Ref. Ares(2023)4358089 - 23/06/2023

EUROPEAN COMMISSION
EUROSTAT

Directorate D Government Finance Statistics (GFS)

Luxembourg
ESTAT/D3/LA/GB/DC/at

Statistics Lithuania
National Accounts Department
Ms Jūratė Petrauskienė
Director General
29 Gedimino Ave.
LT – 01500 Vilnius

Subject: Request for an ex-post advice concerning the statistical treatment of a PPP project related to a multifunctional centre in the town of Sendvaris, Klaipeda District

Ref.: Your letter and email of 22 December 2022

Dear Ms Petrauskienė,

Following your letter under reference, and after analysing the documentation provided, Eurostat with this note is delivering its opinion on the statistical treatment of the PPP Agreement in subject.

A. Description of the case

With a note dated 22 December 2022, the Lithuanian statistical authorities formally requested Eurostat's ex-post advice concerning the statistical treatment of a PPP project for the design, construction and maintenance of a multifunctional centre in the town of Sendvaris, Klaipeda District.

The Klaipeda District Municipality (from now on the Authority) and a private party (the Partner) signed the partnership agreement on 14 October 2022. The contract foresees the design and construction of a multifunctional centre that will provide pre-school and primary basic education, sports and cultural services. The construction of the centre will be finished within three years following the date of the signature, with a planned capital investment of 13.858.689 Euro (excluding VAT), according to the Financial Business Model (sheet Infrastruk sukurimo sanaudos/infrastructure creation costs). According to the planning, the infrastructure should be operational by January 2026.

The Partner will provide cleaning, maintenance and repair services during 12 years following the construction phase.

The Authority will remunerate the Partner with periodic fixed payments that will total 27.689.153 Euro (excluding VAT) over the 12 years of the contract (sum of the annual remunerations, as defined in Annex 3, Appendix 1 to the Agreement, and Financial Business

Model (sheet Metinis atlyginimas), plus the additional values resulting from the indexation of all the costs related to the provision of services following the construction phase.

The Authority transferred to the Partner the possession of the land via a rental agreement before the beginning of the construction works. The asset (multifunctional building) will be transferred to the Authority at the end of the agreement.

B. The accounting issue

The Lithuanian statistical authorities asked Eurostat for an ex-post advice concerning the appropriate statistical recording of the project in national accounts and in the EDP statistics.

The Lithuanian statistical authorities provided Eurostat with a copy of the agreement, in Lithuanian and English, as well as their opinion regarding the accounting classification.

In their own analysis of the Klaipeda District PPP contract, the Lithuanian statistical authorities concluded that this project should be recorded off the balance sheet of government.

On 1 March 2023, Eurostat requested some clarifications and further documentation. Some Annexes relevant for the statistical analysis were missing, among them the Financial Business Model and the text of the Tender. The Lithuanian statistical authorities provided the answers to the preliminary questions and the missing documentation on 7 March 2023. In April, May and June 2023, Eurostat requested some further clarifications on the contract; the Lithuanian statistical authorities and the Central Project Management Agency provided extensive answers.

C. Documentation provided

- Procurement Conditions (Annex 1)
- Tender (Annex 2)
- Financial Business Model (Annex 1 to the Financial Part of the Tender)
- Settlement and Payment Procedure (Annex 3)
- Risk Distribution Matrix between Parties (Annex 4)
- List of compulsory insurance contracts (Annex 5)
- List of Related Companies (Annex 6)
- Pre-conditions for entry into force of the Agreement (Annex 8)
- Assets lifetime (Annex 9)
- Direct arrangement between Public entity, PPP Partner and Funder (Annex 10)
- Assessment and acceptance of works (Annex 11)

Eurostat received an English translation all the above documents, with the exception of Annexes 1 and 2 available only in Lithuanian.

