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EUROSTAT

Directorate D Government Finance Statistics (GFS)

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Statistics Lithuania
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Subject: Amendments to PPP contracts introduced to compensate increased construction costs – ex-post advice

Ref.: Your letter of February 2023/SD-103

Dear Ms Petrauskienė,

Following your letter with reference February 2023/SD-103 (received on 8 February 2023), and the further information received on 7 March and 5 May 2023, Eurostat would like to provide you with its advice on the accounting treatment of some amendments to PPP contracts already introduced to compensate the increased construction costs (ex-post advice).

Description of the case

In Lithuania, three PPP contracts for the design, construction, finance and maintenance of military unit buildings (in Siauliai, Vilnius and Silale districts) were signed on 8 January 2021. These projects are recorded off the balance sheet of general government. Eurostat agreed with the off-balance sheet treatment of these three PPP contracts with an ex-post advice published in November 2021¹.

During the EDP dialogue visit of January 2023, the Lithuanian Central Project Management Agency (CPMA) informed Eurostat that, considering the large increase in construction costs in 2022, an amendment had been made to each of these three PPP contracts. The amendment introduced a one-time extra payment from government to the private partners, to cover the additional and unforeseen construction costs.

1

<https://ec.europa.eu/eurostat/documents/1015035/12427511/Lithuania+-+Statistical+recording+of+three+PPP+military+projects.docx.pdf/ee5f40f5-e740-21fa-8a35-c277bdf525a0?t=1641476737188>

On 20 June 2022, Eurostat had published *Clarifications on the application of a Guide to the Statistical treatment of PPPs: Responses to Frequently Asked Questions*² (from now on, the Clarification note). The document included some clarifications on the assessment of the statistical treatment of a PPP when the Authority takes the risk of movements in construction prices during the Construction Phase. It states that *“The Authority can take or share the risk of movements in construction prices and not for other construction risks such as delay, choice of material, quantity of materials, construction defects, etc. during the Construction Phase without any impact on the statistical treatment of a PPP.”*

The request for advice by Statistics Lithuania asks Eurostat to reply to two questions, both related to the possibility of applying the statistical guidance on amendments that introduce the indexation of construction costs to contracts that originally did not include such a mechanism:

“Do the provisions of the Clarification note apply only to PPP contracts already concluded or also to amendments made after the adoption of the Clarification note?”

“If, in the original PPP contract, the possibility of recalculation of the construction price was not foreseen, ... and the PPP contract was amended in September 2022 to provide for the recalculation of the construction price and to establish objective criteria (indexes published by Statistics Lithuania) to measure the change between the original construction price and the recalculated price, can such amendment to a PPP contract affect the initial statistical evaluation of it?”

Clarification by Eurostat

Indexation mechanism

The general rules for PPP classification (in the PPP guide³) expressly indicate that indexation of availability payments, such as on general price indexes, do not preclude an off-balance sheet recording. This is because the risks transferred from the partner to government by way of such indexation clauses are financial in nature, which can be hedged by government, and does not constitute idiosyncratic risks related to the PPP itself. It is recognised that the market will necessarily consider the existence of such indexation clauses, or absence thereof, to adequately price the PPP, when asking for a certain level of availability payments (for a given quality of service). As a result, it must be presumed that, for instance, a 20-year not indexed PPP would include significantly higher starting availability fees than an indexed PPP (i.e., in the order of 20% higher for a 2% expected annual inflation).

The Clarification note thought to indicate that, in substance, this rule on indexation would also be valid for construction costs. The Clarification note cautions that this indexation should be well measured to prevent that any construction risks are transferred to government through this indexation clause.

²

<https://ec.europa.eu/eurostat/documents/1015035/12618762/Clarification+to+the+PPP+Guide+Q%26A.pdf/e928cb53-a0ae-e73f-11de-083bda4b096c?t=1655738471492>

³ https://www.eib.org/attachments/thematic/epec_eurostat_statistical_guide_en.pdf

Changes in contracts

Any amendment so to a *a posteriori* change indexation clauses for availability fees in a material manner (such as introducing an indexation clause where none existed before, or introducing material changes to an existing formula), would imply a PPP reclassification on government balance sheet, as such a modification would be an *a posteriori* change in the economic performance (e.g., Internal Rate of Return/IRR) that would arbitrarily reduce the risks or rewards of the partner.

