PLANNING COMMISSION

(Secretariat for Infrastructure)

REPORT
OF THE TASK-FORCE
ON
CEILINGS FOR ANNUITY COMMITMENTS

September 22, 2010

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New Delhi, September 22, 2010

Report of the Task Force on Ceilings for Annuity Commitments

Background

1.1 An Inter-Ministerial Task Force was constituted under the chairmanship of Member (B. K. Chaturvedi), Planning Commission for recommending budgetary ceilings for annuity commitments under PPP projects. The constitution of the Task Force was as follows:

(i) Member (B.K. Chaturvedi), Planning Commission - Chairman

(ii) Secretary, Department of Economic Affairs;

(iii) Secretary, Department of Expenditure;

(iv) Chief Economic Adviser, Ministry of Finance;

(v) Secretary, Ministry of Home Affairs;

(vi) Secretary, Ministry of Road Transport & Highways,

(vii) Secretary, Department of School Education & Literacy,

(viii) Secretary, Department of Urban Development;

(ix) Secretary, Department of Health & Family Welfare;

(x) Secretary, Ministry of Shipping; and

(xi) Adviser to Deputy Chairman, Planning Commission.

1.2 The first meeting of the Task Force was held on May 12, 2010. After discussion on the broad principles and parameters, the Task Force constituted a sub-group under the chairmanship of Adviser to Deputy Chairman, Planning Commission, with representatives from Department of Expenditure, Department of Economic Affairs, Ministry of Home Affairs and an official with experience of having worked with the Finance Commission, to examine the issues in detail and submit their recommendations. The Sub-group held its meetings on June 22, June 30 and August 10, 2010, and submitted its Report for consideration of the Task Force. The Report of the Sub-Group was discussed in a meeting of the Task Force held on September 22, 2010 when this Report was finalised.

1.3 The Task Force noted that fiscal prudence requires a ceiling to be established on the extent of annuity commitments under PPP projects as they pre-empt the annual budgets of future years. It was, therefore, necessary to lay down the principles for fixing such a ceiling. It was also necessary to decide the apportioning of annuity payments between Plan and Non-Plan outlays. A view also needs to be taken as to how annuity expenditure would be met out of the budget of the respective departments which have a large Non-Plan outlay but a comparatively small Plan allocation. Further, the specifications and standards to be adopted and the process of approval of annuity-based projects needs to be laid down. This may include the adoption of appraisal techniques such as ‘Value for Money’ (VFM) analysis and ‘Public Sector Comparator’ which have been extensively used in the UK where a large number of annuity projects have been undertaken across sectors.

2. Annuity based PPPs

2.1 Public - Private Partnership (PPP) concessions can either be sustained by user charges to be collected by the concessionaire or through annuity payments to be made by the government. Annuity payments are typically borne by the government out of the annual budgetary allocations spread over time and are essentially in the nature of deferred budgetary payments.

2.2 Annuity or unitary charge refers to the periodic payment received by the concessionaire for financing, construction, operation and maintenance of the project. Private Finance Initiative (PFI) of the UK has extensively used the annuity mode for building schools, hospitals and accommodation, which are designed, built, financed and managed by private sector entities, under contracts that typically last for 30 years. Some annuity based PPPs for highway projects have also been undertaken in the UK where roads are not tolled.

2.3 Annuity contracts can be structured in different ways. The most commonly used structure is Design, Build, Finance and Operate (DBFO) model under which the private sector takes on the responsibility for provision of a facility on a long-term basis in conformity with the given output specifications. The private entity is paid regularly from public funds, based on its performance throughout the contract period. If the private service provider misses performance targets, its payment is reduced.

2.4 Annuity payments create a burden on future budgets for a long period of time. One possibility is to treat all annuity pay-outs as plan expenditure since new infrastructure is being created. However, proliferation of BOT (Annuity) projects and the consequent long-term committed liabilities, spread over multiple Plan periods, would mean that the resources available for future plan programmes would shrink and may even turn out to be zero or negative. This would, in effect, constrain future Plan programmes and foreclose new initiatives that may be necessary over time, as funds would already have been committed to the annuity projects awarded in earlier years. Its effect would be akin to raising excessive borrowings that would commit a bulk of future revenues for debt service, leaving inadequate resources for development. It is in this context that prescribing a suitable cap for annuity commitments becomes important.