Eurostat did not receive one of the annexes to the agreement: the Specifications (Annex 7). Therefore, this opinion is valid insofar as Annex 7 does not include any provision that materially affects the distribution of risks and rewards within the agreement.

D. Methodological analysis and clarification by Eurostat

In the following paragraphs, Eurostat will analyse the PPP Agreement under the lens of the provisions included in each Chapter of the Guide to the Statistical Treatment of PPPs, published jointly by the EIB and Eurostat in September 2016 (hereafter the PPP guide)[1]. The numbering of the following paragraphs reflects the numbering of the Themes in the PPP guide.

D.1 Sector classification of the parties

The definition of a PPP included in the PPP Guide requires that, for statistical purposes, the authority is classified inside the general government sector, and the partner is classified outside the general government sector.

The Klaipeda District Municipality is part of general government sector.

The PPP Partner (Sip 3) is a Special Purpose Vehicle (SPV) set up by the Investor (Sip 2, also a SPV). Both SPVs were specifically created for the execution of this PPP project and are owned by Orion Social Infrastructure Fund, a collective investment undertaking managed by a private management company. Investors to the fund are private persons and private companies. The Fund invests in many projects, not only in this PPP. The PPP Partner was selected after an open tender to which five private companies applied.

The Klaipeda District Municipality is labelled "the Public entity" in the contract examined, and it will be labelled "the Authority" in this advice; the PPP Partner (Sip 3) is labelled as "the Private Entity" in the contract examined, and it will be labelled "the Partner" in this note, in line with the terminology used in the PPP Guide.

The parties involved in this PPP contract satisfy the requirements established by the PPP Guide, pages 19-21.

D.1.1 Duration of the Agreement

The PPP Guide requires that the duration of the contract is at least ten years, and that the asset has an economic life that is longer than the duration of the contract sufficient to cover a meaningful part of the economic life of the PPP assets.

Art 5.1 of the contract examined specifies that "The Agreement shall remain in full force and effect for a period of 15 (fifteen) years …. The term may be shorter if the Works are completed earlier than three (3) years, but in any event the time limit of Service provision shall not exceed twelve (12) years".

According to Annex 9 of the Agreement, most of the assets to be delivered have a lifetime between 40 and 100 years, depending on the construction material. However, few assets (e.g. road pavements) have a lifetime of only 10 years.

Eurostat observes that the contract examined does cover a meaningful part of the economic life of the PPP assets, as required by the PPP Guide, pages 24-25.

D.2 Design and construction of the PPP assets

According to the Agreement, design and construction risks lie with the Partner (Art. 9.2 and 9.5).

[1] https://www.eib.org/attachments/thematic/epec_eurostat_statistical_guide_en.pdf

A completion date is included in the Agreement: “the Works shall be completed within a period of not more than 3 years from the date of entry into force of the agreement” (Art. 4.1).

Annex 11, Art. 3 defines the specific criteria that will be used for determining whether the construction of the asset is complete.

In the contract examined, Eurostat did not detect any of the “**Design and construction of the PPP assets*****” influencing the statistical treatment of the contract that are described by the* <u>PPP Guide</u>*, Theme 2, pages 35-36.***

D.3 Operation and maintenance of the asset

From the date when the construction will be completed until the expiration of the Agreement, the Partner will be responsible for providing (itself or through subcontractors) the following services related to the assets: maintenance, including the green spaces, renovation, repair, cleaning and waste management (Art. 17.3).

Annex 2 (the Tender), includes a Service Delivery Plan which further details the maintenance and cleaning services that the Partner will perform.

The costs related to renovation and repairs of the PPP assets will fall on the Partner. Appendix 4 to Annex 3 defines a “Remedy Time” in which the Partner is obliged to correct any quality breach, or face a deduction from the operational payments.

In the contract examined, Eurostat did not detect any of the “**Operation and maintenance of the asset*****” features relevant for the statistical treatment of the contract that are described in the* <u>PPP Guide,</u> *Theme 3.***

D.4 The payment mechanism

The typical payments associated to a PPP are the “*operational payments”*, regular payments that the Partner is entitled to receive after the construction of the PPP asset is completed.

