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Subject: Ex-ante advice on the statistical treatment of the (finalised and revised) Public Private Partnership (PPP) Project E67/A7 Kekava bypass.

Reference: Your letter Case 0100-15/2021/22 and e-mail from 31/03/2021 and included documents (Ares(2021)4410497 and Ares(2021)2505089);
Your letter Case Nr. 0100-15/2021/412 and e-mail from 18.06.2021 and included documents (Ares(2021)4410527 and Ares(2021)4399071)

Dear Ms Aija Žīgure,

Thank you for your requests for an ex-ante opinion on the statistical treatment of the (revised) Public Private Partnership (PPP) Project E67/A7 Kekava bypass dated 31 March and 18 June 2021. Upon the analysis of the first batch of documents sent by you in March, on 09/06/2021 Eurostat provided you with an opinion that the PPP project assets were to be classified on balance sheet for government. After having closely examined the arguments and the documents provided by you in a second batch in June, Eurostat is now in a position to express a view on this matter.

1. THE ACCOUNTING ISSUE FOR WHICH A CLARIFICATION IS REQUESTED

In July 2018, Eurostat provided to the Latvian statistical authorities an ex-ante opinion on the statistical treatment of the assets to be created through the implementation of the PPP Project E67/A7 Kekava bypass, in which it was confirmed that the assets under the draft PPP contract available at that time should be classified off government balance sheet¹.

Since a number of changes were introduced into the PPP Contract, the Central Statistical Bureau of Latvia (CSB) considered it necessary to reassess the situation and repeated their

¹https://ec.europa.eu/eurostat/documents/1015035/8683865/Advice-2018-LV-Ex-ante+advice_PPP++Project+E67+A7+Kekava+bypass.pdf/ab49a2c1-3a30-4ee2-84f2-148e14ba484f



request for an ex-ante opinion from Eurostat on the statistical treatment of the assets of the Kekava Bypass PPP project.

The key statistical issue is the classification of the assets involved in the PPP contract – either as government assets (thereby immediately influencing government net lending/borrowing (B.9) and debt) or as assets of the partner (spreading the impact on government net lending/borrowing (B.9) – and on imputed debt – over the duration of the contract).

1.1. Project description

The Kekava bypass project involves the designing, building, financing and maintenance of a new road infrastructure – E67/A7 Kekava bypass and is intended to be implemented using a PPP model with availability payments. The total capital expenditure is estimated at 80 to 100 MEUR, and the contract value is, according to the calculations from the feasibility study, around 160 MEUR excluding VAT.

The project aims at the construction of the Kekava bypass on the E67/A7 road section making this road section a two-lane expressway. It entails a road with a total length of 17.5 Km, including the construction of a new road (14.4 Km), the reconstruction of the existing road (3.1 Km) and associated infrastructures (ramps, tunnels, parallel roads, roundabouts and auxiliary roads). Concerning the total length of the roads, 11.1 km of them are planned as four-lane carriageway and 6.4 km planned with two lanes. The project includes also four multiple junctions, four tunnels, one bridge, seven roundabouts as well as parallel roads in total length of 16.2 km.

The PPP contract will be a long-term contract, including a design and construction phase of approximately three years (from the date of Financial Close until the date of issue of the certificate of availability), followed by a 20-year exploitation and maintenance period from the date of availability.

1.2. Documentation provided

CSB provided to Eurostat, via an e-mail from 31/03/2021, a letter with a repeated request for an opinion on the issue and their reasons for the request, general information on the PPP Project E67/A7 Kekava bypass, an analysis of the changes introduced to the PPP contract and their conclusion on the methodological analysis on the statistical treatment of the Public Private Partnership (PPP) Project E67/A7 Kekava bypass. The e-mail included the following annexes:

A Analysis according to the Eurostat guide 2016

B PPP contract

The main text;

- Annex 1: Definitions;
- Annex 2: Payment Mechanism;
- Annex 5: Compensation in the case of early termination;
- Annex 9: Consultation committee.

