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Directorate D: Government Finance Statistics (GFS) and quality

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Ms Vilija Lapenienė
Director General
Statistics Lithuania
29 Gedimino Ave.
LT – 01500 Vilnius
Lithuania

Subject: **Statistical treatment of the PPP project Palanga bypass**

Ref: your letter of 7 February 2014 No SD-148 - Ares(2014)299142
your letter of 6 December 2013 No SD-1168 - Ares(2013)3654516
our letter of 22 January 2014 - Ares(2014)137738
our letter of 18 November 2013 - Ares(2013)3508806

Dear Ms Lapeniene,

Thank you for the information which was provided to us by the Lithuanian statistical authorities on the aforementioned Public-Private partnership (PPP) project. After careful examination of the issue by Eurostat, I am in a position to provide an opinion on the appropriate statistical recording of the PPP project "*Palanga bypass construction and maintenance*" (further PPP Palanga bypass).

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 construction and operation of an 8.25 km road bypassing the city of Palanga.

Documentation provided

The Lithuanian authorities provided to Eurostat the contract including all the annexes. Additional documentation on traffic flow simulation was also provided upon Eurostat's request. The Lithuanian statistical authorities also provided a detailed analysis of the distribution of risk in this PPP project. The Lithuanian statistical authorities also asked for advice on how to interpret and apply the PPP related rules foreseen in the Eurostat Manual on Government Deficit and Debt (MGDD) Part VI.5.

Commission européenne, 2920 Luxembourg, LUXEMBOURG - Tel. +352 43011
Office: BECH F4/933 - Tel. direct line +352 4301-36850 - Fax +352 4301-35199

http://epp.eurostat.ec.europa.eu
laurs.norlund@ec.europa.eu

Description of the case

The PPP Palanga bypass involves construction and maintenance of an 8.25 km road. The construction phase will last two years and, after it, the private partner will operate the road for 23 years. The project has been signed in April 2013. Currently, the planning and programming stage is on-going. The contract has been signed by the Road administration under the Ministry of Transport and by a special purpose company "Palangos aplinkelis" that was created for the implementation of this PPP project. The SPC is owned by the JSC "Plėtros investicijos", which is owned by two private construction companies.

In the contract it is foreseen that the construction will cost 37 million LTL, while the total contract value is 125 million LTL. The PPP Palanga bypass will be mainly financed by a Bank loan, 22% of the construction costs will be covered by the SPC – 11% by a subordinated loan from the construction companies and 11% from equity.

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.5 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 could 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 demand risk is covered by government.

The Lithuanian statistical authorities acknowledged that a specific right for the private partner to ask compensation, once the traffic on the road exceeds foreseen limits, is foreseen in the Addendum 1 to the Risk distribution matrix. Nevertheless, the probability of such an increase of traffic is extremely low, as all the calculations of the possible future traffic were done following the EC Traffic prognosis and national Rules on the Road standardised Pavements Construction Design. In addition The Lithuanian statistical authorities argue the traffic increase risk scenario analysis showed that even in the pessimistic scenario the traffic load would not go beyond the limits established for this particular road pavement class. Taking into account the above considerations, the Lithuanian statistical authorities conclude that the private partner is taking over the majority of the availability risk.

Analysis

The Lithuanian authorities confirmed that there will be no payments from government during construction, government is not providing guarantees. If the construction will last longer than foreseen, the contract will not be prolonged, the costs of the period of the delay will be a loss of the private partner. Payments will start after the construction phase, after the construction completion act is signed and the object is registered in the State register. During the operation phase, there will be payments for road availability, no demand fees are foreseen. Eurostat agrees with the Lithuanian statistical authorities that the demand risk is borne by government and that the construction risk is borne by the private partner.

The Lithuanian statistical authorities are asking clarification of the MGDD part VI.5.3.2, paragraph 36, whether the demand risk should be at all analysed in the PPP projects where only the availability fee is foreseen. Eurostat takes note that according to paragraph 36 "*demand risk should not be applicable*", in cases when "*the final user has no free choice as regards the service provided by the partner*", an example could be a prison. In a PPP concerning the construction of a road, it is likely that the road users will have a choice between which road to use. It cannot be concluded that the demand risk is not applicable; nevertheless, in case of the PPP Palanga bypass project, where there are no periodic payments from government to a private partner relating to the use of the asset (volume/actual traffic) but according to quantitative and qualitative performance, it is rather evident that the private partner is not bearing the demand risk. If a road that is built in the PPP project for some reasons will not be used by the final user, this is a risk of the public partner, and this risk, however, cannot be monetarily evaluated.

For the availability risk, Eurostat takes note that, during the operation phase, there will be an annual availability fee paid in monthly instalments.

