Eurostat clarification note

The statistical treatment of PPP contracts

1. Introduction

This note on the statistical treatment of PPP contracts accompanies the new chapter on Public-Private Partnerships in the 2016 edition of the Eurostat Manual on Government Deficit and Debt (MGDD), which is also published today. The new version of the MGDD has several updated chapters, including the one on PPPs, and there has been the recognition, on Eurostat's side, that specific complementary guidance was needed in the context of PPPs.

Although the new chapter on PPPs in the 2016 edition of the MGDD is very comprehensive, and is indeed now the longest chapter in the MGDD, the need was felt at the same time for a complementary note on the issue, which would be of benefit at the same time to stakeholders in Member States, PPP practitioners and non-specialists in national accounts. The ambition of this note is to provide further explanations on Eurostat rules in order to improve understanding of them, to provide specific application rules for PPP contracts and to be used as practical tool for the examination of PPP contracts.

This is to be considered only as a first step in explaining how contractual provisions might affect the classification of the infrastructure built under a PPP contract, and whether it should be on or off government balance sheet. Eurostat, moreover, is in the process of working on a much more comprehensive document, in co-operation with the European PPP Expertise Centre of the European Investment Bank (EIB), which will be published under the responsibility of both institutions. Thus, further guidance will be produced in order to complement the existing PPP rules and help PPP practitioners, both in the public and private sector, to understand how the different features included in PPP contracts might impact the classifications of PPPs. This further guidance should be published during the summer of 2016.

The building of public infrastructure (construction phase)

Investment is an important part of government expenditure. Much of government investment is undertaken under construction procurement contracts signed with the private sector. In normal circumstances, an investment undertaken by government to build a fixed asset (such as a building or a road) during *n* years, has to be accounted as government expenditure, following ESA 2010 rules, during the same *n* years in which the asset is built, independently of whether the payments to the private sector by government will be made during the same *n* years or not, independently of the number of years over which government will have to reimburse the debt (if any) raised in order to finance the asset and independently of the length of the economic life of the asset upon which the value of the asset will be amortised.

The building of public infrastructure through such public procurement contracts impacts therefore the deficit/surplus of government during the short time span in which the infrastructure is built, and government (EDP) debt (if any) over a potentially longer period

of time. PPPs represent therefore, from this viewpoint, a way to spread the impact on government deficit/surplus and debt over a longer period of time and a possible way for government to deal with fiscal constraints, although at the price of an increase in contingent liabilities.

The recourse to PPPs has been very different among EU Member States, with some countries like the UK spearheading the usage of PPP projects and accounting by itself for slightly less than half of the total amount of public infrastructure built via PPPs in recent years, while other Member States have not yet used this instrument. These differences are also reflected in the accounting treatment of PPPs, with some countries having a considerable amount of PPP expenditure recorded off government balance sheet while in other countries all PPP expenditure has been recorded, for various reasons, on government balance sheet. This heterogeneity of accounting treatment in PPPs is mainly due to the fact that PPP contracts are designed in different ways in the various countries as well as the fact that countries give different weights to different features of the contracts, and sometimes give precedence to the possible fiscal implications of PPPs while in other circumstances they focus their attention exclusively on the sustainability of the project or on whether it really provides good value for money for government compared to more traditional alternatives for building infrastructure. However, the two aspects are not necessarily incompatible.

The basis of accounting rules for PPPs

The basic national account rules for the recording of PPPs are included in the latest version of the European System of Accounts (ESA 2010) which is an internationally devised and applied accounting framework for a detailed description of a total economy and its sectors, including the government sector. In the previous edition of ESA, the European System of Accounts 1995 (ESA95), the issue of PPPs was not treated. PPP rules emerged for the first time in one of the first versions of the MGDD, and were revised regularly, in order to take into account new issues and features previously untreated and progressively discovered in PPP contracts. However, it is important to note in this respect that the changes introduced in ESA 2010 (mainly regarding the need to take into account in the classification of PPP contracts not only the sharing of risks but also the sharing of rewards), are now enshrined into it and that ESA 2010 is the Parliament and Council Regulation 549/2013. The MGDD rules on PPP are a complement to this regulation and have to be consistent with it.

It is also useful to remember that ESA 2010 also introduced the issue of control of the asset, when the analysis of risks and rewards would not be conclusive in this respect. ESA 2010 makes clear and explicit, in particular in 20.282, that "…*the assets have service lives much longer than the contract period so that government may control the assets, bear the risks and receive the rewards, for a major portion of the assets service lives*" and that "*thus, it is frequently difficult to determine whether it is the corporation or the government that bears the majority of risks and reaps the majority of rewards*". Control of the assets as one complementary criteria to be taken into account is also mentioned in ESA 2010 20.285, where it is stated that when the "*assessment of the risks and rewards is not conclusive*" one needs to look at whether it is government or not which determines the design, quality, size and maintenance of the assets as well as the services produced, the units to which the services are provided and the prices of the services produced.

ESA 2010 and the notion of economic ownership

The reason why ESA 2010 looks mainly at risks and rewards is due to the concept of "economic ownership" which is one of its cornerstones. The economic owner of an asset, as opposed to the concept of legal owner, is the unit (ESA 2010 1.90) which accepts the risks and rewards of using the goods in production. Therefore, in order not to be the economic owner of an asset, both risks and rewards must be transferred to another unit.