C Side by side comparison of changes introduced in the PPP contract



Upon the opinion from Eurostat from 9 June 2021 that the PPP project assets are to be classified on balance sheet for government, the PPP contract was further amended in order to address the issues identified by Eurostat to enable the assets to be classified off the balance sheet of general government. Via an e-mail from 18/06/2021, CSB submitted another batch with the reviewed documents and their corresponding methodological analysis, which included a diagram with the process to determine the compensation in case of early termination (in case of the private partner's default), based on which CSB renewed the request for another ex-ante opinion on the statistical treatment of the assets of the Kekava bypass PPP project.

1.3. Legal structure

For the Kekava bypass project the selected procurement procedure was a tendering procedure with negotiations.

The PPP contract will be signed by:

- the Ministry of Transport of the Republic of Latvia (hereinafter the Authority);
- the State Joint Stock Company "Latvian State Roads" (LSR; the Implementing Authority, 100% owned by the State) acting under delegation agreement with the Ministry of Transport (classified in the general government sector); and
- the private partner - an association of persons "Kekava ABT" (ABT) (classified under S.11)

Timeline of events:

July 9th, 2018: Ex-ante opinion from Eurostat confirming that the PPP assets should be classified off government balance sheet;

December 6th, 2018: Qualification phase of the Tender announced;

May 17th, 2019: Invitation to submit initial bids sent out to 4 qualifying bidders;

August 9th, 2019: 2 bidders submit initial bids;

February 28th, 2020: negotiations completed, and bidders invited to submit BAFO;

August 13th, 2020: Tender result announced;

March 17th, 2021: Negotiations completed by LSR with financiers on PPP contract and Direct Agreement;

October, 2020 – June, 2021: Due diligence on ABT carried out by financiers: EIB and NIB (ongoing);

End of May, 2021: the due diligence on the ABT completed by financiers;

June, 2021: the financial and commercial close procedure was agreed upon with ABT and financiers;

June 9, 2021: the ex-ante opinion from Eurostat stating that the PPP project assets should be classified on government balance sheet;

June 9-16, 2021: discussions with the ABT and the financiers to remedy the PPP contract and address shortcomings identified by Eurostat in order to achieve off balance sheet classification;

June 9-16, 2021: consultations with EPEC were held to clarify the interpretation of the Eurostat PPP Guide and enable us to assess if there are reasonable grounds to believe that amendments in the PPP contract would lead to an opinion that the PPP assets would be classified off balance sheet for government;

June 17, 2021: consultation with the Ministry of Finance and Central Finance and Contracting Agency on the revised version of the PPP contract took place.



2. METHODOLOGICAL ANALYSIS

2.1. *Applicable accounting rules*

The general rules to be applied when assessing the statistical treatment of a PPP project are defined in ESA 2010 chapter 15 - *Contracts, leases and licences, §15.41 Public-private partnerships (PPPs)* and chapter 20 – *The Government accounts, §20.276 to 20.302 Public-private partnerships* and in Eurostat's Manual on Government Deficit and Debt (MGDD), Part VI - *Leases, licences and concessions - VI.4 Public-Private Partnerships (PPPs)*.

In addition, Eurostat's analysis below is also based on the "Guide to the Statistical Treatment of PPPs" (the PPP Guide), jointly released by Eurostat and the EIB on 29 September 2016.

2.2. *Availability of national accounting analysis*

As the Latvian authorities had instructed the contracting authority for this PPP to not enter into any PPP contract that would be classified on balance sheet for government, upon Eurostat's opinion from 9 June 2021, amendments to the text were made to the contract text version from March 2021. CSB evaluated the revised finalised wording of the PPP contract, according to the MGDD and the PPP Guide.

Based on the significance of the changes introduced to the text of the PPP contract, CSB has identified and assigned three categories:

1. No change (to avoid any confusion, this category is assigned also in cases where some printing or cross-reference errors were eliminated, or some other minor polishing of wording was performed);
2. Immaterial change – where wording has been improved without changing any principle;
3. Material change – where principles have been improved or new principles introduced.

The table below is the summary of CSB's risk assessment results provided in the request for bilateral advice from 31/03/2021, and which remained in general valid in the revised version (except for some changes in theme 12).² Only one high importance risk was identified, while no other weighted risks were identified.