2.5 It would be seen that annuity-based projects are similar in nature to public sector contracts so far as government funding is concerned. Although these projects transfer certain risks to the concessionaires, such as the construction and maintenance risks, yet the annuity payments are assured through the government budget. In the case of concessions based on user charges, the demand risk is transferred to the concessionaires, thereby exposing them to considerable commercial risk in recovering their capital. While concessions based on user charges lead to mobilisation of additional resources, annuity concessions imply deferred government payments akin to borrowings and do not normally lead to mobilisation of additional resources.

3. International perspective

3.1 The International Monetary Fund has noted in the context of the UK PPP programme that the "off-balance sheet" status of PPPs introduces an "unwarranted bias in their favour", providing a superficial relaxation of budgetary constraints because investment through PPP has exactly the same revenue effect as conventional capital spending or direct borrowing. This public sector cost that PPP gives rise to can only be met through a redirection of revenue from other parts of the public sector, increased taxation or, for sectors like roads and water, higher user charges. The budgetary advantage of PPP - that while direct borrowing counts against the capital budget, borrowing through a PPP intermediary does not – is the consequence of financial reporting structures developed by the Treasury, and does not reflect any economic difference between alternative forms of financing.

3.2 Across Europe, finance ministries are interested in PPP because of its ability to deliver investment, the upfront costs of which do not count against measures of public sector debt. All EU member states are subject to fiscal constraints under the Maastricht Treaty, which restricts 'gross government debt' to 60 per cent of national Gross Domestic Product (GDP). In the UK, the fiscal rules are less flexible. Since 1998, the Labour government's 'sustainable investment rule' has imposed a ceiling of 40 per cent on the ratio of 'public sector net debt' (PSND) to GDP, which is consistent with a much lower debt-to-GDP ratio than that specified in the EU Stability and Growth Pact. As long as privately financed investment is recorded off the public sector's balance sheet, it does not count towards PSND.

3.3 The UK budgeting process follows a golden fiscal rule: "over the economic cycle, the Government will borrow only to invest and not to fund current spending". Further, the Sustainable Investment Rule states that the public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things equal, net debt will be maintained below 40 per cent of GDP over the economic cycle." This has been restated in each budget/ pre-budget report since the Code of Fiscal Stability in 1998. The rationale behind such rules is to promote fairness between generations, that is, the bill for today's current spending, which mainly benefits today's taxpayers, will not be passed on to future generations.

3.4 In the UK, over 85 per cent of public investment is still carried out through conventional terms of procurement. PFI remains a limited proportion of government investment within any particular sector. In no case does PFI represent more than around a quarter of the public investment being undertaken in a sector. They also have individual Departmental Spending Limits for each department ranging from 6 to 7 per cent of their total annual spending. Brazil's currently enacted PPP law prohibits undertaking new PPPs if the projected stream of payments under the programme exceeds 1 per cent of government revenue in any future year. In Korea, the PPP investment is 10-15 per cent of total public investment. In Greece, the current payments of approved PPP projects account for 6-7 per cent of its Public Investments Program and are expected to reach 10-12 per cent in 5 years, and ultimately capped at a limit of 15 per cent.

4. Potential for Annuity based PPPs in India

4.1 In the UK, GBP 69.24 billion (Rs. 5.12 lakh crore) have been invested through annuity-based PPP in 902 projects, of which 696 projects are operational. In India, however, annuity projects have so far been implemented only in the national highway sector.

4.2 The Ministry of Road Transport and Highways (MoRTH) has undertaken 30 PPP (Annuity) projects through NHAI for a capital cost of Rs.14,986 cr. MoRTH has also adopted the annuity mode for projects in the North-East and J&K where toll revenues would be far too low to sustain the construction and O&M costs.

4.3 PPPs based on annuity or unitary charge can be extensively undertaken for construction and maintenance of infrastructure and related services in the social sectors where user charges cannot be recovered for sustaining the investments. Such PPP projects could include government accommodation, education (school and higher), hospitals, jails, etc where the annuity payments/unitary charge are not linked to user charges. The Ministry of HRD has already proposed establishment of 2,500 model schools under the PPP mode. Several initiatives in different sectors have also been initiated by the respective State Governments.

