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- FINAL FINDINGS -

EDP dialogue visit to Portugal

23-24 January 2006

Executive Summary

Eurostat expressed a reservation on the quality of government deficit figures for Portugal in its Press Release 120/2005 on government deficit and debt, issued on 26 September 2005. An EDP dialogue visit took place in Lisbon on 23-24 January 2006 mainly with the aim of clarifying all outstanding issues. The outcome of the meeting will lead to the lifting of the September 2005 reservation.

Discussions were constructive and efforts are being made by the Portuguese statistical authorities to reinforce the statistical co-operation among the institutions involved in the EDP reporting. In this context, Eurostat welcomed the recent agreement signed between the National Statistical Institute, the Central Bank and the Ministry of Finance, which will allow to clarify the role of each institution in the EDP notification process and will result in the reporting of public finance data of improved quality.

The September 2005 reservation expressed by Eurostat concerned the specific case of the dividend paid by a public corporation - *Empres a Desenvolvimento Mineiro (EDM)* (mining) to government in 2004. After discussing the issue, it was possible to conclude that this transaction has to be re-classified as a financial transaction. The amount corresponds to 0.03% of GDP, gross of taxes.

As far as the capital injections undertaken by government into 31 hospitals are concerned - those were converted into corporations by the end of the year 2002 - Eurostat welcomed the fact that the Portuguese authorities have decided to undertake a profitability assessment of these units from 2003 to 2005. This assessment will allow the Portuguese authorities to draw definitive conclusions on the appropriate accounting treatment of the capital injections and will constitute an element for evaluating future capital injections to be undertaken by government into hospitals.

As a general approach, Eurostat recommended adopting a prudent approach for classifying capital injections into hospitals. The assessment should be based both on the business plans and on the examination of further elements such as past profitability of hospitals and other indicators reflecting the macroeconomic environment in which hospitals operate. Whenever there will be doubts on the long-term profitability of the project or there will be no acceptable business plans, the capital injections should be recorded as capital transfers.

The same prudent approach should be followed for the accounting treatment of all capital injections, particularly in the case of RTP (public television), which will receive a capital injection from government in 2006.

As regards the securitisation of tax arrears, Eurostat intends to determine whether the conditions for recording tax arrears as government revenue in 2003 have been fulfilled over time in the context of the existing rules in national accounts. A study by the Tax Department validated by an independent authority will be provided to Eurostat. This will allow Eurostat to gather more information on the issue of substitution of assets and its impact on the 85% criteria. Moreover, Eurostat has launched a Task-Force to review the rules of securitisation and a CMFB consultation will be carried out soon.

Among the main other issues discussed, were the transfer of pension obligations to government, the Public Private Partnerships (PPPs) on motorways and the recording of military expenditures.

Final findings

Introduction

In accordance with article 8d of Council Regulation (EC) No 2103/2005 of 12 December 2005 amending Council Regulation (EC) No 3605/93 as regards the quality of statistical data in the context of the excessive deficit procedure (hereinafter the Regulation) Eurostat carried out an EDP dialogue visit in Lisbon on 23-24 January 2006. The delegation of Eurostat was headed by Mr. Nørlund, director of National and European Accounts. The Directorate General for Economic and Financial Affairs (DG ECFIN) and the European Central Bank (ECB) participated also in the meeting as observers. The Portuguese Statistical Authorities were represented by -INE-, the Central Bank and the Ministry of Finance.

Eurostat carried out this EDP dialogue visit, the first after the entry into force of the new Council Regulation 2103/2005 amending Council Regulation 3605/93, with the aim of reviewing all outstanding issues and, in particular, those that resulted in a reservation on the quality of the Portuguese data indicated in Eurostat's Press Release 120/2005 on government deficit and debt, issued on 26 September 2005 (hereinafter the September 2005 Press Release).

The Portuguese Statistical Authorities announced that an agreement for inter-institutional cooperation was signed on 10 January 2006 between INE, the Central Bank and the Ministry of Finance. Eurostat welcomed this important step, that will allow a clarification of the role of each institution in the EDP notification process and that will result in the reporting of public finance data of better quality.

1) Dividend paid by Empresa de Desenvolvimento Mineiro (EDM) to government in 2004.

Introduction

In the September 2005 Press Release, it was stated that the Portuguese statistical authorities had previously informed Eurostat that they would investigate the nature of a dividend paid by a public corporation, Empresa de Desenvolvimento Mineiro (EDM), which had been treated as government revenue and recorded as such in 2004.