² "Relevant changes introduced:

- 1) *The provision for the lenders to set the threshold that was used to switch from retendering to EMV (estimated market value) has been removed (please see clause 1.2(b) in the March 31, 2021 version). Instead, this decision now solely lies with the public partner (please see clauses 1.2 (a) and 1.2 (b) in the revised version);*
- 2) *The provision for the lenders to choose between the EMV or the highest bid (should bids received be below the threshold) has been removed (please see clause 1.2(b) in the March 31, 2021 version);*
- 3) *The provision for the lenders to receive compensation in addition to the EMV should compensation be determined using the EMV approach has been removed (please see clause 1.6 in the March 31, 2021 version)."* (CSB letter from 18/06/2021)



Eurostat Theme	Changes introduced			Total	Risks identified*	
	Material Change	Immaterial Change	No change		No Risk	Risk identified*
Theme 2: Design and construction of the asset	1	3	1	5	5	
Theme 3: Operation and maintenance of the asset	1	2	4	7	7	
Theme 4: The Payment Mechanism	4	4	7	15	15	
Theme 5: Other payment arrangements	0	0	8	8	8	
Theme 6: Compensation, relief and force majeure events	2	1	0	3	3	
Theme 7: Changes to the PPP contract	0	2	0	2	2	
Theme 8: Changes in law	1	0	0	1	1	
Theme 9: Insurance	1	1	1	3	3	
Theme 10: Warranties and indemnities	0	1	2	3	3	
Theme 11: Early termination of the PPP contract	1	0	0	1	1	
Theme 12: Compensation on early termination	4	0	4	8	7	One High Importance Risk
Theme 13: Expiry of the PPP contract	0	1	1	2	2	
Theme 14: Financing arrangements	1	1	9	11	11	
Theme 15: Government influence	0	1	5	6	6	
Total	16	17	42	75	74	

*Provisions of the PPP contract (and related documents) in light of Chapter 3 of the Eurostat guide 2016.

The Latvian authorities provided to Eurostat a detailed analysis of the revised PPP contract (and related documents) according to the three steps methodology for the assessment of the statistical treatment of a PPP referred to in the PPP Guide.

Regarding step 1 and the identification of the issues that typically influence the statistical treatment, the Latvian authorities have concluded that:

- no AUTOMATIC ON BALANCE SHEET items were identified;
- no items with VERY HIGH importance were identified;
- one item with HIGH importance was identified;
- no items with MODERATE importance were identified.

In step 2, concerning the analysis of the degree to which each of the provisions identified in the previous step could impact on the economic substance of the project, no provision for re-categorization was identified.

Their conclusion of the statistical treatment assessment in step 3 was that, “since the PPP contract has only one HIGH importance item and no VERY HIGH, MODERATE or AUTOMATIC ON BALANCE SHEET items, it should be concluded that, based on the methodology applied by the Eurostat Guide 2016, the PPP contract is off-balance sheet for the Authority.”

2.3. Methodological analysis and clarification by Eurostat

Following the changes introduced into the reviewed PPP contract version from 18/06/2021 and the analysis made available by the Latvian statistical authorities, Eurostat reassessed the finalised PPP contract text and supports the view of CSB that the revisions to the PPP contract do not include provisions that would determine the recording of the PPP assets to be on government balance sheet.



Eurostat focused on the main modifications in the contract, which could potentially produce a change of the assessment of the risks according to the PPP Guide and trigger a change of the originally³ recommended off balance sheet recording of the assets.

The two main issues tackled in the PPP contract version of 31/03/2021 were the role of the Financier in the contract and early termination clauses, specifically in case of an early termination due to Private Partner default. Modifications were introduced and the provisions inducing to a decrease of the Private Partner's risk and potentially ensuring that, at the end, the Financier would be compensated, in some cases even directly by the Public Partner, have been removed.

The methodology for estimating the market value of the contract, where a re-tendering process is not followed, should be designed to reflect the approach that the market would take in valuing the PPP contract and not ensure the recovery of the Partner's incurred costs or outstanding debt, let alone those of the financier.

As per section 6.4.1 paragraph 1 of the MGDD 2019: PPPs are *contracts between government and corporations for the provision of public assets*. This is also reflected in the PPP Guide which does not recognise nor foresee the role of a third party – the Financier – in a PPP contract.