5. Budgetary implications of Annuity projects

5.1 As distinct from an annuity based project, a PPP project which is sustained by user charges does not normally impose a recurring burden on the budgetary resources. Hence, PPP projects based on user charges imply an additionality of resources. By comparison, an annuity-based project does not have a revenue stream of its own and must essentially rely on payments out of budgetary allocations over the years. The mere fact that these commitments can be made 'off-budget' for the present should not lead to excessive annuity commitments that would pre-empt future budgetary resources.

5.2 Annuity based projects require well-considered decisions about long-term service delivery requirements. The financial commitments entered into for the life of the contract not only include the cost of physical assets, but also of a guaranteed service to specified performance levels. The annuity payments would, therefore, have to cover the cost of capital as well as the cost of operation and maintenance of the project. Under a conventionally procured project too, the public sector would have to bear similar costs in the form of budgetary expenditure on a year to year basis. In the past, capital has often been invested through conventional contracts without a clear commitment to adequate future spending on maintenance, leading to poorly maintained assets, inefficient service provision and premature replacement. In contrast, PPPs invest in the future because they ensure that assets are maintained properly, but this may tend to increase the total cost to the exchequer. On balance, the annuity approach offers some advantages as compared to the conventional mode of procurement.

5.3 In the case of annuity based PPP projects, the annuity commitments would create a burden on the future budgets over a long period of time as compared to conventional contracts where the capital costs have to be budgeted upfront. As a result of annuity commitments, the budgets for several years would become inflexible to the extent of these commitments. It is, therefore, important to determine the extent to which the future budgetary options should be restricted due to liabilities undertaken for the present.

6. Impact on fiscal deficit

6.1 Government of India has consistently followed a path of fiscal prudence which includes reduction in fiscal deficit as well as in the proportion of borrowings to GDP. As at present, the total public debt as a proportion of GDP is 51.1 per cent. For 2009-10, the debt servicing burden of the Central Government, as a percentage of the total expenditure in the annual budget, has been estimated at 34.8 percent. Further, interest payments constitute about 30 per cent of the revenue receipts of the Central Government. This is a fairly high debt burden, by any standards.

6.2 The 12th Finance Commission had recommended that the Centre's interest payments relative to revenue receipts should reach about 28 per cent by 2009-10. In the case of States, the level of interest payments relative to revenue receipts should fall to about 15 per cent by 2009-10. In actual terms, the Centre's interest payment relative to the revenue receipts (as per RE of 2009-10) are 29.81 per cent. The 13th Finance Commission has projected that with the augmentation of revenue receipts fuelled by growth, the interest component will in effect come down to 20 per cent of the total revenue receipts by 2014-15.

6.3 In such a scenario, the proliferation of annuity based contracts would tend to neutralise the improved fiscal balance on account of reduction in debt service liability and add further to the budgetary liability of Government of India. It is, therefore, necessary to prescribe a safeguard ceiling for annuity based PPP projects of each Department so as to restrict the fiscal commitment of the government to a sustainable level for maintaining fiscal stability while at the same time enabling the departments to take up a reasonable programme through annuity-based PPP projects.

7. Possible options for fixing ceilings

7.1 For striking a balance between fiscal stability on the one hand and the need for accelerating development through the PPP (annuity) projects on the other hand, the following departmental caps, individually and collectively, could be considered while approving an annuity project.

(a) The sum of total annuity commitments for a particular grant or scheme of the Department for the next five years should not exceed 25 per cent of the current Five Year Plan outlay for such grant or scheme of the Department. For example, if the allocation for a particular scheme of a Department under the current Five Year Plan is Rs. 20,000 crore, its committed annuity payments for the next five years should not exceed Rs. 5,000 crore. This would ensure that enough resources are available for future programmes.

(b) Assuming that the annual plan outlay of a Department would increase at a CAGR of 10 per cent, the annuity commitments that may be made in any one year should not lead to outflows of more than 20 per cent of the projected Annual Plan outlays for the respective grant or scheme in any subsequent year. For example, if the projected annual plan outlay in the third year from the current year is Rs. 10,000 crore, the maximum annuity commitments from all projects awarded during and before the current year should not exceed Rs. 2,000 crore per annum in the said third year. This discipline would ensure a gradual roll-out of PPP projects within prudent financial limits.

