Research on the Application of PPP in Preventing and Resolving Local Debt Risk in China

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Abstract. By the end of 2018, China's local government debt balance was 1.83862 trillion Yuan, and the local government debt ratio was 76.6%. If the hidden local debts is taken into account, the debt ratio of local governments in China will be higher, which may approach or reach the internationally accepted warning standard. The increase of local debt will lead to increase the risk of local financial, economic, credit, social and politics. Therefore, it is necessary to focus on the prevention of local debt risk. PPP mode itself will generate local debts, but PPP mode is one of the effective ways to prevent and dissolve local debts. It can prevent and defuse local debts by absorbing social capital to invest, invigorating existing infrastructure assets with PPP mode, transforming local financing platform with PPP mode and securitization of PPP project assets. However, there are still some problems in the application of PPP model in preventing and resolving local debts in China. It is necessary to reasonably design the risk sharing and prevention and control mechanism of PPP, further standardize the operation and management of PPP, promote the transformation of local financing platform companies with PPP model as far as possible, and actively promote the asset securitization of conditional PPP projects.

1. Introduction

At present, China faces three major problems: preventing and resolving major risks, accurately lifting people out of poverty, and preventing and controlling pollution. One of the major risks is local debt. PPP is one of the effective methods to prevent and resolve local debt, which has important theoretical and practical significance.

2. The Connotation of PPP

PPP is the acronym of Public-Private-Partnership. It is refers to between the government and Private organizations, in order to provide some Public goods and services, on the basis of the franchise agreement, between each other to form a Partnership of cooperation relations, and signed a contract to clear the rights and obligations of both sides, to ensure the cooperation successfully completed, eventually make all parties achieve the most favorable results than act alone. The connotation of PPP is different from organization to organization. The World Bank institute describes it as a long-term contractual relationship between the private sector and the government to provide public facilities or services in which the private sector assumes greater risk and management responsibilities. The Asian Development Bank describes it as a series of partnerships between the public and private sectors in infrastructure and other services, which is characterized by government authorization, regulation and supervision, private sector financing, operation providing services, public-private partnership long-term, risk-sharing and improved efficiency and service levels. In fact, the essence of PPP is a kind of financing cooperation mode, whose core is financing and operation. Centering on financing and operation, a series of legal, economic, operational
and management relations have been generated. And these relationships intersect each other, making them complex. The broad PPP includes BOT, BT, TOT, PFI and other modes.

3. Analysis of Status Quo on Local Debt

China's local debt was 18 trillion Yuan according to the national audit report on June 2013. By the end of 2014, it had grown to 30.28 trillion Yuan. In 2015, the debt ratios over 100 cities and more than 400 counties had been more than 100%. By the end of 2016, China's local government debt was 15.32 trillion Yuan, and the local government debt rate was 80.5%. By 2017, the national debt balance of local governments reached 164.70659 billion Yuan, including the general debt balance of 103.32235 billion Yuan and the special debt balance of 6138.424 billion Yuan. The relevant provinces' balance of local government debt see table 1 by the end of 2017. By calculation, the government debt ratio was 36.2% at the end of 2017. In 2018, the local government budget deficit reached 830 billion Yuan, the local government general debt balance limit reached 12378.922 billion Yuan, and planned issue special bonds 1350 billion Yuan. In fact, the amount of local debt is complex, and the most difficult to count is the debt caused by government investment. Some of these investment projects have a long history, some have not been audited and settled for a long time, and some have even been implemented without necessary procedures. For government-invested projects, many of them are funded by private capital, such as the urbanization process and targeted poverty reduction, which forms a strong debt that cannot be ignored.

4. The Way to Prevent and Dissolve Local Debts in China by PPP Mode

4.1. Prevent and Reduce Local Debt by Absorbing Social Capital Direct Investment

In general, local government debt is mainly composed of direct investment and financing by local governments. Due to limited local financial resources, the direct investment of local governments is greatly limited, and the direct investment will give rise to new debts and increase the pressure on local governments to pay off debts. For example, in many counties and urban areas, the approved funds do not include the costs of planning and design and environmental management, which need additional supporting expenditures from local governments. In some local road construction, due to lack of funds for approval, the construction has been changed, and the actual audit settlement amount is much larger than the budget amount. A large number of projects directly invested by the government are funded by construction companies. These hidden debts are difficult to measure due to their long history and high risks. So in order to prevent the sharp expansion of local debts, it is necessary to reduce the direct investment of local governments and implement infrastructure construction through appropriate financing by local governments. Local governments mainly conduct financing through investment and financing platforms, which can be divided into three main ways: loan financing, bond financing and project financing. PPP mode is often used in project financing. These projects come from infrastructure construction and public services, and it has a certain income attribute, which attracts social capital, that is, social capital can obtain investment return through user payment and necessary government payment. As a result, construction and development projects that should be fully undertaken by the government are mainly undertaken by social capital to prevent and reduce local debts.

