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**Subject: Ex-ante advice on the statistical treatment of the PPP project
Court infrastructure**

Ref: Your email of 6 June 2014

Dear Ms Lapenienė,

Thank you for the note asking for the ex-ante request for advice on the proper statistical recording of the Public-Private partnership (PPP) project “*Design, construction and maintenance of the infrastructure of Courts operating in Vilnius city*” (further PPP Court infrastructure).

After careful examination of the issue by Eurostat, I am in a position to provide an opinion on the appropriate statistical recording of the aforementioned PPP project.

The case

The issue for which an opinion is being sought is a determination of the correct sector classification in national accounts/EDP of assets and underlying financial flows of a PPP contract covering the design, construction and maintenance of the infrastructure of several Courts.

Documentation provided

The Lithuanian authorities provided to Eurostat the contract including all the annexes. The Lithuanian statistical authorities also provided an analysis of the distribution of risk in this PPP project.

Description of the case

The PPP Court Infrastructure involves design, construction and maintenance of the infrastructure of three Courts operating in Vilnius city: the Supreme Court, the Court of Appeal and Vilnius County Court. The duration of the PPP project is 20 years, out of this period, 28 months are foreseen for the construction phase.

The project has not been signed yet. In the analysis, provided by the Lithuanian statistical authorities, it is mentioned that the foreseen construction costs amount to 59 million LTL. The total value of the contract was not provided. The public partner in the contract will be the National Court Administration. The private partner is not known yet, although from the text of the contract it is evident that a special purpose company (SPC) will be created for this purpose. The project presumably will be financed by bank loans and equity and/or subordinated loans from the entities that established a SPC.

Methodological analysis and clarification by Eurostat

Applicable accounting rules

The Eurostat Manual on Government Deficit and Debt (MGDD) part VI Leases, licences and concessions is applicable in this case. In particular Part VI.4 Public-Private partnership (PPPs) is relevant for the analysis.

Availability of national accounting analysis

In their analysis, the Lithuanian statistical authorities considered that the assets of the PPP should be classified outside the general government balance sheet due to the fact that the construction and availability risks are borne by the private partner, whereas the analysis of the demand risk is not relevant in this PPP project.

The Lithuanian statistical authorities explain that government is not providing guarantees to the financing of the project. There are no payments from government to the Private party during the construction phase. As for the availability risk, the Lithuanian statistical authorities stated in that the introduced penalties are automatic and having the significant effect on the results of the partner. The analysis of the Lithuanian statistical authorities explains that the availability fee is constructed from the four different elements and some of them might be changed during the period of the contract either due to indexation, due to improved financing conditions or due to so called price benchmarking.

Analysis

The Lithuanian authorities confirmed that there will be no payments from government during construction, and that government is not providing guarantees. Payments will start only after the construction phase, after the construction completion certificate is issued.

During the operational phase, there will be payments for Court complex availability and no demand fees are foreseen. Eurostat agrees with the Lithuanian statistical authorities that the demand risk analysis is not relevant in this PPP project.

Availability risk

For the availability risk, Eurostat takes note that, during the operational phase, there will be an annual availability fee paid in monthly instalments. Eurostat understands that the availability fee is constructed from four elements M1-M4. The parts M3 (service provision costs) and M4 (Administration and management costs) will be indexed every 12 months according to the consumer price index. In addition, article 61 of the Agreement, as well as part VIII of the annex 3, foresee so called *market testing /benchmarking procedure*: the private entity's obligation to establish regularly (after 2, 7, 12 and 15 years) a prevailing market price for respective services; if the exercise shows that the market price is lower than 95% of or higher than 105% of the price agreed in the contract, the annual availability fee (more specifically M3 part) will be changed. Eurostat considers that the existence of this service price resetting mechanism is a strong indication that the private partner is not bearing full risks. The normal practice in long term contracts would be to index the payments according to inflation. The upwards or downwards movements of service market price during the contract period are economic risks that the private partner is expected to take into account while negotiating the contract.

Furthermore the MGDD part VI.4.4.2 paragraph 81 reads: "*government payments must depend on the effective degree of availability ensured by the partner during a given period of time*". The MGDD further lists the cases when the private partner could be excused for non-performance: *major policy change, additional specifications by government, or force majeure*.

It seems that in the analysed PPP contract there are a wide range of events that would not invoke partner's full responsibility in case of non-performance. One of those is *Relief events* (article 71) that might be activated on the occurrence of the so called "*unforeseen essential events*". The definition of *unforeseen essential events* provided in the contract is rather vague and could in fact include any movement market. Eurostat believes that so called "*unforeseen essential events*" should be seen as a macroeconomic risk and occurrences of such events should be taken into account in the price negotiations.