(c) In any given year, the annuity projects awarded should not involve a total capital expenditure exceeding the total Plan outlay of that grant or scheme for that year. For example, if the Annual Plan allocation for any grant or scheme of a department is Rs. 10,000 crore, then the annuity projects awarded in that year under such grant or scheme should not involve a total capital investment of Rs. 10,000 crore. This would help avoid excessive bunching in the award of projects.

(d) For revenue projects such as in health, education etc., the revenue expenditure during the current Five Year Plan and for the following Five Year Plan period should be treated as Plan expenditure and should also be governed by the above ceilings.

(e) Some of Ministries/Departments, such as the Ministry of Home Affairs have a comparatively smaller Plan budget accompanied by a large Non-Plan budget. In such cases, it may be useful to look at the total budget (both Plan and Non-Plan) of a Department prior to fixing a limit for annuity projects under Plan and Non-Plan outlays. In the case of Non-Plan expenditure such as on modernisation of police, housing for police, accommodation for judiciary, jails, etc., the ceiling of annuity commitments may be fixed at 5 per cent of their annual Non-Plan budget or such lower proportion as the Department of Expenditure may determine from time to time.

(f) There may be schemes that acquire urgency during the course of a Five Year Plan and may require enhanced outlays in the current and subsequent Five Year Plans. In such cases, the aforesaid ceilings may have to be suitably increased. A Department seeking such enhanced ceilings may, in consultation with the Finance Ministry and the Planning Commission, submit its proposals for consideration of the Cabinet.

8. Plan and Non-Plan expenditure

8.1 Another issue which needs to be resolved is the charging of annuity payments to Plan and Non-Plan outlays. While the expenditure incurred on cash construction contracts is typically charged as Plan expenditure, annual maintenance payments over the years are normally booked as Non-Plan expenditure. Interest payments on borrowings used for funding such Plan expenditure are also typically booked as Non-Plan expenditure.

8.2 Annuity payments would normally include the cost of capital as well as the expenditure needed to operate and maintain the assets and to provide related services. In some cases, services may include catering, computer labs etc. In a typical PFI hospital in the UK, payments for services make up between 40 and 50 per cent of the unitary charge. For a typical PFI school project in UK, around 30 per cent of the unitary charge goes towards caretaking, maintenance and other services. If a project is built using conventional procurement, these future costs for services are not normally accounted for, monitored or disclosed, and they get added to the future budgets as and when required.

8.3 In the case of annuity projects in Europe, the entire budgetary allocation for such projects is provided by their respective Finance Ministries as they do not have any distinction between Plan and Non-Plan expenditure. However, this issue assumes significance in India because treating the entire annuity commitment as either Plan or Non-Plan would alter the present principles that determine this categorisation. On the one hand, the Department of Expenditure would typically wish to reduce the Non-Plan expenditure in order to contain the fiscal deficit in future years, categorising all annuity payments over a 15-20 year period would mean that several expenditures that would have normally moved over to the Non-Plan side would continue to be funded out of the Plan budget, thus reducing the room for taking up new projects in future.

8.4 By way of illustration, if the annuity payments for roads or hospitals are to be made entirely out of their respective Plan allocations for the entire concession period, the ability of the respective Departments to take up new projects in subsequent Five Year Plans would be correspondingly reduced or may even reach a negligible level whereas under the present arrangement, Plan projects taken up during a particular Five Year Plan typically shift to the Non-Plan side during subsequent Plan periods, thus vacating space in the Plan outlays for taking up fresh initiatives.

8.5 In case the entire annuity expenditure is booked on the Plan side, a Department that takes a long-term view would not opt for annuity projects as they would unduly reduce its Plan allocations in future years because interest payments and maintenance costs would also get included in the annuity payments spread over the concession period. On the other hand, a Department taking a short-term view may actually take on large annuity commitments leaving little room for new projects in future while hoping that its successors would alter the balance of allocations and manage to usurp some allocations from other Departments in order to take up new projects. Either of the two approaches would be sub-optimal and may arise primarily because of the attempt to book all annuity payments as Plan expenditure.