4.2. Invigorating Existing Infrastructure Assets and Resolving Local Government Debt Through PPP Model

In July 2017, the national development and reform commission issued a notice on accelerating the use of PPP to revitalize existing infrastructure assets. The notice states that the active promotion of PPP mode,
the invigoration of existing infrastructure and the formation of a benign investment cycle will help broaden the sources of funds for infrastructure construction and reduce the debt burden of local governments. To be taken in the inventory of the PPP model in infrastructure projects, according to the project characteristics and the specific circumstances, can be transfer—operation—transfer (TOT), rebuilding—operation—transfer (ROT), transfer—have—operations that), commissioning operations, equity cooperation, such as a variety of ways, the project of asset ownership, equity transfer, management, toll to social capital. For the existing infrastructure projects that have adopted PPP mode and the government holds shares in the project company, the government may transfer part or all of the equity held by the government to the social capital or other investors of the project by means of equity transfer. For infrastructure projects under construction, we can also actively explore and promote the PPP model, introduce social capital to be responsible for the investment, construction, operation and management of projects, reduce the difficulties in advance of projects and other obstacles, and better attract social capital.

4.3. Transforming Local Financing Platforms to Reduce Local Debts Through PPP Model

The opinions of the state council on strengthening the management of local government debt issued in 2014 requires that the government financing functions of financing platform companies be stripped away and financing platform companies shall not add new government debts. The notice on further regulate the behavior of local government debt financing published in 2017 that should further standardize the financing platform company financing management, promote the financing platform company as soon as possible into the market-oriented operation of state-owned enterprises, in accordance with the law of compliance market-oriented financing, local government and its subordinate departments shall not intervene in the financing platform company daily operations and market financing. So, the financing platform company should transform. From the perspective of some local investment and financing platforms that have successfully achieved the transformation at present, their transformation can be roughly divided into the following categories: Developing operational businesses and promoting diversified business transformation; Innovate financing mode to attract social capital transformation; Divestment of government investment and financing functions to become the main industrial transformation. One of the main ways to attract social capital transformation through innovative financing mode is to carry out transformation through PPP mode. In the process of transformation, social capital (PPP) is introduced to deal with existing debts to ensure the smooth repayment of debts and achieve the purpose of resolving local debts.

4.4. Resolving Local Debts Through PPP Projects Asset Securitization

PPP project asset securitization is a tradable asset-backed security issued on the basis of the asset portfolio or cash flow generated by PPP project as the solvency support, credit enhancement through structural design. The notice of related work on promoting cooperation projects of government and social capital in the field of traditional infrastructure (PPP) asset securitization in December 2016. The notice indicated that asset securitization is one of the important financing of infrastructure, to revitalize the stock of the PPP project assets, to speed up the social investors' money recovery, attract more social capital to participate in the PPP project construction is of great significance. In June 2017, the ministry of finance, people's bank of China, securities regulatory commission jointly issued the “Notification of relevant matters on specification for the government and social capital cooperation project asset securitization”. The notice points out that in the project operation stage, the project company, as the initiator (original equity holder), can issue asset securitization products according to different types of user fees, government fees, feasibility gap subsidies and so on, and take the right of return that can bring cash flow to the project and contract creditor's rights as the basic assets. PPP project asset securitization plays a great role in stimulating the vitality of existing assets, enhancing the liquidity of PPP project assets, and enhancing the attractiveness of PPP projects to social capital. In fact, through the setting of the
SPV mechanism, the realization of asset securitization of PPP projects also isolates the risks of local governments, one of the founders of SPV. Through the asset securitization financing of PPP projects, the debts of local governments are also resolved.

5. Analysis of PPP Model in Preventing and Resolving Local Debts in China

5.1. The Difficulty in Implementing PPP Mode Limits Its Function of Preventing and Resolving Local Debts

According to statistics, by the end of 2017, for all the PPP projects in storage, the cumulative landing of PPP projects nationwide reached 4.6 trillion Yuan, accounting for 42.75% of the total PPP management library, and 42.50% of the projects started. The situation of asset securitization of PPP projects is even less optimistic. From December 2016 to April 2018, only 12 asset securitization products of PPP projects were listed on the Shanghai and Shenzhen exchanges, and only one product was offered in the inter-agency private placement product quotation and service system. The low landing rate of PPP projects limits the function of preventing and resolving local debts.

