Recording of licence cancellations

Introduction

1. The aim of this GFS interpretation is to provide guidance on the recording of transactions in the context of cancellations of licences to use non-produced assets, in particular the cancellation of spectrum-use licences held by mobile phone corporations. Concretely, the issue is how to record any amounts due by the licence holder to government when licences are cancelled.

References in ESA 2010 and MGDD

Rent and Government proceeds from resource leases

2. Rent and its use for licence categories is mainly described in ESA 2010 paragraphs 3.186, 4.72, 4.75, 15.04, 15.23 and 15.27.
3. ESA 2010 paragraph 4.72 informs that "*rent is the income receivable by the owner of a natural resource for putting the natural resource at the disposal of another institutional unit. […] Resource rents on other natural resources such as radio spectra follow the same pattern. […] Rent is a payment made under a resource lease for access to a natural resource.*"
4. ESA 2010 paragraph 4.75 explains that the time of recording of rents (D.45) is "*in the period when payable*", i.e., on an accrual basis over the periods of the lease. The Manual on Government Deficit and Debt (MGDD), section 6.1.2.3 paragraph 11 further explains that "*In the case of one initial receipt, it is necessary to accrue it over the period of the contract and to record the prepayment as a financial advance liability (F.89) of government.*" The other accounts (AF.89) liability then reduces over time through transactions that are the counterpart of the rent (D.45) accrued.
5. MGDD, section 6.1.3, Box 1, paragraph 7 states: "*Government receipts are in any case to be recorded as rents [..]".*

Contracts, leases and licences

6. ESA 2010 paragraph 15.27 covers the case when the lease licence (for permits to use natural resource) is finite and transferrable, which leads, in addition to the D.45 to be recorded, to the *"creation of an asset for the user, distinct from the resource itself but where the value of the asset and the asset allowing use of it are linked. This asset (category AN.222) is only recognised if its value, the benefits to the holder in excess of the value accruing to the issuer, is realisable through transferring the asset."*[1]
7. ESA 2010 paragraph 7.55 provides the definition: *"Contracts, leases and licences are recorded as assets when the following conditions are met: (a) the terms of the contract, lease or licence specify a price for the use of an asset or provision of a service that differs from the prevailing market price; and (b) one party to the contract can realise the price difference. The contracts, leases and licences can be valued by taking market information from the transfers of the instruments conferring the rights, or estimated as the present value of expected future returns at the balance sheet date compared to the situation when the legal agreement starts."* And ESA 2010 paragraph 7.57 indicates: *"The value of the asset is equal to the net present value of the excess of the prevailing price over that fixed in the agreement. Other things being equal, this will decline as the period of the agreement expires. Changes in the value of the asset due to changes in the prevailing price are recorded as nominal holding gains and losses."*

[1] underlined is modified, correcting a typo in ESA 2010.

8. Thus, if the licence is not transferable, no underlying contract, leases and licences asset (AN.22) is recorded in the ESA 2010. When transferable, at time the transferrable rights are auctioned off, at market value, an AN.22 asset is created that will have zero value (all the proceeds exchanged being instead recorded within the financial accounts, under F.89).

9. The March 2017 guidance note on such licences[2] therefore concludes that, under ESA 2010, any upfront payment on (finite) lease/licence/permits is prepayment of rent and not a disposal of non-produced assets of the NP.2 type, irrespective of the duration or other characteristics of the lease/licence/permit; instead, an other accounts asset (AF.8) appears as an asset of the licensee and a liability of government.

10. As a result, at inception, the value of the underlying resources (e.g. the electromagnetic spectrum) are unchanged, despite being encumbered by a lease/permit/licence. However, as prices changes when time passes, the non-produced asset created starts gaining value (positive or negative), just like a swap gains value, later on, arising from changes in market prices. As a result, the value of the underlying resource, which changes following changes in prices, is subject to a correction (negative or positive, respectively) compared to its unencumbered value – such that the values of the underlying asset and of the permit are indeed linked.

11. The March 2017 guidance note indicates that this recording is applicable to all kinds of transferrable contracts/leases/permits/licences, irrespective of the underlying resource under contract: a produced asset (leading to an marketable operating lease asset, AN.221), a non-produced asset (contract, leases and licences asset, AN.222), no asset (i.e. for a permits to undertake specific activities, AN.223), or contracts of delivery of other goods and services (AN.224).