Eurostat also takes note of the existence in the contract of an addendum to the Risk distribution matrix. The addendum foresees that in case of "*increase in traffic due to urbanistic expansion of the surrounding territories and other causes*" the annual availability fee could be renegotiated. From the information made available to Eurostat, it seems that no automatic compensation under these conditions are foreseen, no amounts are specified neither in the contract itself, nor in the addendum to the risk distribution matrix, nevertheless the terms of the contract would be renegotiated and additional compensation agreed for the private partner to cover the increase in the annual maintenance costs.

The MGDD part VI.5.4.2, paragraph 81 foresees that the partner should be able to meet the quality standards reflected in performance indicators with the remuneration that is agreed in the contract. There are only a few cases when the private partner could seek compensation for unforeseen increase in costs, related to "external causes": "*major policy change, additional specifications by government, or "force majeure" events*". Eurostat considers that it is a normal practice in PPPs that, before signing a contract, the private partner should determine whether or not the potential risks are outweighed by the benefits. Thus, if a private partner undertakes construction and operation of a road under certain technical specifications, he considers the requirements adequate and implementable. The possible increases in traffic causing deterioration of the condition of a road and more costly, or more frequent, maintenance should be taken into account before the application for a tender. The only exception foreseen in the MGDD, as mentioned above, is the force majeure and the explicit government actions over the life of the contract. Seemingly, these specific condition do not seem applicable to the case of Palanga bypass project, as the private partner retains a possibility to renegotiate the contract basically in case of *any* event causing substantial increase in traffic, irrespective of force majeure and deliberate government actions.

Moreover, Eurostat considers that the presence of this particular formulation in the Addendum proves that the risk of traffic increase exists. It should be stressed that when deciding on the distribution of risks in a PPP project, the probability that a particular risk materializes is not the important element but rather the existence of the particular risk and which party takes this risk.

Presumably the private partner's agreement to take the risk of traffic flow increase in the initial negotiations would imply higher overall contract price for government.

The Lithuanian statistical authorities reason that due to a low probability that the traffic might go beyond the foreseen limits, the public partner takes over just a small "fraction" of the availability risk. This leads to the conclusion that the private partner is bearing the majority of risks, as foreseen in the MGDD part VI.5.4.2, paragraph 39. Eurostat believes that this paragraph should not be interpreted by itself but rather in the context of the whole part VI.5.3.2. This is also mentioned in the para 39: "*the analysis of the risks borne by each party must assess which party is bearing the majority of the risk in each of the categories, under the conditions mentioned above…*" Paragraph 30 clearly states that, in theory, all risks should be transferred, nevertheless, in reality, sharing of risks between the partners is observable. The text further specifies what is meant by sharing: "*it may be seen as normal that some risks are taken by government (for instance in the case of very exceptional events or for government action that change the conditions of activity that were agreed previously)*". Thus the reading of paragraph 39 should be that almost all risks should be taken by the private partner, with exception of those risks that fall beyond the private partner control and are unforeseeable at the time of the contract; examples of such risks could be legal disputes, archaeological discoveries, findings of polluted arrears, etc. In addition, in frequent cases of such events which do not depend on the management/competence of the partner, the responsibility of government could be assessed if it has not carried out the whole due diligence related to such risk before the signature of the contract.

Eurostat considers that the usage of the term "additional specifications by government" needs further clarification. In the MGDD part VI.5.4.2, paragraph 86 refers to a compensation that could be paid to the private partner once government asks for changes or additions to the originally agreed asset specifications. In case of a road PPP, this could for example be an explicit requirement for a new traffic lane or a higher road class. The Lithuanian statistical authorities in their analysis raise questions on the notion of "an obvious government action". Their view is that in the case of a road PPP, the public partner has always a right to divert traffic elsewhere (e.g. heavy traffic), so that the designed road load would not be reached. The non-execution of this right is seen by the Lithuanian statistical authorities as a "government action" and as such allowing a private partner to ask for compensation. Eurostat confirms that, in the example of a school PPP, as mentioned in the letter from the Lithuanian statistical authorities, it is a government decision how many pupils will attend the school. On the contrary, in a road PPP project there might be no direct/obvious link between the government action and the increase in traffic. The MGDD part VI.5.4.2, paragraph 86 gives the following examples of what is considered as "obvious government actions": "*decisions by government that represent a significant policy change or such as the development of directly competing infrastructure built under government mandate*". Eurostat would like to stress that the above formulation of the MGDD refers to a government action and not to a non-action (in LT example, non-execution of the right for traffic diversion). It is clear that a government action may contribute to creating an environment that enables new businesses, new urban developments, etc., nevertheless, the "obvious government action" should not be abstract but rather having a direct link/relevance to the PPP asset.

On the basis of the above, Eurostat cannot agree with the Lithuanian authorities that the availability risk is taken by the private partner.

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.

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. Eurostat is therefore publishing 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 25 April 2014.

Yours sincerely,

(eSigned)

Laurs Nørlund
Director