



EUROPEAN COMMISSION



EUROSTAT

Directorate C: National and European Accounts

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Ms Aija Zigure
President
Central Statistical Bureau of Latvia
Lacplesa Street 1
LV- 1301 Riga

Subject: Analysis of the proposal of recording the Dienvidu (South) Bridge construction and its financing in national accounts

Ref.: Your letter 0601-10/1657 dated 23 July 2007
Our letter dated 17 August 2007
Your letter 0601-10/1941 dated 31 August 2007-09-20
Your email dated 19 September 2007 from Vija Veidemane

Dear Ms Zigure,

We received your letter dated 31 August 2007 providing further information on the recording of the building of the Riga South Bridge and its financing scheme in national accounts, as well as additional information by an e-mail on 19 September 2007 on a proposed treatment in national accounts (T-accounts). These documents, among others, also include a presentation of Deutsche Bank on the financing scheme involved (EVF).

The accounting issue

The Latvian authorities seek the advice of Eurostat concerning the correct recording of the construction and financing of the Dienvidu (South) Bridge of Riga.

Description of the case

The Dienvidu (South) Bridge

The Dienvidu Bridge is to ensure the traffic flow between the south-western part of Pardaugava and the areas of the Riga right bank without crossing the city centre and thus reducing congestion. The bridge will also allow transit traffic to go around the city centre. The traffic capacity of the transit highway "Via Baltica" will also increase. The construction started in November 2004. The bridge is the largest construction project of its kind in the Baltic countries for the past 25 years.

The Enhanced Vendor Financing (EVF) scheme

According to the documents provided by the Latvian authorities and to the letter sent to Eurostat on 23 July 2007, the financing of the construction is done via a special "Enhanced Vendor Financing" (EVF) model, organised by Deutsche Bank (DB).

The special financing scheme EVF consists of three parts:

1. A procurement contract, which is a standard construction contract, with deferred payment terms, signed between the contractor and the City of Riga. The contractor's "performance" results in a trade credit payable by the City of Riga.
2. A contractor financing agreement between DB and the City, which ensures that DB makes a payment to the contractor when the contractor fulfils its requirements.
3. A swap contract element, comprising a currency or fixed-to-float interest rate swap, together with a credit default swap, whereby the credit risk (held by the bank on the contractor) is transferred to the City of Riga.

The amounts recorded in national accounts

According to the information that you provided in your letter dated 23 July 2007, the costs related to the construction of the South Bridge that have been incurred to date, and that are expected to be incurred in future, are as follows:

2004 – 0.68mn LVL
2005 – 10.76mn LVL
2006 – 34.37mn LVL
2007 – 54.45mn LVL
2008 – 33.19mn LVL
Total: 133.45mn LVL

In your letter dated 31 August 2007, you mention having recorded in national accounts, thus within the deficit reported in the April 2007 notification:

2004 – 0mn LVL
2005 – 8.2mn LVL
2006 – 29.95mn LVL.

Methodological analysis and clarification by Eurostat

Applicable accounting rules

The applicable accounting rules in this case are ESA 95 §3.59 (time of recording of output), and §3.112-3.116 (concerning the recording of gross fixed capital formation). The Eurostat advice to the request of the Italian National Institute of Statistics (ISTAT) about trade credits of Local Health Units, published on the Eurostat GFS website¹, can also be taken into account. ESA 95 §5.81 foresees that category AF.4 includes loans to finance trade credits.

¹ http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2373,47631380&_dad=portal&_schema=PORTAL

Availability of national accounting analysis

Aside from answers to Eurostat's questions made in the letter above, the Latvian authorities sent to Eurostat by e-mail on 19 September 2007 a proposed treatment of the transactions relating to the construction and financing of the Dienvidu Bridge.

Analysis

This section analyses the possible impact on general government deficit and debt in national accounts, starting with an analysis of the functioning of the Enhanced Vendor Financing (EVF) scheme.

The functioning of the EVF scheme

The scheme seems to be working as follows:

The Contractor building the bridge receives "*milestone*" payments from Deutsche Bank, while the City of Riga will pay regularly small and predetermined amounts over a long period to DB starting from 15 July 2010 to 15 June 2025 (actually routed via the contractor).

The City of Riga also enters in a swap deal, because it wishes fixing payments in euro whereas the contractor must be paid in lats. This is a currency (and interest rate) swap. Another element of the swap agreement signed seems to be a credit default swap (CDS). A CDS is a swap designed to transfer the credit exposure of fixed income products between parties. It is the most widely used credit derivative. It is an agreement between a protection buyer and a protection seller whereby the buyer pays a periodic fee in return for a contingent payment by the seller upon a credit event (such as a default or failure to pay) happening in the reference entity.

In this case, the CDS insures DB against the default risk of the contractor and thereby reduces the final cost to the City of Riga. It is understood that the bank acts as a protection buyer and Riga as a protection seller, whereby the bank pays a periodic fee in return for a contingent payment by Riga upon a credit event (such as a default or failure to pay) happening to the reference entity (the contractor).

It should be noted that the Deutsche Bank presentation of the scheme indicates that in the absence of any clause, Riga, *de facto*, would indirectly support the cost associated with the credit risk of the constructor, because the constructor builds into his selling price the higher interest rate charged by the Bank (see: "*Hence by agreeing to the purchasing price, the City will be paying for credit risk protection...*"). The using of a CDS thus allows Riga to, *de facto*, get rid of this credit risk cost, as if the bank had lent to Riga itself (see: "*Thus, the City would have an additional objective... to recoup the premium expense for credit risk protection.*" and "*...swap in which the credit risk in case of Contractor default is transferred to City.*"), cutting City of Riga overall procurement costs.