8.6 A rational approach would seem to suggest that the allocation of annuity payments to Plan or Non-Plan expenditure should not be used as an occasion to alter the present balance as that would raise larger questions beyond the scope of the present exercise. The Task Force, therefore, took the view that an effort should be made to maintain the existing rationale which allows Plan expenditures to be shifted to Non-Plan in due course. If this is not done, the future Plan allocations of individual Departments would be crowded out by past annuity commitments, thus restricting their ability to take up new schemes.

8.7 One option could be that the annuity payments for a specified period, say five years, are charged to Plan expenditure. Another option could be to quantify the total capital cost of a project and treat the annuity payments equivalent to such cost as Plan expenditure. This would include financing costs such as interest during construction (IDC) and price contingencies, which are otherwise funded out of non-Plan allocations. The balance annuity payments could be made from Non-Plan allocations. For the revenue expenditure component of annuity payments, all payments during the current Five Year Plan could be treated as Plan expenditure and thereafter booked as Non-Plan expenditure.

8.8 After considering all relevant factors, the Task Force recommends that all expenditure on annuity payments for the first ten years may be booked as Plan expenditure and thereafter shifted to the Non-Plan side. To give effect to this broad principle, projects that commence during the first three years of a Five Year Plan will be booked under the Plan head during the current Plan period and the subsequent Plan period. In effect, this would mean that such projects would be booked under Plan expenditure for 7 to 10 years depending on their year of commencement. Projects commencing in the last two years of the Plan period should be treated as Plan projects during the current Plan period and two subsequent Plan periods. In effect, such projects would be booked under Plan for 11 to 12 years.

9. Norms for approval of Annuity projects

9.1 As brought out above, PPP projects undertaken in the annuity mode are in the nature of deferred government spending. The entire funding for such projects is to be met out of government's budget although on a deferred basis. Hence, the total cost of such projects and the budgetary allocations for the same would need a scrutiny similar to the conventional projects so far as government expenditure is concerned.

9.2 In the UK, annuity based PPP projects have primarily been viewed as an alternative mode of procurement in substitution of the conventional contracts. The justification is that the conventional contracts do not capture the private sector efficiencies and life cycle costs of a project. As a result, they cause greater financial burden on the exchequer as compared to long-term annuity contacts. However, before the PPP mode is adopted, a careful evaluation is undertaken to establish that the government is likely to get the value for its money. This is normally described as a Value for Money (VfM) analysis. In addition, the government also applies a Public Sector Comparator to establish that the cost to the exchequer would be lower in the case of PPP-based procurement as compared to the conventional mode of procurement. Considering the practice followed in the UK, where the annuity approach has evolved over time, it should be evident that adoption of the annuity mode in respect of any project would be justified only if it saves public money. However, no such analysis is presently being done in India before approval or award of the annuity based projects.

9.3 A quick analysis of 12 projects (list at Annex-I) undertaken in the road sector during the last one year indicates that the annual annuity payments would be about 24 per cent of the Total Project Cost (TPC). In these projects, the TPC also includes interest during construction, contingencies etc. which are usually assumed as 25 per cent of the construction costs. If these are excluded, the construction cost will be 80 per cent of the TPC. In effect, what is being built under these annuity projects would have required a budgetary allocation equal to 80 per cent of the TPC had the conventional mode been adopted. Under the annuity mode, however, about 96 per cent of the TPC of these road projects would have to be paid out of budgetary allocations in the first four years after completion of construction. Though this comparison has to be adjusted for some relevant factors, the basic point which emerges is that the budgetary payout in the first four years after construction will be almost equal to the TPC and for the remaining about 10-14 years, the government would still continue to bear an annual outgo of 24 per cent of the TPC. This is evidently a high cost to bear.

9.4 This issue is not confined to highway projects alone. In case of the residential projects being undertaken by Ministry of Home Affairs for Central Para Military Forces, the cost of construction of 5 clusters is expected to be Rs. 2,488 crore and the annual annuity commitment as projected by the consultants is Rs. 600 crore or 24.1 per cent of construction cost.