In principle, such an *a posteriori* amendment to the indexation clauses related to construction costs would have the same impact and imply the reclassification of the PPP on government balance sheet.

However, given that the possibility of indexation of construction costs had not been envisaged by the 2016 PPP Guide, and has been introduced only by the 2022 Clarification note, an issue arises as to whether an *a posteriori* amendment introducing an indexation of construction costs should be treated similarly to an amendment of the indexation of availability fees (reclassification of the PPP), or whether Eurostat would allow a transitory period.

Eurostat would like to clarify that the principle established in the Clarification note, paragraph 1, *Price movements during the construction phase*, applies also when such an indexation for the construction phase is introduced by way of an amendment to the original contract, on condition that the construction works were ongoing (or had not yet started, but the contract already reached financial close) at the moment in which the indexation is introduced in the amended contract. Moreover, it can only apply for contracts that reached financial close before 20 June 2022, date in which the Eurostat's Clarification note was published. This rule recognises the need for a specific transitory period following the moment Eurostat clarified its position, also considering the exceptional circumstances that determined the large 2022 construction prices increase across the EU.

PPP contracts whose financial close occurred after the publication of Eurostat's Clarification note of 20 June 2022, will likely include a provision related to the indexation of construction costs. In case they do not include such a provision, any successive material amendment introducing this type of indexation would be considered as implying government taking over the construction risks, with consequences for the statistical treatment of the contract.

It should be noted that a construction price indexation may *de facto* overlap with an availability fee indexation, notably when high construction inflation is associated with elevated general inflation – as this has been recently observed in several countries in the EU. The risk of overlapping would exist if the indexation of the availability fee takes as reference, for the base date, the closing date of the contract rather than the first availability payment date, likely pointing at significant risks assumed by the Authorities.

To avoid such a risk, the text of the amendment and/or the associated note prepared for the Statistical office or for Eurostat should specify if and how the introduction of the indexation of the construction costs alters the initial IRR of the PPP. As a rule, the proposed amendment should not alter the initial IRR of the PPP.

Obviously, an indexation of construction costs (as well as any indexation of availability fees) should work symmetrically and foresee the possibility of a reimbursement to government in case of decline in construction costs.

Application of these principles and rules to three Lithuanian PPPs

On 5 May 2023, the Lithuanian statistical authorities provided the text of the *Amending agreements* introducing the indexation of construction costs to the three PPPs and explained that the construction works for the three projects started in July 2021 and will be finished by July 2024. The three PPP contracts were signed on 8 January 2021, and their amendments occurred in September and November 2022. These amendments are therefore in line with the rules set above with respect to the applicability of the principle established in Eurostat's Clarification note of 20 June 2022, although the absence of overlapping between construction costs indexation and availability indexation would need to be confirmed (i.e., the IRR of the project is unchanged).

It is recalled that in case an indexation of construction costs is introduced in a PPP contract, either as an amendment to a PPP project under construction in 2022, or in a new contract not yet under construction but with financial close before June 2022, then the indexation mechanism must isolate changes in the cost of construction resulting from movements in construction prices from changes in the cost of construction due to other construction risks, which must be allocated to the Partner (such as design, delay, choice and quantity of materials etc.), as it was indicated in the Clarification note.

The Lithuanian amendments to the contracts introduce an indexation system that adapts the costs of construction (as initially estimated at the time the PPP contract was signed) to the changes in the value of the indicator “*Price indices of construction cost elements, dimension main group of constructions costs*”, published by Statistics Lithuania. Only the construction and installation costs are included in the newly introduced indexation mechanism, not the costs related to design, certification, project management work, etc...