Payments of compensation

12. ESA 2010 paragraph 4.136 includes payments of compensation within the category other miscellaneous current transfers (D.759) and defines the transactions as consisting of *"current transfers paid by institutional units to other institutional units in compensation for injury to persons or damage to property, excluding payments of non-life insurance claims. Payments of compensation are compulsory payments awarded by a court of law, or voluntary payments agreed out of court. This heading covers voluntary payments made by government units or NPISHs in compensation for injuries or damage caused by natural disasters other than those classified as capital transfers."*

13. A distinction is made between the recording as other capital transfers (D.99) or other miscellaneous current transfers (D.759) according to whether the payment is *"major"* in nature or not. Indeed, ESA 2010 paragraph 4.165h, which explains a case where compensation can be to recorded as other capital transfers (D.99), states: *"major payments in compensation for damage or injuries not covered by insurance policies […] The payments are awarded by courts of law or settled out of court. Examples are payments of compensation for damage caused by major explosions, oil spillages, the side-effects of drugs, etc."*

Cancellation of debts

14. ESA 2010 paragraph 4.165 includes the following other capital transfer (D.99) transactions:

    "(f) the counterpart transaction of cancellation of debts by agreement between institutional units belonging to different sectors or subsectors (for example, the cancellation by the government of a debt owed to it by a foreign country; payments in fulfilment of guarantees which free defaulting debtors from their obligations) — except the particular case of taxes and social contributions payable to the general government sector (see point (j)). Such cancellations by mutual agreement are treated as a capital transfer from the creditor to the debtor equal to the value of the outstanding debt at the time of cancellation. Likewise the counterpart transaction of debt assumption, and of other similar transactions (activation of guarantees related to non-

[2] Guidance note on mobile phone licences, exploration rights and other licences, 27 March 2017

standardised guarantee schemes, or debt rescheduling where part of debt is extinguished or transferred), is another capital transfer …"

Discussion of the issue

Cancellation of licences

15. It is common that, upon granting a licence, government receives a lump sum, which in national accounts is recorded as an advance (AF.89L). When a licence is cancelled before its maturity, government may have to pay back part or all of the advance not yet used (i.e. covering future periods). Any such repayments will be in line with the conditions established within the original licence contract, covering obligations of both parties, consequences for any breaches of contract, etc.

16. An early termination with full compensation of the outstanding advance payment not yet used to the licence holder is simply a redemption of the government liability in other accounts payable (AF.89L) with, as counterpart, the means of payment (probably cash).

17. The cancellation of the licence may also involve no refund to the licence holder, or the refunded amount may be lower than the amount of the liability still outstanding. This difference between the liability and the government payment should be recorded as government revenue at time of cancellation, but clarity is needed on the transaction category.

Recording the difference between the government liability and the government payment

18. It has been argued that the difference between the liability and the government payment should be recorded as rent (D.45) revenue, based on the fact that the March 2017 guidance note[3] indicates in its paragraph 13: *"Under ESA 2010, any proceeds on a licence to lease a non-produced asset should be recorded as rent D.45"*. Furthermore, MGDD, 6.1.3 Box 1, paragraph 7 reads: *"Government receipts are in any case to be recorded as rents ..."*.

19. Recording this difference in D.45 seems to somewhat conflict with the accrual principle, as D.45 should accrue continuously. In addition, when considering similar cases where landlords keep the guaranteeing deposit due to damages or breaches of contracts, a similar approach would lead to an incorrect recording of output (P.1), which would distort the operating surplus of the period.

20. The D.45 recording does not recognise the compensation of damage that is implied when government does not fully refund the permit holder. Indeed, if the cancellation involved government paying additional amounts above the existing payable (possibly due to breach of contract on its side), a government expenditure would be required. This would be a transfer payment, but certainly not a D.45 transaction (as no negative D.45 revenue should be contemplated).

21. Finally, paragraph 13 of the March 2017 guidance note is dealing with proceeds on leasing, not with proceeds on cancellation. The guidance note explicitly covers termination in paragraph 28 and prescribes recording a revenue, but without detailing a category. Paragraph 13 of the guidance note was designed to deal with the fact that the standard proceeds on such permits are not transactions in non-financial non-produced assets (NP.2, related to the AN.22 type) but are instead accrued revenue (e.g. rent, D.45), to be spread over the duration of the contract. Paragraph 13 was not intended to address the specific case when licences are terminated.