9.5 As against the above examples of high levels of annuity commitments, in recently bid out transmission project in Haryana, the annuity payment is Rs. 54 crore against a TPC of Rs. 287.5 crore. This would reduce by 3 per cent p.a. over the concession period. At the stage of award, the annuity commitment constitutes about 18 per cent of the TPC, but the average over a 25 year concession period would be less than 16 per cent.

9.6 A close scrutiny of the aforesaid annuity payments in different sectors seems necessary to arrive at some broad conclusions relating to the cost that may be acceptable to the government for procurement through the annuity mode. By way of a simple illustration, if a housing loan is borrowed with a repayment period of 15 years, the annual outgo would be about 12 per cent of the borrowed amount. However, the annuities being paid by the government in the case of road projects are, on an average, about 24 per cent of TPC (refer para 9.4 above). These annuity payouts also include the maintenance costs and concessionaire's profit. The gap between the annuity payments for the road projects and the annual repayment for a housing loan appears to be 12 per cent and the question that arises is whether this gap of 12 per cent per annum for a period of 15 years is a justified financial burden that the government should agree to bear against the likely maintenance costs and the concessionaire's profits. It is also relevant to note here that annuity projects do not carry much financing or commercial risk and as a result, the risk premium should be quite low. *Prima facie,* therefore, this does not seem to represent value for money.

9.7 It would, therefore, be in public interest if projects are taken up through the annuity mode only after it is established through the VfM analysis in each case that the annuity mode of delivery will yield a more efficient and cost-effective outcome. In addition to the VfM analysis, the Public Sector Comparator should also be applied as a tool for evaluating whether the annuity mode of procurement would be more advantageous as compared to the conventional mode. In making these comparisons, the Net Present Value (NPV) should be worked out using a suitable discount rate to be fixed with due regard to the cost of borrowings by the Government.

9.8 It is possible that owing to the prevalent risk perception, high interest rates, return requirements or the project structure, the costs of an annuity project do not represent value for money from the government's perspective. In such a situation, the conventional contracts based on 'item rates' need not necessarily be viewed as the only alternative. An effort should be made to explore the possibilities of an EPC contract based on the turnkey or lump sum approach. Such EPC contracts can capture most of the advantages of an annuity project and yet provide a comparatively economic option compared to a high-cost annuity project.

10. Standards and Specifications

10.1 The deferment of payment liability should not lead the project authorities to view the annuity mode as a means of procuring higher standards compared to those prevailing under the conventional mode. Any move that leads to more expensive specifications and standards would only add to future budgetary commitments. As such, there should be a clear mandate that the annuity mode would rely on the same standards as are applicable to the conventional mode. Deviations, if any, should be clearly justified and adopted with approval of the competent authority after assessing their cost implications.

11. Disclosure of annuity contracts

11.1 The nature of liabilities created by annuity payments is similar to that of borrowings, as both require repayments spread over a long period (10-15 years or even longer). Hence, it is imperative that the treatment accorded to annuities in fiscal management should be similar to that accorded to borrowings. As such, annuity commitments, like borrowings, should be subject to hard budgetary constraints.

11.2 In the UK, since PFI transactions lead to long-term commitments on annuity payments which will have an impact on future spending plans, the Government has taken steps to ensure that Parliament is fully informed of the extent of the estimated commitments. This information is laid before the Parliament at least twice a year. The Treasury Task Force has issued guidance, in consultation with the National Audit Organisation, on the arrangements for the reporting of information on PFI projects to the Parliament.

11.3 The Government of UK publishes its estimates of the unitary charge payments – single annual payments made by the procuring authority to the private sector which cover all the costs, both capital and service, of PFI projects – to be made under all signed PFI contracts in the Financial Statement and budget Report. These payments represent the full price of the specified facility being made available and cover all costs over the life of the contract. These Departmental commitments of future revenue are monitored by Government, included in consideration of future budgets and therefore, taken into account by Departments in deciding how much of PFI investment to undertake. In addition to the provision of general information on future commitments, the guidance sets out the need for procuring authorities to inform Parliament of projects where contracts contain clauses which depart from those set out in the Standardisation of PFI contracts, in addition to those which give rise to reportable contingent liabilities.

11.4 The 13th Finance Commission has also deliberated on this issue in its Report. The relevant extracts of the Report of the 13th Finance Commission (Chapter 9) are reproduced below.