Another clause in the contract that might be seen as a possibility to change the availability fee agreed in the contract is so called "variation" procedure. Eurostat understands that the public entity might change the requirements to the project, thus causing additional costs to the partner or disturbance in the provision of services. This falls within the case of "additional specifications by government" as foreseen in the MGDD. However the annex 13 of the contract foresees the right also for the private partner to initiate the variation procedure and, as a consequence, the annual availability fee might be changed. It is not very clear in what cases this procedure might be started, but it is rather unusual that the private partner may have the right to change requirements to which he has committed in the contract.

The article 34 of the draft contract mentions so called *temporary assignment of fulfilment of Private entities responsibilities* in cases of "*extraordinary circumstances*". In case the service would be rendered by some other economic operator, the Private entity will not provide any service, still, according to the contract, the latter will be still entitled to receive payments (with some deductions). Thus the partner who is not in a position to perform its obligations still gets remuneration.

In addition Eurostat would like to express concerns on the force majeure clauses, established in the contract. Article 72.1 of the draft contract gives only examples of what could be considered as a force majeure. The MGDD part VI.4.4.2. paragraph 87 explains what should be normally included in the force majeure clauses: “*a precise list, excluding any “macroeconomic” risks normally borne by economic agents*”.

Regarding the refinancing costs, the current text of the draft agreement foresees that in case financing conditions would improve, benefits will be shared by the parties by splitting them into two equal parts. As this PPP project has not been signed yet, Eurostat would like to draw the attention of the Lithuanian statistical authorities to the fact that the refinancing clauses were extensively discussed in the Task Force for the MGDD update and therefore some new rules will be adopted in the forthcoming MGDD version.

Penalty mechanism

The MGDD VI.4.4.2 paragraph 83 reads: “the existence of marginal penalties would be evidence by a reduction in government payment far less than proportional to the amount of services not provided, and such a situation would be contrary to the basic philosophy of a significant transfer of risks to the partner”. The Lithuanian statistical authorities indicated in their analysis that the penalties foreseen in the contract are automatic and there are no limits defined. Eurostat cannot agree with this conclusion, as in several places of the agreement there are clauses putting a limit on the penalty.

Article 58.5 of the draft agreement reads: “Any deductions from the Annual consideration payable to the Private Entity shall not exceed the amount required to ensure the payment of the respective part of the Annual Consideration to be used to return the financing provided by the Financier (M1) to the private entity”. To Eurostat’s understanding this article exactly sets the limit to the penalties.

In addition, the part IX of the Annex 3 specifies further, that in case of Relief event, if the partner is not delivering service, the deductions applicable should not go beyond part M3 of the availability fee. Eurostat considers that the latter clause is contradicting the main principle of the availability risk: no availability, no payment (the entity will still receive M1, M2 and M4 parts). The same applies in the situation of *temporary assignment of fulfilment of Private entities responsibilities* in cases of “*extraordinary circumstances*”.

Termination clauses

The Lithuanian statistical authorities in their analysis explain that in case of private partner default, the private partner is penalised and also he loses its profit.

The MGDD part VI.4.3.4. article 52 explains the termination clauses in case of partner’s default: “if the default takes place during the operating phase, the contract should explicitly mention the compensation due to the partner, if any, at the time government takes over the asset from the partner, should not exceed the current market value of the asset (taking into account the likely cost required to bring the asset to an adequate condition), as reliable estimate by independent experts.”

The Article 77.1 of the draft agreement introduces the formula of compensation. The formula is based on the financing, repayment of financing, shareholders' investment return rate, and other, but it does not relate to the current market value, as described above. The draft agreement also foresees (Article 77.1) that overall compensation for termination of the agreement "*must never be lower than 90% of the financing granted by the Financier and not yet repaid upon termination.*" This limit is a clear indication that the private partner is not bearing full risk associated with its performance and asset availability.

Eurostat considers that on the basis of the different points of the analysis above, the transfer of availability risk in this PPP contract to the partner is insufficient.

In this context, Eurostat is of the opinion that the assets constructed by this project should be considered as assets of general government. Thus the costs of constructing the assets must be treated as gross fixed capital formation expenditure of government during the construction period, with an impact on the government deficit, and as a counterpart, a loan granted by the private partner to government is to be recorded, resulting in an increase in government debt.

Conclusion

On the basis of the above considerations, in particular that the availability fee could be increased not only due to explicit government decision/actions but also due to a wide range of other factors, Eurostat is of the opinion that the PPP assets of the contract 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.

This preliminary view of Eurostat is based on the information provided by the country 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. To this end Eurostat would request to be informed of the final details of the operation (contract and accompanying papers where relevant) when they are available, or (should this be the case) information that the planned operation has been abandoned.

In this context, we would like to remind you that Eurostat is committed to adopting 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/ex-post advice which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat intends, therefore, to publish all official methodological advice (ex-ante and ex-post) given to Member States, on the Eurostat web site. In case you have objections concerning this specific case, we would appreciate if you let us know. In any case (regardless of whether you have objections or not) we would like to receive an answer from you on the issue no later than *22 July 2014*.

Yours sincerely,

(eSigned)
Eduardo Barredo Capelot
Director