Payments of compensation by license holders or debt cancellation

22. The two candidates for the appropriate recording of government revenue were other miscellaneous current transfers (D.759) and other capital transfers (D.99).

23. Compensation payments are usually recorded in national accounts either as other capital

[3] Guidance note on mobile phone licences, exploration rights and other licences, 27 March 2017

transfers (D.99, ESA 2010 paragraph 4.165h) or payments of compensation (within D.759, ESA 2010 paragraph 4.136), depending on whether the payments are major or not. Compensation through a capital transfer gives an identical recording solution as debt liability cancellations (both recorded as other capital transfers, D.99).

24. Arguments in favour of recording a payment of compensation (within D.759 or D.99) – the prevailing view of the GFS TF – rather than debt cancellation were:

    a. An intention by the creditor of cancelling the claim against government (in other accounts, AF.89L) is missing; i.e. there is no intention of the permit holder to convey a benefit to government. The prevailing motive for the transaction is an inability of the license holder to fulfil its contractual obligation, rather than any considerations to provide a benefit to government.

    b. The licence holder defaulting on its obligations results in a contractual obligation to compensate government, which is evidenced when termination of the licence occurs without (full or partial) refund of the pre-payment. The default is likely because the license holder failed to perform contractual obligations. The payment is thus similar to a penalty.

    c. It is expected that contracts involve compensation payments depending on who was at fault, so that if the holder is not being fully compensated, it implies it is at fault (least partially at) for the termination of the contract and hence it would be viewed that government is being compensated.

    d. Debt cancellations decisions usually involve the creditor (asset holder) cancelling the liability, whereas here the decision is made by the debtor (liability issuer, here government). Here, the creditor lacks discretion to cancel the liability. Typically, debt cancellations are characterised by the debtor being unable or unwilling to service its debt, and the creditor then deciding to cancel the liability. Without an agreement by the creditor, no debt cancellation can be recorded. Typically, such a cancellation agreement is not foreseen in the original contract establishing the debt.

25. Arguments in favour of recording the payment of compensation as an other capital transfer (D.99) – rather than a current transfer – were:

    a. The event is major, exceptional, unexpected and non-recurring and the amounts involved are likely to be significant.

    b. By analogy with the recording of calls on guarantees, such expenditure is described in ESA 2010 paragraph 4.165f, within other capital transfers (D.99), and no recording as a current transfer (D.7) is currently foreseen. Such activations of guarantees could alternatively also be seen as a payment of compensation within ESA 2010 paragraph 4.165h, as the guarantor effectively compensates a creditor for a default.

26. In summary, the majority of the GFS TF favoured recording the (implicit) payments of compensation as an other capital transfer (D.99), the government revenue amounts being seen as a compensation payment from the former licence holder for a large/irregular amount, in line with ESA 2010 paragraph 4.165h.

Conclusions on the recording in government finance statistics

27. This GFS interpretation licence prescribes that the difference between rent pre-paid and refunded in the event of a licence cancellation is recorded as an other capital transfer revenue (D.99) for government, as a major payment of compensation.

Illustration/ T-accounts

Government terminates a licence. The former licence holder had previously pre-paid rent and the amount outstanding at the time of the cancellation is 800. Government refunds the former licence holder 600 in cash, which reduces the AF.89 liability by 600 (shown in blue font). The remaining 200 is recorded as a D.99 capital transfer revenue for compensation, counterparted by eliminating the remaining AF.89 liability (shown in red font). The aggregate is an F.89 transaction of -800.

Opening balance sheet

S.13				S.11 (licence holder)			
Assets		Liabilities		Assets		Liabilities	
		AF.89	800	AF.89	800		

Transactions

S.13				S.11 (licence holder)			
Uses/Assets		Resources/Liabilities		Uses/Assets		Resources/Liabilities	
		D.99	200	D.99	200		
B.9/B9f	200			B.9/B9f	-200		
F.2	-600			F.2	600		
		F.89	-600-200			F.89	-600-200