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Directorate D Government Finance Statistics (GFS)

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Statistics Lithuania
National Accounts Department
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Subject: Request for an ex-post advice concerning the statistical treatment of a PPP project for the construction of police headquarters buildings in the town of Siauliai

Ref.: Your letter of 6 March 2023

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 6 March 2023, 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 the police headquarters buildings at Purienu St.48, in the town of Siauliai.

The Police Department under the Ministry of the Interior (from now on the Authority) and a private party (the Partner) signed the partnership agreement on 28 December 2022. The contract foresees the design and construction of the police headquarters building in Siauliai District. The construction of the centre will be finished within three years following the date of the signature, with a planned capital investment of 10.166.934 Euros (excluding VAT), according to the Financial Business Model (sheet Infrastruk sukurimo sanaudos). According to the planning, the infrastructure should be operational by June 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 18.121.200 Euros over the 12 years of the contract (sum of the annual real remunerations, as defined in Annex 3, Appendix 1 to the Agreement, excluding VAT), 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. The asset (headquarter buildings) 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 PPP contract, the Lithuanian statistical authorities concluded that this project should be recorded off the balance sheet of government.

Some Annexes relevant for the statistical analysis were missing in the request for advice, among them the Financial Business Model, which was later provided by the Lithuanian statistical authorities.

After analysing all the documentation provided, Eurostat had some questions, all swiftly answered by the Lithuanian statistical authorities and Central Project Management Agency.

C. Documentation provided

The following are the various documents related to this contract, as listed in the Partnership Agreement:

- Partnership Agreement
- 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 Associated Companies (Annex 6)
- Pre-conditions for entry into force of the Agreement (Annex 8)
- Direct agreement between the Public entity, PPP Partner and Funder (Annex 9)
- Assets lifetime (Annex 10)
- Assessment and acceptance of works (Annex 11)

Eurostat received an English translation all the above documents, with the exception of the Financial Business Model provided only in Lithuanian.

Eurostat did not receive Annexes 1 (Procurement Conditions), Annex 2 (The Bid), and Annex 7 (Specifications). This opinion is valid insofar as these annexes do 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 Police Department under the Ministry of the Interior is obviously part of the general government sector.

The PPP Partner (Safe community) is a Special Purpose Vehicle (SPV) set up (incorporated on 12 December 2022) by the Investor (Investiciju uostas, also a SPV). Both SPVs were specifically created for the execution of this PPP project and are owned by Usaldusfond BaltCap Infrastructure Fund (the ultimate beneficiary), the largest private equity fund manager in the Baltic states. Investors to the fund are private persons and private companies. The Fund invests in many projects, not only in this PPP.

The Partner was selected after an open tender. The announcement of the public procurement procedure was published in the Centrinis viešųjų pirkimų portalas (Central Procurement Portal)[2]. Six bidders (private companies) were selected in the prequalification of tenderers phase, from which four passed to the final phase. The public procurement report is available[3].

The Police Department is labelled "the Public Authority" in the contract examined, and it will be labelled "the Authority" in this advice; the PPP Partner (Safe community) is labelled as "the Private Partner" 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 force for a maximum 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".

[1] https://www.eib.org/attachments/thematic/epec_eurostat_statistical_guide_en.pdf
[2] https://cvpp.eviesiejipirkimai.lt/Notice/Details/2020-653829
[3] https://cvpp.eviesiejipirkimai.lt/ReportsOrProtocol/Details/2023-635714?formTypeId=4

According to Annex 10 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).

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*****" features relevant for the statistical treatment of the contract that are described by the*** **PPP Guide*, 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, and cleaning (Art. 18.4).

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 be paid by the Partner. Supplement 4 to Annex 3 defines a "Correction 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*** **PPP Guide,** ***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 PPP Guide, the payment mechanism must allow for adjustments to the operational payments in case of unavailability or poor service performance.

According to the Agreement, if the new police headquarters cannot be used for the performance of its services, the Authority shall not pay the Annual Remuneration. The principle of zero availability-zero payment shall apply (Art. 23.8). In case of partial nonavailability of the asset, 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. 47.1 and Appendix 4).

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 includes figures for the Monthly Remuneration starting in January 2026, while Annex 3 include the figures for the Monthly Remuneration starting from June 2026. There is no certainty the construction works shall be completed by then. However, since the principle of zero availability-zero payment (Art. 23.8) 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, Ser. 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. 27).

In the contract examined, Eurostat did not detect any of the "*Other payment arrangements*" features relevant for the statistical treatment of the contract that are 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 22.1).

A well-defined list of force majeure circumstances is included in the PPP Agreement examined, none of them attributable to the Partner or related to macro-economic conditions (Art. 42.1).

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. 42.7).

In the contract examined, Eurostat did not detect any of the "**Relief and force Majeure*****" features relevant for the statistical treatment of the contract described by the** <u>**PPP Guide**</u>**, 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. 37). Among the listed cases: "In accordance with official requests (letters) from the European Union and/or the state authorities of Lithuanian **to ensure that the Contract is not recorded in the government balance shee**t" (Art. 37.2.4).

Additional works or services can only be initiated by the Authority (Art. 16.3). 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. 16.5).

In the contract examined, Eurostat did not detect any of the "**Changes to the PPP contract*****" features relevant for the statistical treatment of the contract described by the** <u>**PPP Guide,**</u> **Theme 7, pages 81-82.***

D.8 Changes in law

Art. 33.2.1 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. 22.1.1 and 22.1.2 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. 22.2). 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*** <u>**PPP Guide**</u>***, Theme 8.***

D.9 Insurance

The Partner is obliged to conclude insurance contracts at its own expense and risk, for its own benefit (Art. 33.1). Annex 5 lists all the compulsory insurance contracts, including one to insure the assets built for the maximum replacement value against all risks (Annex 5, Art 6).

In the contract examined, Eurostat did not detect any of the "**Insurance*****" features relevant for 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. 48.1 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 relevant for 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. 40 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 relevant for 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 43-46 of the examined PPP contract.

Art. 43 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 43.1 as follows:

NK = FI + FG + NA - D - K - AR – VN, where:
FI = the share of the financing provided by the Funder (in this specific contract a commercial 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;

K = remuneration not yet credited/recovered and penalties;
AR = renovation and repair works already paid by the Authority but not yet performed;
VN = the direct losses[4] incurred by the Authority as a result of the early termination, as agreed with the Partner.

Art 43.1 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 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 default 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 10.166.934 (50% of this is 5.083.467). The senior debt outstanding (the Funder's loan, "FI" in the formula above) at the end of the construction phase (the beginning of the 4th year) will be EUR 8.071.930, at the beginning of the 5th year it will be EUR 7.394.134, at the beginning of the 6th year it will be EUR 6.654.721, and at the beginning of the 7th year it will be EUR 5.915.307 (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 be progressively repaid. The same happens in case of explicit government financing guarantees.

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 the beginning of the 4th, 5th and 6th year into the contract, the amount that the government will have to pay will

[4] Art. 48.1 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 applied 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 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 relevant for 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 (Safe community) is responsible for rising the totality of the financing required for the project. Financing is provided in the form of equity and loan from the Investor (20%), and loan by a commercial bank (80%).

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. 15.3 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 9, Direct Agreement, Art. 7/Novation).

In the contract examined, Eurostat did not detect any of the "*Financing arrangements*" features relevant for 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 and do influence the statistical treatment. In particular, the contract foresees, for a number of years, a government 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