More in general, Eurostat would like to stress that, both the MGDD and the PPP Guide, do not mention the possibility of contractual arrangements between government and the financier, as the contractual arrangements on which to decide whether risks and rewards are on the side of the public partner or the private partner are those signed between these two parties. The risk incurred by the financier should not be the direct concern of government, as the contractual arrangement relating to the financing of the contract is signed between the private partner and the financier, and not government. According to the rules, in order for the infrastructure to be built to be recorded off government balance sheet, the majority of the risks must be on the side of the private partner and not of government. And obviously the risk incurred by the private partner includes the risk that it will not be able to reimburse its debt. By devising rules which would create an additional liability for government in case the private partner would not be able to reimburse its debt plus other costs incurred by the financier, is tantamount to reduce the risk of the private partner and of the financier, as well as to increase the risk of government.

The approach to determine the market value of the PPP contract has been improved to comply with Theme 12.1.3 by addressing the issues identified by Eurostat in its opinion of 9 June 2021. Nevertheless, the finalised version of the contract, in its points 1.1 (d), 1.2 (a), (b) and (c) of appendix 5, by putting conditions on the retendering process regarding the number and value of bids received and the use of estimated market value, still does not fully satisfy the theme 12.1.3 of the PPP guide in its item 7⁴, nor items 4⁵, 8⁶ and 9⁷; as a consequence, high importance risks

³ Ex-ante advice from July 2018: <https://ec.europa.eu/eurostat/documents/1015035/8683865/Advice-2018-LV-Ex-ante+advice+PPP++Project+E67+A7+Kekava+bypass.pdf/ab49a2c1-3a30-4ee2-84f2-148e14ba484f>

⁴ “Under the conditions of the re-tendering process set out in the PPP contract, the validity of the re-tendering process is not conditional on a minimum number of bids being received or a minimum contract value being offered



were identified in accordance with the Guide. Eurostat nevertheless considers the combination of these items as only two high impact issues since the last two items are the detailed consequences of item 7.

In terms of the assessment of the risks according to the PPP Guide, Eurostat sees no existence of Very High, Moderate or Automatic on balance sheet items, however there are two high importance risk items to consider. Even though, according to the PPP Guide, Eurostat considers that the majority of the risk and rewards of this PPP project are with the private partner and that the assets therefore are to be recorded in the accounts of the partner and off-balance sheet for the public authority.

3. EUROSTAT'S VIEW

On the basis of the above considerations and analysis, Eurostat agrees with the opinion of CSB and understands that the majority of the risks and rewards of this PPP project attached to the asset during the whole duration of the contract are with the private partner and that the assets therefore are to be recorded in the accounts of the partner.

Following the analysis of the changes introduced in the finalised PPP contract according to the PPP Guide and of the table provided by the Latvian authorities of the revised PPP contract provisions that influence the statistical treatment, Eurostat agrees with the Latvian authorities and considers that the PPP assets are to be classified off balance sheet for government.

4. PROCEDURE

This view of Eurostat is based on the information provided by the Latvian authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view.

In this context, we would like to remind you that Eurostat is committed to adopt a fully transparent framework for its decisions on debt and deficit matters in line with Council Regulation 479/2009, as amended, and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat is therefore publishing all official methodological advice (ex-ante and ex-post) given to Member States on its website.

(i.e. the results of the re-tendering process are held to be valid even if no bids are received or if bids have a lower value than expected);", p. 105 of the PPP Guide.

⁵ "The Authority is only obliged to opt for an estimated market value in situations in which there is no liquid market;", p. 105 of the PPP Guide.

⁶ "Under the conditions of the re-tendering process set out in the PPP contract, if the re-tendering process is followed and the number of bids received is below a certain number (or lower than expected) or the prices offered are below a certain value (or lower than expected), the price offered is deemed to be the market value and the contract does not provide for some other amount (e.g. an estimated market value) to be used to determine the market value;", p. 105 of the PPP Guide.

⁷ "Under the conditions of the re-tendering process set out in the PPP contract, if the re-tendering process is followed and no bids are received then the market value of the contract is deemed to be zero (i.e. the contract does not provide for some other amount, such as an estimated market value, to be used as an alternative basis for the compensation payment);", p. 105 of the PPP Guide.



EUROPEAN COMMISSION
EUROSTAT

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Yours sincerely,

(e-Signed)

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Director