

Directorate C: National and European Accounts

Luxembourg, **02-08-2011**
ESTAT/C-3/FL/LA/VK/mg D(2011) 917541

Ms Adriana Ciucea
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Subject: Treatment of the infrastructure investment projects, ex-ante case

Ref.: Your letter dated 01 February 2011

Dear Ms Ciucea,

Following your letter of 1 February 2011, I am in a position to give you Eurostat's preliminary view on the statistical treatment of the foreseen investment projects.

The accounting issue for which a clarification is requested

The ex-ante issue for which an advice is being sought concerns the treatment of the foreseen investment projects in the context of the National Infrastructure Development Programme. In particular, it should be clarified what is the appropriate time of recording of government expenditure relating to the acquisition of the assets, and whether there is any impact on the government debt.

Documentation provided

The Romanian statistical authorities provided a brief description of the case and a proposed treatment in national accounts. In addition, the Romanian authorities provided the related legal act, the Emergency Ordinance No 105/2010 of 22 November 2010 (EO), in Romanian and in English.

At the request of Eurostat, the Romanian authorities have also provided clarification on some points in July 2011.

Description of the case

According to the Emergency Ordinance No 105/2010 (EO), six projects will be launched by the Romanian government for the period 2011-2020. The projects will be focused on modernization and renovation of local roads and villages, and the establishing of an integrated water supply and sewerage and sewage system in accordance with the European standards.

The performance and the initial financing of the related construction activities will be under the responsibility of numerous non-government partners who will enter into a contract with government. It is understood that these contracts will not have features of PPPs.

Only contractors providing a letter of comfort issued by a bank will be accepted by government for undertaking the relating tasks. It is understood that the letter of comfort will indicate a willingness of the bank to support the contractor with a loan covering the financing of the project until a final acceptance is issued by government and payments from government are collected. As it is stipulated in the EO, the related borrowing of the contractors could be the subject of government guarantees. The Romanian authorities confirmed that the investments will be initially financed only by contractors via loans from commercial banks (and not from government).

According to the documentation provided, the construction of individual projects will be launched in 2011-2014, while cash payments by government will be made during the period 2013-2010. The amounts involved are significant (the total investment value is almost 4% of GDP). Each construction phase should be concluded by a quality acceptance which will be issued by a third independent party and may refer to partially or to fully completed investment (partial and final acceptance). It is understood that the issuance of such a quality certificate would be a basic condition for the purchasing of the assets by government.

In case the construction is completed before the planned delivery date established in the EO, and the partial quality acceptance is issued, the asset would allegedly remain the property of the contractor who would exploit it in its own name and may provide the involved assets to users (local government units) until a final acceptance is available. However, already at this stage, dates for future government payments for acquisition of the assets will be specified.

After the final acceptance is issued, the related payments will be made by government (the Ministry of Development and the Ministry of Environment) to the contractor (service provider) according to the payment schedule stipulated in the EO. It seems that the payments will be provided by government, on behalf of the service providers, directly to the banks, reducing the contractors' debt towards them.

It is also understood that in case there are any deviations in terms of the contracted conditions, e.g. the assets do not comply with the requested standard or there are additional costs or the delivery is late, corresponding penalties will be charged to the contractor as specified in the final acceptance. The planned budgetary appropriations which will not be used by government in the corresponding year could be used in the following period within the limit relating to the total contractual value.

Methodological analysis and clarification by Eurostat

After an examination of the documents provided by the Romanian statistical institute (NSI), Eurostat has reached the following views.

Applicable accounting rules

The Council Regulation 2223/96 incorporates the national accounts concepts and definitions of the European System of Accounts (ESA95) in Community Legislation. In particular, §§ 1.57, 3.59, 3.112 and Annex 7.1, referring to the time of recording, are applicable. The third edition of Manual on Government Deficit and Debt (MGDD) provides further elements for interpreting the accounting rules of ESA95. Of particular relevance in this case is Part VII on debt related

transactions and guarantees and Part VI.4 on public infrastructure financed and exploited by corporations.

Availability of national accounting analysis

The view of the Romanian authorities is that the contractor will be the owner of the assets until the particular project is concluded and government starts making payments. Negative impact on the government deficit will be recorded in the year when the payments are made and the transfer of ownership from a contractor to the government takes place. In addition, the Romanian statistical authorities recognise a risk due to the foreseen issuance of government guarantee and the existence of the related budgetary appropriations, since this might lead to the recording of debt assumptions in national accounts.

Analysis

Eurostat bases its opinion on the available information concerning the foreseen infrastructure investment projects. There are two issues to be examined: (i) when government expenditure relating to the acquisition of the related assets is to be recorded and (ii) whether there should be an impact on government debt.

It is to be recalled that the national accounts principles (ESA95) imply that the accounting treatment of operations should reflect economic reality (nature of entities and their economic behaviour), and not legal or administrative criteria. In case of potential or apparent conflict between ESA95 provisions, national accounts decidedly give priority to substance over form.

Time of recording of government expenditure

ESA95 §1.57 reads: "*The system records flows on an accrual basis; that is, when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled. Thus, output is recorded when produced, not when paid for by a purchaser, and the sale of an asset is recorded when the asset changes hands, not when the corresponding payment is made*". According to ESA95 § 3.112, "*Gross fixed capital formation is recorded when the ownership of the fixed assets is transferred to the institutional unit that intends to use them in production.*"

However, ESA95 states specific provisions for the case of assets constructed over more than one accounting period, of which the accumulated value is treated as work-in-progress (ESA95 § 3.119b), which forms part of the inventories of the producer, *unless a contract of sale* has been agreed in advance.