Discussion and methodological analysis

According to the explanations provided by the Portuguese Statistical Authorities, the occurrence of this dividend resulted from a government decision related to the sale of EDM property rights in SOMINCOR, EDM being its major shareholder at that time.

As it is stated in the ESA95 Manual on Government Deficit and Debt, dividends apply to payments from the unit to government that are funded from the unit's income. Dividends do not apply to payments funded by asset sales, capital gains, or reserves accumulated over several years (with the exception of those which are foreseen for smoothing of dividends), even if they are called dividends in the accounts of the unit. These should be treated as withdrawals of equity in F.5.

Findings and conclusions

It was possible to agree during the meeting that the dividend paid by EDM to government will be reclassified as a financial transaction in 2004. The amount to be reclassified as a financial transaction is EUR 46.5 million (0.03% of GDP), corresponding to the amount gross of taxes.

As a conclusion of the discussion held during the meeting, Eurostat finds that the reservation on the quality of the Portuguese data can be lifted.

After concluding on the accounting treatment of the dividends paid by EDM to government in 2004, it was also agreed during the meeting that the Portuguese statistical authorities will further analyse the nature of the dividends paid by EDM to government in 2005 (EUR 13 million) and will inform Eurostat about their findings.

2) Capital injections into hospitals

Introduction

In the September 2005 Press Release, it was stated that Eurostat intended to clarify reported cases of capital injections undertaken by government between 2001 and 2004 in Portugal, as well as in other Member States, and to settle this issue at the latest in 2006, following provision of information on such cases by Member States.

In Portugal, general government has undertaken capital injections into hospitals starting in 2002, in the context of the transformation of hospitals from government units into corporations. In 2002, 34 public hospitals have been converted into 31 corporations and received capital injections for a total amount of EUR 898 million (0.7% of GDP). In 2003 and 2004, other five hospitals were converted into corporations both at the level of central and local government, having received a total amount of capital injections of approximately EUR 156.6 million. In 2005, two additional hospitals were converted into corporations, Sta Maria and S. Joao, two of the biggest hospitals of Portugal, which received respectively a capital injection of 133 and of EUR 112 million (0.17% of GDP). Another two hospital units were merged in 2005 with existing corporations converted in 2002, and received capital injections from government.

Discussion and methodological analysis

The discussion held in the meeting focused on analysing the available elements that would allow the Portuguese statistical authorities to decide on the classification of the capital injections into hospitals in national accounts.

According to the rules for recording capital injections in national accounts (ESA95 Manual on Government Deficit and Debt), in the case of a new corporation or new activity, the treatment of the capital injection will depend on the specific examination based on the various indicators, which are usually used in investment analysis. The presence of private investors is considered as a key indicator although is not applicable in the Portuguese case. The rules also specify that it should be obvious that government does not intend to use the new unit largely for public policy purposes. The present rules specify that the capital injection is treated as a financial transaction for its full amount if after a “normal” period of losses, as usually observed for similar investments, the corporation would be structurally profitable. On the other hand, the capital injection is treated as a

non-financial transaction for its full amount if, on the basis of various factors, there are doubts on the long-term profitability of the project, such as an uncertain economic environment, non-compensation of some costs imposed by government, etc.

Findings and conclusions

Eurostat considers appropriate that the Portuguese statistical authorities have decided to undertake a profitability assessment of the accounts of these units from 2003 to 2005. This profitability assessment will be undertaken by INE. The purpose of this assessment will be, in particular, to allow the Portuguese authorities to have further elements and draw definitive conclusions on the appropriate accounting treatment of capital injections undertaken by government into hospitals starting from the year 2005.

Moreover, the Portuguese Statistical Authorities informed Eurostat that business plans will be prepared for the four entities which received capital injections in 2005. These business plans will be analysed by INE, which will then communicate to Eurostat its conclusions on the classification of these capital injections as financial or non financial transactions, according to national accounts rules. The main findings of the analysis on the long-term profitability of the hospitals and business plans will be sent to Eurostat together with the business plans of the four hospitals.

As a conclusion, Eurostat recommended to the Portuguese statistical authorities to adopt in the future, a prudent approach for classifying capital injections into hospitals. The assessment should be based both on the business plans and on the examination of further elements such as past profitability of hospitals and other indicators reflecting the macroeconomic environment in which hospitals operate. Whenever there will be doubts on the long-term profitability of the project or there will be no existing business plans, the capital injections should be recorded as capital transfers.

