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EUROSTAT

Directorate C: National and European Accounts
Unit C-5: Validation of public accounts



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Mr L Verjus
President
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City Atrium C
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Subject: Demand for official advice on ESA95 registrations
Ref.: Your letter T/C2/2005/ 275 of 8 November 2005

Dear Mr Verjus,

Following your letter of 8th November I am in a position to reply to the questions you asked on the appropriate statistical classification for the two cases you have presented.

Procedure

There is no explicit Community legislation which governs a procedure by which Eurostat gives its views on operations which have not yet taken place. Nevertheless Eurostat is prepared to give a preliminary views on the statistical classification of such operations provided that it is in possession of all of the necessary background information and provided that it may reserve the right to reconsider its view on the operations if this information turns out to be incomplete, or the nature of the operations changes in some way.

In your letter you ask for Eurostat's view on hypothetical cases. In these circumstances Eurostat is prepared to enter into a dialogue on the applicable general accounting rules, as set out below, but would request you to send concrete proposals later with full accompanying background material.

Issue 1 - Alternative ways of financing investments in the social sector

1. The accounting issue for which a clarification is requested

Our understanding of the three proposed schemes is as follows:

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Hospitals and other old age outfits currently benefit in Belgium from an investment grant provided by government, of 60% of the amount invested (40% is to be funded by the unit itself). Those units that benefit from those capital transfers are classified in S.11, and the agency paying them is in S.1312.

There are three new alternative schemes envisaged, as described in the document submitted by you, to finance the same investment, other than an outright transfer payment of 60 (one assumes that an investment of 100 is foreseen and own resources provide 40):

(1) *Scheme 1*: government grants a zero interest rate 30-year bullet loan (say 100), with the requirement that a part (say 40) is set aside in a dedicated account that will be used, including accrued interest, to redeem the principal of 100 owed in 30 years.

(2) *Scheme 2*: the unit borrows from a bank (say 60) but (a) interest on the loans is paid by government and (b) the principal will be repaid from cash set aside in a dedicated account that is originally financed by a zero interest loan from government (say 40). This 40 plus accrued interest must repay the $100=40+60$ owed in 30 years.

(3) *Scheme 3*: the unit borrows from a bank (100), but government agrees irrevocably to pay 60% of debt service (interest and principal).

The government cash outflows at the outset of the schemes (60 under the current system) would therefore become: 100 in scheme 1, 40 in scheme 2, and 0 in scheme 3.

2. Methodological analysis and clarification by Eurostat

ESA95 directs that transactions be valued at a fair value, with ESA95 paragraph 5.136 recommending the partitioning of transactions when “the financial transaction is undertaken other than for purely commercial considerations”. It is also to be noted that SNA93 paragraph 3.80 explicitly recognizes that claims where the time gap on the payment is large (a trade credit in SNA93 paragraph 3.80) should be marked down, to allow the recognition of an interest component. ESA95 paragraph 6.51 also indicates the valuation rules of secondary transaction in loans.

Furthermore, the Manual on Government Debt and Deficit (MGDD: point 2.2 of section II.4.3) specifies that specifies that a government liability will be recorded if the law authorising issuance of the debt specifies the government’s obligation of repayment; the budget of the State specifies each year the amount of repayment; this debt...is systematically repaid by the State (interest and principal).

Eurostat’s preliminary views are as follows for each hypothetical option:

Scheme 1:

It is being asked whether the 100 originally paid is a financial transaction. While the financial character of the transaction is beyond dispute, because government acquires a claim, it appears that it is not a purely financial transaction. Instead it would seem that there is a "gift component" involved, as measured by the difference with the present value of the claim acquired. It seems that the recommendation set out in ESA95 paragraph 5.136 is relevant for this scheme. This points to the need to record a 60% capital transfer.

The amount set aside might be the observed quantitative element that may be used to partition the transaction.

The second part of your question on this option is not applicable, given the points above.

Scheme 2:

There are no direct references in ESA95 or SNA93 which specifically treat this case. Nevertheless, as noted above, the MGDD (point 2.2 of section II.4.3) does deal with cases where the government takes on responsibilities for repayment of principal and interest of debt issued by an enterprise. The application of this scheme would therefore most probably imply the recording of the part obtained from the bank (say 60%) as government debt, as the annual interest on principal is paid by government, and also considering that the principal will be repaid from the money provided by government set aside in a dedicated account. It would appear that the irrevocable commitment to pay all interest makes it a different type of scheme from a subsidy on interest scheme.

Under this condition, government is therefore seen to provide 100 in the form of a direct 0% interest loan of 40 and of on-lending of 60. This brings us back to scheme 1, with a need to partition the transaction for the measurement of the government deficit at inception.

Scheme 3:

In this case it seems that the lending should:

- a) either be split 60-40 government/non-government debt. The counterpart of the incurrence in liabilities (F.4) is a capital transfer (D.9) likely to be of an investment grant nature. The subsequent cash payments are in part financial transactions (redemption in F.4) and in part interest D.41, or;
- b) 100% attributed as government debt with as counterpart: 60 in D.9 and 40 in F.4 assets.

It would seem that the choice between a) or b) would depend on the detailed provisions of the contract between government and financed entity, which currently are not available to us.

I note that the three schemes treated as suggested then impact identically, or nearly identically, on government deficit and debt in each accounting period.

Concerning the question that you raise on point 2.2 of par II.4.3 of the MGDD (page 97), if all three conditions listed are met then the debt issued by the non-government entity must be considered as government debt. It is however not excluded in some circumstances (there are parallels for example in the "ISPA case", as described in the Eurostat decision of 23 May 2005) that not all of the three conditions need to be met for the debt issued by the non-government entity to be considered as government debt.