The increase in the construction costs that occurred between January 2021 (the date the contract was signed) and the date the construction could start (all the authorisations having been received), or June 2022 at the latest, is considered by the indexation mechanism in order to define the amount to be compensated by government. The annual inflation initially estimated in the projects' Financial Model (3%) is deducted from the indexation adjustment (see the definition of “PSPR” under art 50 of the amendment).

The calculated inflation-related increase in the construction costs will be paid out by government to the private partners in one payment, when the construction works will be finished, together with the first monthly operational remuneration (availability fee).

In the three PPP projects concerned by the contractual amendment, construction works are still ongoing, so no final values for the additional payments due are yet available. However, the Lithuanian authorities estimate that this contractual amendment will require additional payments representing around 20.7% of the value of the investments originally planned.

This additional payment will most likely be recorded as an investment grant (D.92), which may need to be accrued over the time of construction.

Finally, Eurostat notes that the original/non-amended Lithuanian PPP contracts related to the three military bases (signed on 8 January 2021) include an indexation of the availability payments (costs related to provision of services, renovation, repairs, and administration) to the monthly harmonised consumer price index (HICP) with a base date defined as 1 January 2021 (Annex 3, part VII, Art. 25, p.81). This indexation feature might overlap with the indexation of the construction costs, as discussed in the previous section.

Overall, Eurostat considers that the three amendments introducing indexation of construction costs have no impact on the statistical treatment of the three PPP contracts by themselves, unless further examination would show that the IRR of the PPP is *de facto* increased due to some double impact arising from the two indexations (of construction costs and availability fees). The Lithuanian statistical authorities should also verify if the formula used to determine the additional payments can lead to negative values, meaning amounts to be reimbursed to government, which Eurostat presumes is not the case.

Other considerations relating to the three PPPs

While the specific questions in the request for advice addressed in this letter are not directly related, Eurostat wants to draw the attention of the Lithuanian statistical authorities to the potential impact of the recent advice given by Eurostat on other PPP projects in Lithuania, such as the construction of police headquarters buildings in the town of Siauliai and the multifunctional centre in the town of Sendvaris. Specifically, Eurostat highlights that the three PPP contracts concerning the military bases include a clause that determine the compensation that government would pay, in case of early termination due to the Partner's fault, as a function of the outstanding senior debt. This is like a financing guarantee according to the PPP Guide.

The Lithuanian statistical authorities should verify whether this implicit government commitment associated to other government financing accounts for 50% or more of the capital expenditure incurred. If this is the case, the three PPP contracts should be recorded on the government's balance sheet, as indicated in the PPP Guide, Theme 12, pages 107-108. In this verification, the Lithuanian statistical authorities will have to consider the construction indexation payment as government financing.

Conclusions

Eurostat considers that the 2022 amendments to the three ongoing PPP contracts introducing an indexation of construction costs do not affect by themselves the initial evaluation that the contracts could be recorded off the balance sheet of general government, unless further examination would show that the IRR is *de facto* increased due to a double impact of the indexation of the availability fees and of the construction costs. The Lithuanian statistical authorities should also verify if the formula used to determine the additional payments can lead to negative values, meaning amounts to be reimbursed to government, which Eurostat presumes is not the case.

In addition, Eurostat is of the opinion that the three PPP contracts related to the military bases in Siauliai, Vilnius and Silale, and possibly also other Lithuanian PPP contracts currently off

balance-sheet (e.g. Kaunas school), include provisions related to the compensation that the Authority will have to pay in case of early termination due to Partner's fault, which, according to the PPP Guide, might imply that these projects should be recorded on the balance sheet of government.

The Lithuanian statistical authorities will have to consider the construction indexation payment as government financing and verify the impact this may have on the financing criteria applicable for PPP classification (taking into account also the guarantee implied by the early termination clause due to Partner's fault).

Procedure

This view of Eurostat is based on the information provided by the Lithuanian statistical 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-post 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.

Yours sincerely,

(e-signed)
Luca Ascoli
Director