According to the <u>PPP Guide</u>, the payment mechanism must allow for adjustments to the operational payments in case of unavailability or poor service performance.

According to the Agreement, in case of non-availability of the assets, defined as their unsuitability for the performance of the education process, the Authority shall not pay the Annual Remuneration. The principle of zero availability-zero payment shall apply (Art. 22.8). In case the asset becomes non-available during school holidays, the operational payments shall continue, with deductions applied (Art. 22.8). In case of partial non-availability of the assets, the Authority shall not pay the full Annual Remuneration, with the deductions to be applied defined in Appendix 4.

In case the Authority or the Partner detect a quality breach in the service provided, this must be reported in a Logging Tool, and the remedy actions must be performed within a contractually defined number of days (Appendix 4, Art. 1.3 and Table 1).

In the contract examined, deductions are foreseen in case the service provided fails to meet the standards of services defined in the Specification and the Tender (Art. 46.1 and Appendix 4).

During renovation and repair works, in case of partial or total non-availability of the assets, Art. 22.8 does not apply, and the remuneration will continue to be paid, provided the renovation and repair work is performed within the deadlines agreed with the Authority (Art. 17.6), although the extension of these deadlines are not specified in the contract.

Eurostat notes that the time given to the partner for this works should be reasonable, otherwise this provision would be an issue of MODERATE importance for the statistical treatment of the contract, according to the PPP Guide, paragraph 4.6.3, page 51 (Rectification periods).

Eurostat observes that the "*payment mechanism*" in the contract examined does satisfy all the main requirements specified by the* PPP Guide*, Theme 4, pages 45-58.

D.5 Other payment arrangements

According to the PPP Guide, page 64, the Partner should not be entitled to receive operational payments before the construction of the asset is complete.

The Financial Business Model and Annex 3 include the figures for the Monthly Remuneration starting from January 2026, when there is no certainty the construction works shall be completed. However, since the principle of zero availability-zero payment (Art. 22.8) applies to this contract, **Eurostat assumes that no operational payment will be made by the Authority before the construction is completed. If this is not the case, the statistical treatment of this contract should be re-considered (see PPP Guide, page 64, paragraph 5.1).**

In case the price of construction works deviate from the planned one, the risk is with the Partner (Annex 4, Seq. No. 3.5).

The costs of service provisions, of renovation and repair works and the administration and management costs are indexed (Annex 3, Art. 26), and the indexation rate applied is the monthly harmonised consumer price index (Annex 3, Art. 29).

The PPP partner has the right to carry out commercial activities on part of the assets built, in case or times when these are not used by the Authority, informing the authority at least 60 days in advance (Art. 17.11). Eurostat did not find, in the Agreement examined, any reference to third party revenues for the Authority related to the eventual commercial activities performed by the Partner. In case such revenues exist, the statistical treatment of this Agreement should be re-considered (see PPP Guide, page 69, paragraph 5.5).

In the contract examined, Eurostat did not detect any of the "*Other payment arrangements*" features influencing the statistical treatment of the contract described in the* PPP Guide, *Theme 5.

D.6 Compensation, relief, and force majeure events

According to the PPP Guide (p.75), "*provisions by which the Authority takes or shares the risk of events that affect the delivery of the project do not influence the statistical treatment if all of the following conditions are met: There is a finite number of well-defined events (i.e. the Authority should not be exposed to an indefinite number of risks); The events do not capture changes in macro-economic conditions; The events are not attributable to the acts or omissions of the Partner; and the events, or the consequences of the events, are not reasonably foreseeable or estimable".*

Furthermore, the provisions should "*not compensate or provide relief for anything other than the effects of the event in question*" and "*exclude from any compensation due by the Authority* *any amounts that the Partner should be able to recover under the required insurances*" (PPP Guide p.81).