I wish to stress that these preliminary views of Eurostat are based on the information provided by you and your services on hypothetical cases. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the hypothetical cases, Eurostat reserves the right to reconsider its views. To this end I would be grateful if you could supply to me the final details of the operation (contract and accompanying papers where relevant) when they are available, or (should this be the case) inform me that the planned operation has been abandoned.

Issue 2 - Treatment of investments by a special purpose vehicle

1. The accounting issue for which a clarification is requested

Our understanding of your question is that the Government may wish to undertake a Private-Public Partnership with a special purpose vehicle (SPV) which would be (exactly or nearly) 100% owned by a Public Corporation (XYZ), which itself is 100% owned by government. The SPV will construct roads and receive a shadow toll from the Government based on traffic flow along the roads.

2. Methodological analysis by Eurostat

You quote several paragraphs of the Manual on Government Deficit and Debt (MGDD) and ask for clarifications. Given that the ESA95 and SNA93 do not provide explicit guidance in the area of PPPs (even if there is some guidance on classification of units – see below), it is appropriate that the clarification provided in the Eurostat Manual on Government Debt and Deficit is drawn upon. We believe that the following general principles would apply to the type of operation envisaged:

- The MGDD (Chapter IV, point 2.1) specifies that “There is no reason to move the PPP assets onto the government balance sheet for the motive that the corporation is public, as long as the public partner acts as a market unit (50% cost coverage criterion) and payments by government may be considered as sales (counterpart of the provision of services for the community).”
- Whilst the MGDD (Chapter IV, point 3.1) does specify that “In case of a 100% public-owned corporation, the fact that a contract with government is almost exclusively the source of its revenue would not imply a reclassification as government unit if it is evidenced that market-oriented payments (meaning of a similar kind to that observed between other market units) are made to the partner, and if government bears only risks that a commercial entity could not normally be expected to bear (very high political or security risks, for instance)”, we do not believe that this can be generalised to a conclusion that contradicts the clear statement in Chapter IV point 2.1 quoted above that there is no reason to move the PPP assets onto the government balance sheet for the motive that the corporation is public.
- The MGDD (Chapter IV, section 3.1) further specifies that “Complications arise when such a special unit, which is the government’s counterpart in the contract, is created directly by government. In this case it must be closely checked whether the unit can be considered as an independent institutional unit according to ESA95, and whether the unit is a true market producer. It could be a case of classifying it as an “ancillary” unit, notably by reference to SNA §4.40 to §4.44 (also implicitly in ESA95), such that it might be more appropriate to say that the fees paid by government are not sales receipts for a “real partner”, but just transfers within the general government sector.” This could be applicable in the case that a government issues instructions for the creation of an SPV and is worth investigating in this case (see below).
- The MGDD (Chapter I.1, point 5.4) specifies that “Payments from general government to public institutional units in respect of actual services provided are to be treated as corresponding to sales....when in the absence of private producers in the same kind of activity, the general government pays public units for actual

service....The price received from the general government is economically significant from the public producer's point of view if this public producer is only financed according to the volume of output it produces". It therefore appears clear that shadow tolls, providing they are fully related to volume of services delivered (i.e. the government does not provide a revenue guarantee by some means, whether through a revenue floor or a pre-planned price review), would be considered as sales for the purposes of assessing the 50% rule.

- Given the above, there is one issue where further reflection will be needed – the extent to which availability payments can be considered as sales for the purpose of assessing the 50% rule. Your specific questions relate to shadow tolls, however we noted that in the introduction that you mention the possibility of “une indemnité de mise à disposition fonction du nombre des véhicules, de la disponibilité...”. We would like to reserve our view on this matter until we see further details of what might be proposed.

Given that your letter does not provide details of the planned operation, we cannot provide a preliminary view at this stage. However we would urge your services to examine the following points carefully

i) the extent to which the SPV is created by government instruction. Were the Government to make a specific demand on XYZ to create the SPV, one might take the view that this government instruction is equivalent to government directly creating an SPV, and therefore that issues of control of government over main decisions of the SPV must be closely examined.

ii) the extent to which the SPV created can be considered as an institutional unit separate from XYZ, and, if it is not, whether “payments by government under this contract are a predominant part of the partner's revenue, such that for this public corporation this contract alone results in a significant change in the size or nature of its activities”. In the case where there is such a significant change in the size or activities of a consolidated XYZ+SPV unit, this would lead to moving the PPP assets onto the government's balance sheet.

iii) the basis for payment of the shadow tolls. Where these tolls are 100% related to traffic volume, then they can be considered as sales for the purpose of assessing the 50% rule. Any other restrictions on their payment (for example a revenue floor or a design of the pricing structure – including a pre-planned price review – which would lead to the SPV having at least part if not all of its revenue stream guaranteed) would call into doubt their treatment as sales for assessing the 50% rule (and would also call into doubt the transfer of demand risk as described in the MGDD Chapter IV). It would also be useful to check the practical arrangements to be made for measuring traffic volume to ensure that this will genuinely be the basis for payment.

iv) the allocation of the other risks described in the MGDD Chapter. Once the institutional aspects have been considered above, it is right and proper that all of the relevant rules of Chapter IV should be applied to the transaction.

I would therefore be grateful if you could investigate the above points further and supply me with the relevant details of the operations so that Eurostat may take a preliminary view on the specific operation.

Yours sincerely,



Maurs NØRLUND
Director