 the French authorities established an SG scheme for priority PPP<sup>8</sup> projects as a response to the financial crisis. This was prompted by the high number of very large PPPs<sup>9</sup> in the pipeline, which risked not proceeding without government support.

The French government authorised a EUR 10 billion guarantee facility to be utilised on projects approved by an inter-ministerial committee and which were scheduled to reach financial close prior to the end of 2010<sup>10</sup>. The scheme is managed by MAPPP, the French PPP unit.

The main modalities of the SG scheme are as follows:

- The State provides an unconditional, on-demand guarantee granted to senior lenders in case of a debt service payment default occurring as a result of cash flow shortfalls or early termination of the PPP contract;
- The guarantee covers a portion of the senior debt put in place for the project. The precise amount is decided on a case by case basis but does not exceed 80% of the debt;
- The guaranteed amounts cover the principal outstanding, unpaid interests and associated costs;
- If a guarantee is called, a 6-month standstill period has to be observed after which the State becomes a lender to the project and shares with the other lenders on a *pari passu* basis the rights on cash flows and security;
- The guarantee is priced on a commercial basis in order to incentivise an early refinancing when the lending market recovers and to comply with EU State aid regulations. In practice, the guarantee fee varies between 75 and 150 bps based on the perceived riskiness of the specific project. In the event of a call under the guarantee, the pricing due to the State is increased such as to incentivise a refinancing.

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<sup>8</sup> Whether through “contrats de partenariat” or concessions.

<sup>9</sup> Examples are the EUR 7 billion Tours-Bordeaux high speed line (“LGV SEA”), the EUR 7-8 billion Canal Seine-Nord inland waterways, the EUR 2 billion Tram-Train in La Réunion, the EUR 1 billion Charles de Gaulle Express airport link, the EUR 3.5 billion Bretagne Pays de la Loire high speed line (“LGV BPL”) and the EUR 1 billion new Ministry of Defence building in Balard.

<sup>10</sup> This deadline was subsequently extended for the projects already approved but which had not reached financial close.

An interesting feature of this SG scheme is that it can also be made available to cover the refinancing risk involved with the so-called “hard mini-perms”<sup>11</sup> lending facilities. In substance, the guarantee would be called should the refinancing not prove possible upon expiry of the mini-perm’s legal maturity.

To date, four projects worth over EUR 13 billion have been authorised for a total guaranteed amount of EUR 3.3 billion (i.e. “Tram-Train”, “Charles de Gaulle Express”, “LGV SEA” and “LGV BPL”). Another two are currently under assessment (i.e. the “Balard Ministry of Defence building” and “Ecotaxe” (the lorry road pricing project)). However, no guarantee has been formalised to date<sup>12</sup>.

**Guaranteed minimum service charges** – A regular feature of PPPs in France is the use of the “cession de créances”. More detail is provided in Box 3 of the main document.

**Termination payments** – Most PPP contracts in France provide for floors (often around 85%) and caps (often around 95%) on the share of the debt outstanding which will be covered by the amounts due by the public authority following a PPP company default termination.

**Debt Instrument** – Aside from the SG scheme mentioned above, the French government has adopted another crisis mitigation measure through the setting aside of a EUR 8 billion loan facility funded by saving accounts (“fonds d’épargne”) managed by the Caisse des Dépôts. The facility is aimed at large infrastructure projects and renewable energy investments, including those implemented through PPPs. The loans are granted on advantageous terms (e.g. pricing, maturities) but require a public guarantee of some shape or form. PPP project companies may seek “fonds d’épargne” loans for up to 25% of the senior debt raised.

## 2. United Kingdom

There is no SG scheme as such in the UK. However, bespoke guarantees have been used on individual transactions.

**Debt instrument** – In adopting support measures against the financial crisis, the UK established The Infrastructure Finance Unit (“TIFU”) in HM Treasury in March 2009. This was able to provide loans on commercial terms to PPP projects, alongside commercial lenders and the EIB. TIFU was disbanded in late 2010 having made one loan of GBP 120 million to the Manchester Waste PPP scheme.

**Termination payments** – A conditional debt underpinning was used on the large and complex “M25” road widening PPP project. This reached financial close in May 2009. In this case, the State agreed to guarantee that the sums due by the State to the PPP company upon termination of the PPP contract following PPP company default (only following successful completion) would be at least equal to 60% of the contractually defined senior debt termination compensation amount. This undertaking departs substantially from the standard provisions of road PPP projects in the UK. As a further example, PPP contracts for the maintenance and renewal of the London Underground contained contractual provisions which guaranteed the lenders the recovery of 95% of debt outstanding in the event of contract termination for a default of the PPP company.

<sup>11</sup> A “hard mini perm” is a *project finance* structure where the legal maturity of the loan is set at a shorter term than the project cash flows permit (typically around 7 years), forcing the borrower to refinance the loan before maturity or face default.

<sup>12</sup> The Tram-Train project reached commercial close but was cancelled in early 2010.