> *It is important that contingent liabilities be reported fully and that adequate provisioning be made for such liabilities. We have recommended modification of the fiscal rule that limits government guarantees. The public sector as a whole is vastly enhancing its use of the Public Private Partnership (PPP) mode for project financing. This frees valuable fiscal space for the provision of public goods in areas where such finance is unlikely to be forthcoming.*
>
> *We welcome this trend of private participation in the public sector. We also recognize that PPPs create explicit and implicit obligations on the part of the public entity that is party to them so that, in the final instance, they become contingent liabilities of the Government of India. The fiscal fallout of such partnerships could reflect on the health of the aggregate balance sheet of the public sector and may create demands for enhanced budgetary support to the public sector entities contracting such liabilities. Explicit contingent liabilities, which may be in the form of stipulated annuity payments over a multi-year horizon, should be spelt out. Implicit contingent liabilities in this context are obligations to compensate the private sector partners for contingencies such as changes in specifications, breach of obligations and/or early contract termination for force majeure. These are relatively difficult to quantify. We think that the FRBM Act should stipulate these contingent liabilities.*

11.5 In view of the above, it is proposed that the actual annuity commitments that are entered into by a Ministry/ Department should be compiled by the Budget Division of Finance Ministry annually and the statement of annuity commitments may be depicted transparently in the budget documents. Any preferential financing provided through government on-lending or via public financial institutions should also be disclosed. Further, any project financing or off-balance sheet project support provided by entities owned or controlled by government which may give rise to contingent liabilities should also be stated. Further, a separate object head for ease of accounting of annuity pay-outs should also be created.

12. Recommendations

12.1 In the interests of efficiency and accelerated development, it seems necessary to encourage annuity based projects, especially in the social sectors where user charges cannot sustain these investments. However, such projects should be undertaken only if they satisfy the following criteria.

12.2 A study of annuity projects should be undertaken based on current data of NHAI and other sectors to assess its success in comparison with other countries and to assess our inability to get good offers.

12.3 *Value for Money (VfM):*

Each project should be subjected to a VfM analysis to establish that the likely annuity payments are justified and offer value for money. The methodology for VfM analysis should be fair and transparent. A Public Sector Comparator should also be applied to establish and ensure that the cost of a PPP project to the exchequer is lower than the cost under a conventional contract, duly adjusted for the cost of capital and O&M expenses.

12.4 EPC/ Turn-key contracts:

It is possible that owing to the prevalent risk perception, high interest rates, return requirements or the project structure, the costs of an annuity project do not represent value for money from the government's perspective. In such a situation, the conventional contracts based on 'item rates' need not necessarily be viewed as the only alternative. An effort should be made to explore the possibilities of an EPC contract based on the turnkey or lump sum approach. Such EPC contracts can capture most of the advantages of an annuity project and yet provide a comparatively economic option compared to a high-cost annuity project.

12.5 Ceiling on annuity commitments

Commitments for annuity payment by each Department may be made subject to the following ceilings to be applied individually and collectively to all annuity projects:

(a) The sum of total annuity commitments for a particular grant or scheme of the Department for the next five years should not exceed 25 per cent of the current Five Year Plan outlay of such grant or scheme of the Department. For example, if the allocation for a particular scheme of a Department under the current Five Year Plan is Rs. 20,000 crore, its committed annuity payments for the next five years should not exceed Rs. 5,000 crore. This would ensure that enough resources are available for future programmes.

(b) Assuming that the annual plan outlay of a Department would increase at a CAGR of 10 per cent, the annuity commitments that may be made in any one year should not lead to outflows of more than 20 per cent of the projected Annual Plan outlays for the respective grant or scheme in any subsequent year. For example, if the projected annual plan outlay in the third year from the current year is Rs. 10,000 crore, the maximum annuity commitments from all projects awarded during and before the current year should not exceed Rs. 2,000 crore per annum in the said third year. This discipline would ensure a gradual roll-out of PPP projects within prudent financial limits.

(c) In any given year, the annuity projects awarded should not involve a total capital expenditure exceeding the total Plan outlay of that grant or scheme for that year. For example, if the Annual Plan allocation for any grant or scheme of a department is Rs. 10,000 crore, then the annuity projects awarded in that year under such grant or scheme should not involve a total capital investment of Rs. 10,000 crore. This would help avoid excessive bunching in the award of projects.