The consideration of the EVF scheme in national accounts

Given the above, the construction contract of the Bridge financed by the EVF is a mere modality of a normal public procurement for investment, with the consequence that an expenditure must be recognized in the accounts of the buyer (Riga), against the incurrance of a liability. In particular, the arrangement is in no way a PPP in the meaning of the Eurostat decision of 2004.

The character of the liability incurred, as debt or as payable, will depend on the analysis of the EVF scheme below.

Transactions impacting the deficit

Concerning the impact on the *deficit*, the government expenditure (Fixed capital formation – P.51) is not at time of annual payments by the City of Riga (to DB), but at time of construction: at time of milestone payments, or even earlier, in application of ESA 1995 §3.59. According to this paragraph: "...*the output produced is treated as being sold to the purchaser in stages as the latter takes legal possession of the output. When the contract calls for stage payments, the value of the output may often be approximated by the value of the stage payments made each period.*" Therefore, the impact on the deficit should be recorded when the milestone payments (which can be used as a proxy) are made, or even before.

The deficit as notified also includes accrued interest on the liability incurred.

We understand that the deficit notified in April 2007 indeed already included amounts for fixed capital formation on this project, although for lower amounts than those reported in the balance sheet of Riga. We also understand that you will enquire on the reasons for this difference, and that you will correct the reported deficit if necessary.

We also wonder how this impact of the fixed capital formation of Riga was incorporated in the notified deficit, given that you explained in your letter dated 31 August 2007: "*As it was explained before, the Riga City Council did not show correctly liabilities and investments in the balance sheets and budget reporting as well as in statistical reports.*"

Issues concerning the debt

Financial transactions arising from the special financing method of the construction can impact the debt of general government. The main issue here is whether the payables arising against the constructor are to be treated as trade credits or rather as loans.

Trade credits are not part of the Maastricht debt, unless they have the character of a loan, in which case they would be considered part of the Maastricht debt. See also the Eurostat advice to the request of ISTAT (Italian National Statistical Institute) about trade credits of Local Health Units published on the Eurostat GFS website.

If the financing had been supported by the constructor, a trade credit would likely be recorded. However, when a bank has *de facto* provided financing, it is questionable whether a trade credit or a loan should be recorded. Generally, trade credits would be *short-term financing instruments*, extended by constructors in favour of clients to cater for the time lag between delivery and payment settlements.

Moreover, by signing a credit default swap agreement, DB transfers the risk of project default, and to this extent, it seems that DB has a *de facto* loan agreement with Riga, not only after completion of the bridge, but also during the construction.

In this case, Deutsche Bank, by being the entity servicing the milestone payments instead of the City of Riga, seems to offer a loan to the City of Riga. The EVF scheme can thus be considered as a device whereby DB extends a loan to the City of Riga.

We understand that no government liability (Riga local government) was recorded yet in the financial accounts of general government as notified in April 2007 (EDP table 3A) and that

you intend to do so. In your letter dated 31 August 2007, you indicate planning recording a transaction in payables. In your e-mail dated 19 September 2007, your T-accounts seem to show a recognition of a loan liability against the contractor.

As analysed above, we consider that the EVF scheme is such that a government debt should be recorded, and not a payable, against the bank, for the amounts extended by the latter.

Further remarks

Finally, given the above, we observe that the statistical discrepancy, which reached 10.9mn LVL in 2005 and 7mn LVL in 2006 for general government as reported in the April 2007 notifications, will increase further, after taking into account the recording of a liability, to 19.1mn and 37mn respectively, or 0.21% and 0.33% of GDP. We draw your attention to the fact that the Latvia government statistical discrepancies would then seem sufficiently high to warrant additional enquiries on your side.

With respect to the T-accounts provided on 19 September 2007, we draw your attention to the fact that some entries on the Use side have been allocated to the government sector instead of the non-financial corporation sector, and that the change in balance sheet in non-financial assets for general government is empty, and we wonder why an entry in government payables for "long-term financial investment – accrued income" arises for an amount that differs from the property income payable by government you plan to record.

Conclusion

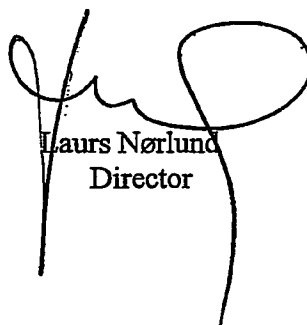
Eurostat concludes that the correct recording of the construction and financing of the Dienvidu (South) Bridge of Riga requires recognizing a government expenditure during the construction phase against the incurrence of a liability, and that the financing structure proposed by Deutsche Bank (EVF) implies recognizing a government debt against the bank (loan) rather than a trade credit payable.

Accordingly, the LV authorities will have to record the appropriate transactions in government accounts in time for the October 2007 EDP notification. The LV authorities will also have to reconcile the gross fixed capital formation (P.51) figures sent by the Riga City Council with those recorded by the CSB, and to enquire on the resulting statistical discrepancies.

Procedure

In this context, we would like to remind you that Eurostat is committed to a fully transparent framework for its decisions on debt and deficit matters in line with the amended Council Regulation 3605/93 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 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 5 October 2007.

Yours sincerely,



Laurs Nørlund
Director