In this respect, ESA95 § 3.59 reads: "*When a contract of sale is agreed in advance for the construction of a building or other structure extending over several accounting periods, the output produced each period is treated as being sold to the purchaser at the end of the period: i.e. in the purchaser's fixed capital formation rather than work-in-progress in the construction industry. In effect, the output produced is treated as being sold to the purchaser in stages as the latter takes legal possession of the output*".

In addition, ESA95 Annex 7.1 clearly states, as a matter of principle, that uncompleted buildings and structures are included in "other buildings and structures" (AN.1112), to the extent that the ultimate user is deemed to have taken an ownership by the existence of a contract of sale/purchase. The purchaser is deemed to be the economic owner of the realised part of such building and structures, even if, generally, these fixed assets may not be used before completion.

In the current case, the public infrastructure assets are subject to a contract of sale agreed in advance, given the lack of other potential purchasers and the special conditions associated (transfers of land, etc). These assets are immovable or they cannot be used for other purposes than those designed, unless there would be significant costs for transformation.

In addition, it has been specified that, in some cases, when the construction is completed before the planned delivery date, final users (local government units) could start using the completed parts of the assets before the final acceptance is issued. In this case, government would be charged to cover maintenance costs of the constructor (in addition to the future payments for the purchase of the assets), but the constructor would legally remain the owner of the assets. However, it seems that already at this stage, government would effectively take over the assets, which in this case cannot be considered as "incomplete" buildings or structures as mentioned in ESA95, and would *de facto* become an economic owner, if not yet the full legal owner.

The GFCF expenditure, recorded as mentioned above, will therefore have an impact on the government net lending/net borrowing. The counterpart entry in the financial account will be recorded as payable (F.7) of government, extinguished by the effective payments to the constructors which will take place later.

Under these conditions, Eurostat does not consider that government capital expenditure should be recorded only when a final acceptance is issued by a third independent party which would trigger the transfer of legal ownership of the assets (as well as the authorisation to use the cash available in budget appropriations), since it would not reflect the economic substance of the arrangement.

As far as the value of the assets to be recorded on an accrual approach are concerned (following the progress in works) with an impact as government gross fixed capital formation (GFCF) from the first year of construction, ESA95 § 3.52 recommends, in the absence of stage or milestone payments, to use a value estimated on the basis of "*costs to date, including a mark-up for operations surplus or mixed income*" for the buildings and structures acquired in an incomplete state. The final costs could in addition include penalties charged to the constructor for delays and insufficient quality, which will be determined only at the time when a *final* quality acceptance is issued.

Normally such information should be easily available, at least for contracts of rather significant amounts (for instance for those above of 50 mn lei). In the case of smaller contracts, for pragmatic reasons, the government GFCF could be imputed when government will actually start using the buildings or structures (or make them available for final users).

Impact on government debt

As stipulated in the EO, the contractors will finance the projects via external "*...non reimbursable and reimbursable funds, from the state budget, through the budgets of the line ministries, as well as from other legally created sources...*" In addition, according to this legal act, the borrowing contracted by contractors could be subject to government guarantees. Furthermore, the following is stated in the note provided by the Romanian authorities: "*Given the large value of investment projects, small number of constructors and therefore their limited ability to finance works, we consider that the repayment of loans to be contracted will be provided from the state budget on the account of works performed*".

As stipulated in the MGDD, guarantees are normally recorded as contingent liabilities not impacting government debt, unless they are called. Thus, normally there would be no impact on government debt before government would make payments to the constructor.

However, Eurostat agrees with the Romanian NSI that following the provision of guarantees by government, it would be necessary to check who should be considered as the real debtor: the partner responsible for the construction of the assets or government. If the government is recognised, at inception of the contract or in the context of further refinancing operations, as the real debtor according to the bookkeeping evidence of the bank, the debt should be considered as government debt, notably, when the banks would have no direct recourse on the constructor and the banks would effectively receive the payments directly from a government unit.

Open issues

Eurostat would like to receive more information on the conditions under which the banks would provide financing to the private contractors with an explicit government guarantee.

Conclusion

Based on the information provided by the Romanian authorities and on the above considerations, Eurostat's provisional position is that the expenditure relating to the acquisition of non-financial immovable assets, in the context of sale/purchase contracts, is to be recorded on an accrual basis (i.e. following the progress in construction) and are to be valued on the basis of the costs incurred by the constructor, independently of any certification, and not when the cash payment will be made.

Regarding a possible impact on the government debt, Eurostat's view is that it could appear only indirectly at the time of payments by the government, except if a close examination of the loan contracts between constructors and their creditors show an irrevocable commitment of the government units, whatever the amounts borrowed, to repay the debt incurred by the contractors; this could occur in case of provision of guarantees by government.

In addition, it is understood that the assets will be used (and maintained) by local authorities, which will be owners of the assets, such that the corresponding CFCF will be recorded at the level of this government sub-sector. As the payments will be made by the State Budget, for consistency reasons, intra-governmental transfers should be recorded between both central and local government sub-sectors at the time of payments by the State Budget.

Procedure

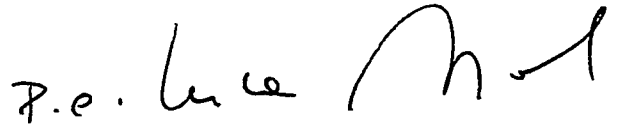
There is no explicit Community legislation which governs a procedure by which Eurostat gives its views on operations which have not yet been enforced. Nevertheless, Eurostat is prepared to give a preliminary view on the statistical classification of such operations provided that it is in possession of all of the necessary background information. The preliminary view is given in accordance with the guidelines for ex-ante advice published on the Eurostat web-site.

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 the amended

Council Regulation 479/2009 and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat intends, therefore, to publish all future 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 23 August 2011.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'F. Lequiller', with a large, stylized flourish at the end.

François Lequiller
Director