(d) For revenue projects such as in health, education etc., the revenue expenditure during the current Five Year Plan and for the following Five Year Plan period should be treated as Plan expenditure and should also be governed by the above ceilings.

(e) Some of Ministries/Departments, such as the Ministry of Home Affairs have a comparatively smaller Plan budget accompanied by a large Non-Plan budget. In such cases, it may be useful to look at the total budget (both Plan and Non-Plan) of a Department prior to fixing a limit for annuity projects under Plan and Non-Plan outlays. In the case of Non-Plan expenditure such as on modernisation of police, housing for police, accommodation for judiciary, jails, etc., the ceiling of annuity commitments may be fixed at 5 per cent of their annual Non-Plan budget or such lower proportion as the Department of Expenditure may determine from time to time.

(f) There may be schemes that acquire urgency during the course of a Five Year Plan and may require enhanced outlays in the current and subsequent Five Year Plans. In such cases, the aforesaid ceilings may have to be suitably increased. A Department seeking such enhanced ceilings may, in consultation with the Finance Ministry and the Planning Commission, submit its proposals for consideration of the Cabinet.

(g) Any project which has been approved upto October 2010 will not be reviewed on the ground that it exceeds the above ceilings.

12.6 Plan and Non-Plan outlays

All expenditure on annuity payments for the first ten years may be booked as Plan expenditure and, thereafter, shifted to the Non-Plan side. To give effect to this broad principle, projects that commence during the first three years of a Five Year Plan will be booked under the Plan head during the current Plan period and the subsequent Plan period. In effect, this would mean that such projects would be booked under Plan expenditure for 7 to 10 years depending on their year of commencement. Projects commencing in the last two years of the Plan period should be treated as Plan projects during the current Plan period and two subsequent Plan periods. In effect, such projects would be booked under Plan for 11 to 12 years.

12.7 *Standards and Specifications*

The standards and specifications to be adopted for annuity projects should be similar to those followed for similar conventional contracts. The deferment of payment liability should not lead to more expensive specifications and standards as that would only add to budgetary commitments.

12.8 *Disclosure of annuity commitments*

The actual annuity commitments entered into by all the Departments may be compiled by the Budget Division of Finance Ministry annually and the statement of annuity commitments may be depicted transparently in the budget documents. This would conform to the recommendations of the 13th Finance Commission. Creating an object head for ease of accounting of annuity pay-outs may also be considered.

12.9 *Treatment of annuity commitments as debt*

Annuity projects imply a committed liability for annual payments over the concession period. These are akin to debt service or charged expenditure because annuity payments are a form of deferred budgetary liability. As in the case of debt, the Finance Ministry would review the annuity commitments from time to time and lay down further ceilings as may be necessary in the interest of prudent fiscal management.

Annex-1

List of Annuity Projects awarded since Mar-2009						
Sl.No	**Name of the Project**	**Length (in km)**	**EIRR (%)**	**Annual Annuity Commitment (Rs cr)**	**TPC (Rs cr)**	**Annuity as % of TPC**
1	Jammu - Udhampur	65	23.2	403	1,814	22.22
2	Quazigund-Banihal	15	22.37	490	1,987	24.66
3	Patna- Muzzaffarpur	60	28.38	189	672	28.13
4	Haridwar - Dehradun	39	20	106	478	22.18
5	Hazaribagh-Ranchi	75	18.31	128	625	20.48
6	Chhapra-Hazipur	65	16.84	131	575	22.78
7	Forbesganj-Jogbani	9	16.4	14	74	18.92
8	Jorbat – Shillong	62	22.54	145	536	27.05
9	Chenani to Nashri	12	22.66	635	2,519	25.21
10	Mokama- Munger	69	20.85	80	351	22.79
11	Nagpur-Betul	174	17.98	582	2,499	23.29
12	Muzaffarpur-Sonbarsa	86	15.27	105	512	20.51
13	Srinagar-Banihal Section	67	20.62	270	1434	18.83
Total				**3,278.00**	**14,076.00**	**23.29**