The Authority has to compensate the Partner losses (additional costs) in case of well defined "Compensation Events", all depending on the acts or omission of the Authority (Art. 21.2).

A well-defined list of force majeure circumstances (Art. 41.2) is included in the PPP Agreement examined, none of them attributable to the Partner or related to macro-economic conditions.

If the Partner fails to provide the services due to force majeure, the Authority has the obligation to continue paying the Annual Remuneration until such circumstances cease to exist (Art. 41.8).

In the contract examined, Eurostat did not detect any of the "**Relief and force Majeure*****" features influencing the statistical treatment of the contract described by* **the *PPP Guide, Theme 6, pages 75-78.***

D.7 Changes to the PPP contract

The Agreement defines the cases when the contract can be amended, always with the agreement of both parties (art 36). Among the listed cases: "**In accordance with official requests (letters) from the European Union and/or the Lithuanian authorities to ensure that the Agreement is not accounted for on the balance sheet of the governmental sector**" (Art. 36.2.4).

Additional works or services can only be initiated by the Authority (Art. 15.3). The price of the additional works and services shall be calculated based on the price of the additional material and by reference to the market construction/installation costs (Art. 15.6).

In the contract examined, Eurostat did not detect any of the "**Changes to the PPP contract*****" features influencing the statistical treatment of the contract that are described in the* **PPP Guide,** *Theme 7, pages 81-82.***

D.8 Changes in law

Art. 36.2.1 foresees that the Agreement might be amended in case there is a substantial change in the legislation. This amendment requires agreement of both parties.

Art. 21.1 and 21.2 of **the Agreement attributes to the Authority the risks deriving from "changes to the existing legislation** … imposing additional requirements for the performance of the works and/or the provision of the services, **when such a change is classified as material to the legislation"**. If such an event impacts the costs of the works or provision of services, the Partner will have the right to a compensation (Art. 21.2). **The Partner shall assume the risk of amendments to legislation which are not considered material.**

Clause 1.1 of the contract explains that **Material** Change in Legislation - means a change or new enactment of **Special Legislation …** affecting the rights and obligations of the Parties under the Agreement. Clause 1.1 also clarifies that **changes in legislation of a general nature** (e.g., changes in the regulation of the activities of economic operators with regard to the form of their business, changes in the regulation of corporate and personal income taxes, etc.) **shall not be considered a change in Special Legislation).**

Eurostat observes that the "**Changes in law"** ***features included in the contract examined satisfy all the main requirements specified by the*** **PPP Guide*****, Theme 8.***

D.9 Insurance

The Partner is obliged to conclude insurance contracts at its own expense and risk, for its own benefit (Art. 32.1). Annex 5 lists all the compulsory insurance contracts, including one to insure the assets built for the maximum replacement value against all contingencies (Annex 5, Art. 6).

In the contract examined, Eurostat did not detect any of the "**Insurance*****" features influencing the statistical treatment of the contract that are described in the*** **PPP Guide,** ***Theme 9, pages 87-91.***

D.10 Warranties and indemnities

A part of the Agreement deals with "Representations and warranties of the parties" (Art. 6 and 7), and basically list the obligations of the Authority (mainly related to the conditions of the Land plot) and of the Partner.

Art. 13.1-13.13 list all the obligations of the Partner and of the Investor, but do not include any provision related to the need of the Partner to indemnify the Authority for losses incurred as a result of Partner's performance. However, Art. 47.1 foresees that any of the parties in default of its obligations shall reimburse the other party for the direct losses incurred.

In the contract examined, Eurostat did not detect any of the "**Warranties and indemnities*****" features influencing the statistical treatment of the contract that are described in the*** **PPP Guide,** ***Theme 10, pages 93-95.***

D.11 Early termination of the PPP contract

The cases of early termination due to Authority default are listed under Art 39 and do not include cases of the Authority taking risks related to Partner's performance.