5.2. The Illegal PPP Model Has Increased Local Government Debt

In the practice of non-standard PPP project, social capital actually increases the debt of local governments in the mode of "real debt of tangible shares + loan of shareholders". Due to the "equity and real debt" have characteristics of fixed return and regular repurchase, while "small equity and big debt" shows the requirement of early exit. Therefore, the mode of "equity and real debt" + "small equity and big debt" is essentially a debt PPP investment and financing mode, which violates relevant regulations and is suspected of illegal operation. In addition, in order to attract the participation of social capital, some local governments accelerate the launching of PPP projects, issue "comfort letters" with no legal effect, and take the land transfer income as the guarantee, etc., which also leads to the increase of hidden liabilities of local governments. If in the process of bilateral cooperation, the private sector takes back the investment in advance through the so-called agreement and transfers the debt and risk to the local government, it goes against the original intention and essence of PPP model.

5.3. Uncertain Risks in PPP May Lead to an Increase in Local Government Debt

PPP model has some risks, including market risk, financial risk and policy and legal risk. These risks are uncertain, mainly reflected in the following aspects: First, the uncertainty of risks caused by the long cooperation period. Generally, the PPP model lasts for 10-30 years. Due to the long cooperation period, it will face many uncertain risks, such as legal change, policy adjustment, change of government, bank interest rate, inflation, market demand, force majeure and bankruptcy of social capital. Second, project complexity leads to risk uncertainty. In the project identification stage, there may be "feasibility" research and demonstration errors, "value for money" evaluation and measurement errors, "affordability" judgment distortion and other problems; In the project preparation stage, there may be some problems, such as the lack of ability and progress of the implementation organization, the poor design and level of the implementation plan preparation, and the low efficiency of department communication and coordination. In the procurement phase of the project, there may be illegal violations of procurement procedures, insufficient consideration of procurement standards, out-of-control procurement costs, improper selection of partners and other problems; There may be objective dynamic changes in the project implementation stage, the role of regulatory responsibility dislocation, related policy changes, the emergence of cooperation conflicts and other issues; In the process of project handover, there may be some problems such as unclear boundary and fuzzy standard of the object of handover, moral hazard and disorderly execution of the handover work, quantitative difficulties of handover compensation and
constant disputes. Third, risks of PPP project failure. The failure risk of PPP projects may occur in the whole process of PPP projects. For example, the PPP project of Ireland's "common site" hospital ended in the project preparation stage, the PPP project of India's Dabo power plant failed in the investment stage, and the PPP project of the channel tunnel between Britain and France failed in the operation stage. It can be seen that the uncertainty of risks in PPP projects is one of the important factors leading to the failure of PPP projects, and the poor grasp and treatment of uncertain risks in PPP projects may lead to the increase of local government debts.

6. Countermeasures of PPP Model in Preventing and Resolving Local Debt Risk in China

6.1. Further Improve and Standardize PPP Models and Raise the Landing Rate of PPP

As a matter of fact, there are many laws and regulations on PPP issued by China, especially in the aspect of operation, there are evidences to follow. It is only necessary to strictly follow relevant regulations. The following aspects should be paid attention to in the process of implementation. One is pay attention to the improvement of existing PPP projects. Firstly, determine whether the project is suitable for PPP mode, and cancel those that are not suitable for PPP mode. Secondly, determine whether the PPP mode is illegal and illegal, and make fundamental modifications to the illegal and illegal parts. Thirdly, determine whether the PPP mode is unreasonable and unfair. Two is pay attention to the implementation of existing PPP projects. The Function exertion of PPP project ultimately need to fall to the ground, and to solve the problem of the PPP project hard landing, need comprehensive system into consideration and propulsion, such as government and social capital cooperation method, and adjust the related local regulations and measures for the administration of the PPP, coordination of the PPP project progress regulations contradictory problems, establish multi-sectoral cooperation policy support system, operation management on construction of whole life cycle of the PPP project. Corresponding policies should be supported to advocate a business environment of contract spirit, rule of law and good faith, and create a market environment necessary for PPP mechanism. Three is pay attention to the supervision of the implementation of existing PPP projects. The key to prevent and defuse local debt risks by applying PPP model is to supervise PPP projects. The key points of supervision are: whether the PPP project is carried out in strict accordance with the contract and the provisions of national laws and regulations; whether the random changes lead to the increase of local government debts and risks; whether relevant information is disclosed in a timely manner; whether new problems and contradictions are reported and resolved in a timely manner. Four is pay attention to optimize the PPP mode management process. In the early stage of project construction, PPP project approval procedures should be simplified and negative inventory management should be implemented. For industries encouraged or allowed to enter by the state, the initiative of social capital should be fully mobilized, and the evaluation of value for money and financial affordability should be led by the financial department. The management in project operation and the assessment when the project is due shall be conducted in combination with the full-caliber budget of the financial department, comprehensive financial report, cross-annual rolling budget, debt management, transfer payment, etc. In short, only by further improving and standardizing the PPP model and improving the landing rate of PPP can the PPP model play its role in preventing and defusing local debt risks.