3) Securitisation of tax arrears

Introduction

The sale of tax arrears by government to a private financial institution was recorded as government revenue in 2003, for an amount of EUR 1760 million (1.3% of GDP). Eurostat intends to determine whether the conditions for recording tax arrears as government revenue in 2003 have been fulfilled over time in the context of the ESA95 manual on government deficit and debt securitisation rules.

Discussion and methodological analysis

According to the ESA95 manual on government deficit and debt, in order for the transaction to be considered as a sale, the initial price paid must not be lower than 85% of the “true” market price (or “fair value”), and if there is no organised market to demonstrate a market price, the estimated market price for the calculation above must be estimated by a body independent from government.

The issue of transfer of risks and rewards from government to the Special Purpose Vehicle (SPV) was broadly discussed during the meeting. As regards the transfer of risks, the Portuguese Statistical Authorities mentioned a downgrading of rating of the bonds issued by the private financial institution in the context of the securitisation of tax claims, as a signal that a transfer of risk to the private investors has indeed occurred.

Eurostat noted that this issue was currently being debated in the context of the Eurostat Securitisation Task-Force. Eurostat informed the Portuguese statistical authorities during the meeting about the main issues that have been discussed in this Task-Force, particularly as regards the substitution of assets, the guarantees that might be provided by government ex-post in a securitisation operation, the Deferred Purchased Price (DPP) and the specific case of the securitisation of tax claims.

Findings and conclusions

The Portuguese statistical authorities will provide to Eurostat a study of the Tax Department, which will show the original market value of the tax claims being replaced, and of those selected for substitution. The study will be validated by IDEFE, the same independent entity that estimated the market value of the portfolio of tax arrears at time of contract. This study will allow Eurostat to gather more information on the issue of the substitution of assets and its impact on the 85% criteria.

4) Capital injections undertaken by government in 2004

Introduction

Two capital injections were undertaken by government in 2004 into EMPORDEF (ammunitions) and ANAM (Madeira's airport), for amounts respectively equal to EUR 13 million and EUR 1 million, and have been provisionally classified by the Portuguese statistical authorities as financial transactions.

Discussion and methodological analysis

During the discussion held in the meeting, the Portuguese statistical authorities informed Eurostat that the capital injection into EMPORDEF will be reclassified as a capital transfer due to the fact that this corporation seemed to have been bearing losses into recent years. Classifying such a capital injection as a non-financial transaction will reflect the application of the present rules in national accounts. As a general rule, a capital injection made to cover accumulated losses is treated as a non-financial transaction for its full amount.

The Portuguese statistical authorities will inform Eurostat whether the capital injection into ANAM will have to be reclassified as a capital transfer. During the meeting, Eurostat noted that a report from the Court of Auditors on 2004 State Budget Accounts' pointed out that ANAM was bearing losses in 2004. For the Portuguese Statistical Authorities, the issue needs to be further analysed because it is dubious whether one year of losses is a reason for classifying the capital injection as a non-financial transaction.

Findings and conclusions

The capital injection into EMPORDEF will be reclassified as a capital transfer. The findings of the analysis concerning ANAM will be sent to Eurostat within the next EDP notification.

5) Capital injections undertaken by government and dividends received by government in 2005

Introduction

Prior to this meeting and on Eurostat request, the Portuguese statistical authorities provided Eurostat with a list of capital injections undertaken by government in 2005. The most significant ones related to EMPORDEF (EUR 15 million), Parpública (EUR 40 million, 0.03% of GDP), RTP (EUR 56 million, 0.04% of GDP) and SIMAB (EUR 30 million, 0.02% of GDP).

Discussion and methodological analysis

From the discussion held in the meeting, it was possible to conclude that the capital injection into RTP will be classified as a capital transfer in 2005. Moreover, the Portuguese statistical authorities will inform Eurostat whether there would be any concrete ground for classifying the foreseen capital injection into RTP in 2006, as a financial transaction. Due to the past history of repeated losses of RTP, as well as to the fact that the corporation has negative own funds, Eurostat underlined the need for a prudent approach in this respect. RTP is at present being restructured, and in 2004 the capital injection undertaken by government in RTP (EUR 199 million, 0.1% of GDP) was recorded as a capital transfer.