In the contract examined, Eurostat did not detect any of the "**Early termination of the PPP contract*****" features influencing the statistical treatment of the contract that are described in the*** **PPP Guide,** ***Theme 11, page 98.***

D.12 Compensation on Early termination of the PPP contract

The cases of Compensation on Early termination of the PPP contract are covered by the Articles 42-45 of the examined PPP contract.

Art 42 regulates the case of Compensation on **early termination due to the fault of the Investor or of the Partner.**

The compensation that the Authority will have to pay to the Partner in such a case is defined by Art 42.1 as follows:

NK = FI + FG + NA - D - B - K - AR – VN, where:
FI = the share of the financing provided by the Funder (in this specific contract a bank) and used by the Partner, including the accrued outstanding interest;

FG = the cost of repayment of the financing provided by the Funder, including costs of termination of the financing agreement;
NA = unpaid remuneration for the services provided before the termination.
D = insurance benefits received by the Partner as a result of termination;
B = the fine payable by the Partner for being late with the construction works;
K = deductions from the remuneration not yet credited/recovered and damage payable;
AR = renovation and repair works already paid by the Authority but not yet performed;

VN = the direct losses[2] incurred by the Authority as a result of the early termination, as agreed with the Partner.

Art 42.1 also specifies that NK, the value of the compensation determined with the above formula, cannot in any case "be higher than the value of the Assets to be transferred to the Public Entity", which shall be "determined by an independent property appraiser".

Eurostat notes that the above formula for determining the compensation on early termination due to Partner's fault is based on senior debt compensation, with a cap determined by the market value of the assets. The compensation mainly based on the financing provided by the Funder can be viewed as close to clause 12.1.5/Approach 5 - Senior debt compensation (see the PPP Guide, Theme 12, pages 107-108). The cap can be viewed as a proxy of clause 12.1.4/Approach 4 – Book value of the asset (see the PPP Guide, Theme 12, pages 106-107).

Examining the compensation mainly based on the financing provided by the Funder, it must be considered that the PPP Guide, Theme 12, clause 12.1.5 Approach 5, page 108, establishes the following: "***PPP contract provisions that base the compensation payable on Partner default on the senior debt outstanding (or a percentage of it) are akin to a financing guarantee (see Theme 14.4) and do influence the statistical treatment****. Accordingly, the influence of such compensation provisions on the statistical treatment needs to be assessed (in combination with other government financing provisions) according to the principles stated in Theme14.4".*

The PPP Guide, Theme 14.4, page 121, states that "*If a government commitment of financing or any other support amounts to 50% or more of the capital expenditure to be incurred for the construction of the asset, the PPP is automatically recorded ON BALANCE SHEET for government*".

According to the Financial Business Model attached to the PPP contract examined, the capital expenditure incurred over the three years of construction is EUR 13.858.689 (50% of this is 6.929.344). The senior debt outstanding (the Funder's loan/"FI" in the formula above) at the beginning of the 4th year will be EUR 9.700.001, at the beginning of the 5th year it will be EUR 8.818.183, at the beginning of the 6th year it will be EUR 7.936.365, and at the beginning of the 7th year it will be EUR 7.054.546 (Financial Business Model, sheet Investuotojas ir Finansuotojas).

Over the years, the amount of the outstanding debt (and the related amount that the Authority will have to pay in case of early termination due to Partner's fault) will decline, since it will

[2] Art. 47.1, defines "direct losses" as those that may arise from any personal injury or death of any person, damage to or loss of property, or otherwise, arising out of the Party's default on or improper performance of any of its obligations. It is not clear if this definition applies also to 'VN". While the costs for the Authority to complete/rectify the asset are covered by the provisions of Art 10, it did not seem to Eurostat that "VN" would also cover the additional operation, maintenance and financing costs. The Lithuanian Statistical Authorities clarified that the additional (for the Authority) operation, maintenance and financing costs (if they occur) are included in "VN".

be progressively repaid. The same happens in case of explicit financing guarantees from government.