6.2. Properly Design the PPP Mechanisms of Risk Sharing and Prevention and Strictly Control the Increase in Local Government Debt

In terms of preventing and resolving local debt risks, the rational design of PPP risk sharing and prevention and control mechanism should take into account at least several aspects:(1) influence of PPP project on current local government debt; (2) influence of PPP projects on local debts in later stage; (3)
risks that PPP projects may face in the whole process of investment, financing, operation and handover, etc., which may affect local debts; (4) risks caused by changes in social capital, which will have an impact on local government debts; (5) the relationship between local government debt and local stability. The core of PPP risk prevention and control mechanism is explicit for the debts and risks should be taken and isolated from the debts of the PPP project, resolutely put an end to a social capital “equity and real debt” and “small equity and big debt” phenomenon, and resolutely put an end to a "guarantee" or "comfort letter" issued by local government, resolutely put an end to appear be out of the risks and benefits of local government. The key to the PPP risk sharing and prevention and control mechanism is that the government and social capital need to agree on a response mechanism in advance for the occurrence of operational difficulties or financing repayment problems, limit the government's responsibility within the scope of investment, and avoid the unlimited extension or transformation of risks. Of course, risk inspection, risk early warning and risk treatment mechanism should be established to timely understand risks in the construction and operation of various PPP projects, and necessary countermeasures should be taken to avoid risks from concentrated outbreak. In case of corresponding risks, the government and social capital should cooperate and actively respond. As long as the PPP risk sharing and prevention and control mechanism is properly designed, the increase of local debt can be strictly controlled, and the local debt can be effectively prevented and dissolved while promoting local economic and social development.

6.3. Accelerate the Transformation of Local Financing Platform Companies and Actively Promote Asset Securitization of PPP Projects

In terms of preventing and resolving local debts, the asset securitization of PPP projects should pay attention to the following aspects: (1) the transfer of the underlying assets must be authentic. The original interest party "sells" the underlying assets to SPV in a real way. After the SPV holds the assets, it is equivalent to isolating the original interest party's operational risk and bankruptcy risk from the asset securitization products, which can effectively protect the interests of investors. One of the investors here is a local government or a state-owned enterprise. The so-called "real sale" means that the original interest party will no longer be involved in the asset, no longer have the right of recourse and distribution of residual income, and there are no reserved risks related to the asset;(2) successful issuance of asset securities. After the application for asset-backed securities is approved, the SPV entrusts the securities underwriter to be responsible for selling the securitized asset products, and the sales revenue shall be used as the consideration for the purchase of the underlying assets and paid to the original equity party at the agreed price. Whether asset securities can be successfully issued mainly depends on whether investors buy them. Due to the long cycle and low rate of return of PPP projects, it is difficult to attract small and medium-sized investors. Therefore, long-term investors, such as insurance funds, pension funds and housing provident funds, should be allowed to join the asset securitization;(3) seamless connection between the securities market and PPP model. In order to reduce the dependence of PPP mode on bank funds, bond financing is an important path. As far as China is concerned, the low cost and long cycle of bond financing is in line with the demand for PPP financing. Bond products with various types and levels can provide diversified choices for PPP financing subjects. Therefore, the issuance and transaction mechanism of asset securitization should be improved to encourage asset securitization. Only when the securities market and PPP model are seamlessly connected can the asset securitization of PPP projects be dynamic.

7. Summary

The original intention of the PPP model is to invest and operate local infrastructure and public service projects by social capital without increasing local government debt or at a low level of local government expenditure, so as to promote the rapid development of local economy and society. Therefore, preventing local debt is the inherent function of the PPP model.
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