The list of dividends paid by public corporations to government in 2005 was also requested to the Portuguese statistical authorities prior to this meeting. Besides the specific case of EDM that had been previously agreed to be further analysed, the most significant amounts are those paid by Parpública (EUR 21 million, 0.01% of GDP) and GALP (energy) (EUR 36 million, 0.02% of GDP). These amounts are in line with amounts paid by these public corporations to government in recent years.

Findings and conclusions

The capital injection into RTP in 2005 will be classified as a capital transfer¹. Eurostat requested the Portuguese statistical authorities to carefully analyse the specific case of Parpública as this corporation received a capital injection of 0.03% of GDP, while at the same time it has paid dividends corresponding to half of this amount.

The Portuguese statistical authorities will send to Eurostat, before the next EDP notification, an analysis of the recording of capital injections undertaken by government in 2005 according to ESA95 rules.

6) Transfer of pension obligations to government

Introduction

¹ The Portuguese statistical authorities had suggested to insert the following sentence: "With no intention of interfering with the financial policy of public owned companies, Eurostat requested the Portuguese authorities to confirm the origin of the dividend paid by Parpública, once the corporation has received a capital injection of 0.03% of GDP".

In 2003 the transfer of pension obligations from CTT to government (0.7% of GDP) has been recorded as government revenue, following consultation with Eurostat. In the following year, 2004, other pension obligations were transferred to government, such as those of CGD (1.9% of GDP), NAV (0.17% of GDP), ANA (0.13% of GDP) and INCM (0.1% of GDP).

Discussion

A recent report from the Court of Auditors has confirmed the existence of a mismatch between the *lump sum* received by government and the net present value of the accrued pension obligations, notably in the case of CTT. During the discussion, the Portuguese authorities referred that this mismatch was of public knowledge at the time of the transfer. During the meeting, the accounting implications of these findings were discussed.

Findings and conclusions

It was agreed that Eurostat and the Portuguese statistical authorities would further analyse this issue by reference to the ESA95 manual on government deficit and debt.

7) Public Private Partnerships (PPPs) on motorways

Introduction

The PPPs contracts on motorways have been assessed in the past by INE which had concluded that the non-government partner is bearing the majority of the risks attached to the contracts. As a result, and in line with the ESA95 manual on government deficit and debt guidance, the assets have been classified as off-balance sheet of government.

Discussion and methodological analysis

Eurostat asked the Portuguese Statistical Authorities if the existing contracts on PPPs have recently changed, as it had been reported that some of the existing contracts related to shadow tolls paid by government to the private operators could be modified. The Portuguese statistical authorities informed Eurostat that no changes had been implemented.

During the meeting, it turned out that the payments of shadow tolls by government to the private companies were recorded mainly on a cash basis. In this context, it was decided that the Portuguese statistical authorities will record such transactions according to the accrual principle, i.e., at time of traffic irrespective of delays in time payments owing to normal administrative lags or to negotiation between parties on the final amounts.

However, the Portuguese statistical authorities proposed that in the case of disagreement between parties leading to court decisions, the recording should be done according to the following approach: the amount recognised by the government accordingly to the accrual principle (e.g. in the year when the economic event takes place) and the difference between the previous amount and the payment demanded by the private operator when a Court decision in favour of the private operator occurs.

Findings and conclusions

As a conclusion, although the above practice does not respect completely the accrual principle, it should be seen as a mixed approach and only used when facing marginal differences between the amounts under negotiation. The advantage of this approach is the one of reducing the revisions of previous data. Nevertheless, historical data will be revised accordingly, if needed. In addition, Eurostat will examine the existing contracts signed between government and the private operators.

In Portugal, several PPPs are being implemented in the health sector. Eurostat underline the need for INE to analyse the existing partnerships according to the present rules in national accounts.

8) Military expenditures

According to previous explanations provided by the Portuguese statistical authorities, expenditure on military material is recorded on a cash basis. Following the Eurostat's forthcoming decision on the recording of military expenditures, the recording of the expenditure will be changed accordingly. The Portuguese authorities also clarified that no large deliveries had been made in 2005 or were planned for the near future.

9) Institutional Statistical Cooperation

The inter-institutional agreement signed between INE, the Ministry of Finance and the Central Bank will allow clarifying the role of each institution in the notification process. The institutional responsibilities in the framework of the Excessive Deficit Procedure have been a cause of concern in the past, with the Ministry of Finance acting as the sole responsible for compiling the government deficit and debt figures of the most recent years. The inter-institutional agreement sets a transitory framework in the March 2006 notification. From this notification onwards, INE will be responsible for coordinating the exercise and compiling the data for all years but the one of the notification.