While the other components of the formula will add and subtract something from the amount of "FI", it is clear that in case of early termination due to Partner's fault, at least at the beginning of the 4^{th} and 5^{th} year into the contract (in 2026 and 2027), the amount that the government will have to pay will be above the 50% of the capital expenditure incurred. **A government commitment of financing (including a non-explicit financing guarantee like this one) 50% or more of the capital expenditure incurred implies that the PPP is automatically recorded ON BALANCE SHEET of government.** And this applies also if the implicit financing guarantee above 50% of the capital expenditure is relevant only for the initial years.

After analysing the contractual provisions related to early termination due to Partner's fault, Eurostat notes that, according to the rules established by the PPP Guide (Theme 12, pages 107-108), the assets and liabilities related to the PPP examined should be recorded ON BALANCE SHEET of government.

D.13 Expiry of the PPP contract

Art. 10 of the contract deals with the return of the assets to the Authority when the contract expires, and specifies that, at the time of return, the assets shall conform to defined quantitative and qualitative requirements … allowing to continue to use the asset for the rest of its lifetime.

In the contract examined, Eurostat did not detect any of the "Expiry of the PPP contract" features influencing the statistical treatment of the contract that are described in the PPP Guide, Theme 13, pages 115-116.

D.14 Financing arrangements

In the contract examined, the private Partner (Sip 1) is responsible for rising the totality of the financing required for the project. Financing is provided in the form of equity (21%), loan by a bank (65,5%) and loan (13,5%) by the Funder (Orion Social Infrastructure Fund).

Government does not participate in the financing and does not provide guarantees (**except those embedded in the conditions for compensation due to early termination, as explained above in section D.12)**.

The payment mechanism is not demand based.

In relation to refinancing, Art. 14.3 states that the Partner shall have the right to change the sources of financing, the amount of financing or the terms of financing set out in the Financial Business Model, provided that such a change … does not increase the liabilities and risks of the Public Entity.

The Lender/Funder does have step in rights, in case of default of the Partner, with no changes for the rights or liabilities of the Authority (Annex 10, Direct Agreement, Art. 7/Novation).

In the contract examined, Eurostat did not detect any of the "Financing arrangements" features influencing the statistical treatment of the contract described in the PPP Guide, Theme 14, pages 119-129.

However, the formula for determining the compensation that the Authority has to pay in case of early termination due to Partner's fault does include an implicit government

guarantee of the senior funder debt, which has implications for the statistical treatment of the contract (see previous section D.12).

D.15 Government influence

In the PPP contract examined, the Authority has no share in the ownership of the Partner, and no entitlement to any part of Partner's profits or revenue.

In the contract examined, Eurostat did not detect any of the "*Government influence*" features relevant for the statistical treatment of the contract that are described in the PPP Guide, Theme 15, pages 130-134.

E. Conclusions and Eurostat's view

The Lithuanian statistical authorities did not highlight, in their analysis of this contract, any issue of relevance for its statistical treatment. However, Eurostat identified one issue that, by itself, requires the recording of this PPP contract on the balance sheet of government.

As it is analysed in section D.12 of this advice, the contractual provisions base the compensation payable by the Authority in case of early termination due to Partner's fault on the senior debt outstanding, which according to the PPP Guide is akin to a financing guarantee from government. In particular, the contract foresees, for a number of years, an implicit government's commitment of financing 50% or more of the capital expenditure incurred. This implies that the PPP is automatically recorded ON BALANCE SHEET of government (see PPP Guide, Theme 12, pages 107-108).

After analysing thoroughly the documentation provided, Eurostat view is that the Partnership Agreement subject to this consultation must be recorded on the balance sheet of general government. The gross fixed capital formation expenditure and the related flows, including debt are to be recorded in the accounts of general government.

F. 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.

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