### 3. Italy

Formal SGs are generally not available in support of PPP projects in Italy. However, a number of instruments which exhibit some of the characteristics of an SG have been used on individual projects.

**Revenue or usage guarantee** – Revenue support from the public sector has been used on some transport projects where the private sector bore ridership risk, such as the EUR 505 million “Milan Metro Line 5” project which reached financial close in 2007.

**Sub-sovereign creditworthiness guarantees / Residual value payments** – The Cassa Depositi e Prestiti (70% owned by the Italian State) is working on the implementation of a number of guarantee products to be used in support of large infrastructure projects. Under the “Fondo di Garanzia per le Opere Pubbliche” (“FGOP”) the Cassa Depositi e Prestiti could guarantee creditworthiness of the sub-sovereign PPP contract grantors across several sectors (e.g. transport, water & wastewater). This would be particularly used in cases where the grantor is required to make residual value payments upon PPP contract expiry (this is particularly relevant in the road sector).

**Loan guarantees** – SACE SpA, the Italian export credit agency owned by the Italian Ministry of the Economy and Finance, provides loan guarantees for strategic infrastructure projects in Italy, including PPPs. In this respect, SACE very much operates on a commercial basis. It provides “debt service” guarantees to senior lenders (e.g. commercial banks, EIB, other financial institutions) and charges a pricing commensurate with the risks it bears.

### 4. Belgium (Flanders)

**Refinancing guarantee** – To mitigate the impact of the financial crisis, the Flemish government introduced in April 2009 a refinancing guarantee scheme. The scheme is available to projects (i) which have already been tendered or would become ready for tender by April 2011 and (ii) which are undertaken as DBFM contracts with “De Lijn”, the Region-owned company in charge of public transportation in the area.

Under the scheme, the Flemish government guarantees the lenders under certain conditions, such as where: (i) the debt refinancing obligation of the PPP company falls between year 5 and year 10 of the DBFM contract life; and (ii) the PPP company is not able to refinance the debt at prevailing market conditions.

In the event of a call under the guarantee, the Flemish government would repay the senior lenders and would substitute the original loan facility with a new one on identical terms albeit with a 25 bps pricing increase.

As a *quid pro quo* for providing the guarantee, the scheme requires that, if the refinancing is successfully implemented on the banking market, 75% of the financial benefits from the refinancing are passed through to the public sector.

**Loan guarantee / Refinancing guarantee / Sub-sovereign creditworthiness guarantee** – Recently, public sector guarantees have been granted in the context “Flemish PPP schools” project, a significant investment which will potentially include up to 211 schools. The transaction reached financial close in June 2010. The guarantees provided cover trigger events such as default on the senior debt service, failure to refinance and sub-sovereign status events.

## 5. [Germany](#)

**Guaranteed minimum service charges** – Germany makes extensive use of the “forfaitierungsmodell” at the municipal level. More details can be found in Box 3 of the main document.

## 6. [Portugal](#)

**Loan guarantees** – In March 2009, the Portuguese government passed a budgetary amendment allowing it to extend guarantees for up to EUR 6 billion in favour of projects, including PPPs. This covers a wide range of State support mechanisms, including guarantees to publicly owned companies. The most advanced example is the “RAVE 1” project, the first section of the Lisbon-Madrid high speed line. This circa EUR 1.3 billion project includes a EUR 700 million senior debt package, part of which is provided through an EIB loan guaranteed by the Portuguese State.

## 7. [Turkey](#)

The Turkish Treasury has the ability to grant different types of guarantees in favour of PPP projects, including guarantees of:

- payments to be made by a public authority to the PPP project company;
- full and partial payment to the lenders of subordinated loans;
- lenders for the repayment of senior loans in case of an early transfer of the PPP assets back to the public authority.

In practice, the main guarantees used in Turkey to date are as follows:

**Revenue or usage guarantees** – The most widely used PPP model in Turkey is the Build Operate and Transfer. In these PPPs, minimum revenue and traffic guarantee schemes are sometimes used, in particular for toll motorways and airports. For instance, in a toll motorway project, the public granting authority would guarantee revenues from a minimum number of vehicles at an agreed toll level.

**Debt assumption undertakings** – The PPP contracts recently developed in Turkey for infrastructure projects contain a debt assumption mechanism such that upon termination for PPP company default, the company’s rights and obligations under the debt facilities are to be assumed by the State.

## 8. [Spain](#)

**Termination payments** – The Spanish Council of Ministers approved a draft law in November 2009 allowing the State to guarantee commercial bank debt for future PPPs. This would make the concept of “Responsabilidad Patrimonial” (or “State Responsibility”) more explicit and quantifiable in PPP contracts. This concept has been interpreted as meaning that lenders will recover their debt outstanding in the case of termination caused by a PPP company default.

## 9. [Greece](#)

**Sub-sovereign creditworthiness guarantees** – PPP contracts being developed by a range of public entities across Greece (e.g. schools), will include a guarantee from the Greek Ministry of Finance for the sub-sovereign payment obligations.





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