As ESA 2010 specifies that risks and rewards must both be transferred to the private sector to spread the impact on government accounts for the construction of infrastructure over the whole period of the contract and not only during the construction period, it might seem surprising that governments for which the fiscal impact seem to be the overwhelming concern would not make sure that this is done in their entirety. In reality, ESA 2010 does not state that all risks and rewards should be transferred to the private partner but only that most of them should be. It seldom happens in fact that all risks and rewards are transferred. Usually the private partner and/or the financial institutions financing the project would ask government to take back some of the risks via various means (force majeure events, termination clauses, guarantees, etc.), while government either would want to cash in on some of the rewards of the project (via rules against "excessive" rewards for the private partner, renegotiation clauses, etc.), or would try to "control" the private partner itself, by entering into the capital of the private partner (usually in a Special Purpose Entities (SPEs) created for the specific purpose of the PPP project) and/or obtaining some veto rights in order to block or influence the decisions that the private partner will make during the duration of the contract[1]. Although this is understandable from many points of view and especially from that of political risk (public opinion, the press and the national Court of Auditors might criticise the excessive costs of some PPPs), the attempt to cash in on rewards or to control the private partner itself might end up with a classification of the assets on the government balance sheet.

One common objection which is frequently made to Eurostat is that indeed some rewards are transferred back to government, but as a counterpart government also takes back some of the risks, so this should be considered as a "fair deal" which should not lead to the reclassification of the assets inside government. Unfortunately, in this case it is often forgotten that the transfer of risks and rewards is a "*conditio sine qua non*" for the recording of the asset off government balance sheet, so that the "compensation" of risks with rewards would go against the principle of economic ownership mentioned above. In practice, if most risks and rewards would be with government, this would be very close to a situation where government would be giving the private sector a procurement contract for building the assets at an agreed price plus a service contract for their maintenance, with obvious accounting implications.

This guidance note will now show which features should be taken into account in the analysis of a PPP contract, which of them would be the most important and how to proceed on a step-by-step basis in the assessment of the different features.

[1] By doing so, government might limit the autonomy of decision of the private partner and its negotiating powers in contracts. The concept of autonomy of decision is a key concept in national accounts for being an institutional unit.

2. General features to examine in a PPP contract

Type of asset to be built and features associated with the asset

Many assets have recently been the object of PPPs. A non-exhaustive list includes, for instance, roads, schools, hospitals, sports halls and other infrastructure. Independently of the type of asset being built, the first thing to examine in a PPP contract is whether it really qualifies as a PPP project. To qualify as a PPP project, the following conditions must be met:

- there must be a significant capital expenditure by the private partner to create or renovate/refurbish fixed assets, which must then also be maintained by the private partner for the duration of the contract;
- there must be regular unitary payments to the private partner through availability or demand fees made by government and not by the users of the asset (if the users pay for the use of the asset, this would likely be a concession and not a PPP). The payments received from government must be the majority of the payments received by the private partner in the context of the use of the asset;
- the economic life of the asset (for substitutable assets) must be at least equal to the duration of the contract. This means that, in normal circumstances, the asset is not supposed to be substituted during the course of the contract;
- if an already existing asset is to be refurbished, the value of the asset after refurbishment must be at least twice as large as the value of the asset before refurbishment, which means that the value added to the asset through refurbishment must be higher than the original value of the asset.

In some circumstances, part of the asset built in the framework of the contract must be the object of a separate analysis, e.g. when not maintained by the private sector, and considered as a government asset at the outset of the contract.

Public unit taking part in a PPP

As the name itself suggests, a PPP is a partnership which should take place, in normal circumstances, between a public unit and a private unit. From the national accounts point of view, an asset built in the context of a PPP can be recorded in the government balance sheet only if the public unit is a unit classified inside the general government sector (S.13). This would exclude, in normal circumstances, PPPs where the public unit is a unit classified in the public sector but not in the government sector, i.e. a public corporation which is a market producer. However, it must be underlined that in some specific circumstances, even in this last case the explicit contractual intervention of government could be such that the PPP project should be classified in government accounts, which is to say that the public unit would really undertake the project on behalf of government.

Sector classification of the private partner

In some circumstances, government or a public unit could have a percentage of the ownership of the private partner (usually of an SPE jointly created). The sector classification of the private partner must be assessed by applying national account rules. In some cases, the private partner could be considered as controlled by government even in the absence of a shareholding by government above 50% of the total, for instance when

government or a public unit would maintain veto rights over important decisions to be taken by the private partner in the framework of the contract, while being minority shareholders. The fact that the private partner would be controlled by government, or that government would de facto have a minority blockage over some of the important decisions of the private partner in the PPP contract, would not necessarily mean that the asset built will be considered as a government asset, but it will be a very important aspect to be taken into account (especially if coupled with the fact that the asset would be controlled by government and that government would own the asset at the end of the contract) in the analysis of the risks and rewards of the contract, part of which will have to be imputed to government in any case given its participation in the capital of the private partner (for instance through dividends, in the case of rewards).

In such circumstances, it would not matter whether control over the private partner would be achieved by government directly, or indirectly (for instance via a public bank or another public unit).

One common case, in this respect, is where an SPE will be created jointly by the private partner and government, with government holding a stake in the SPE. The exact powers of government over this SPE will have to be carefully assessed, in order to determine whether the SPE can be considered as controlled by government as well as the degree of freedom of the private partner in the context of the implementation of the contract.

Type of contract

As specified before, as a minimum, for a PPP contract to be considered as such, the asset built has to be maintained by the private partner. This is the case for both the Design, Build, Finance, Maintain (DBFM) and the Design, Build, Finance, Maintain, Operate (DBFMO) types of contract. The difference between these two types of contract is that in DBFMO contracts, the asset is operated by the private partner, while in DBFM contracts it is usually operated by government. In this last case, it will be necessary to determine whether government will obtain revenue from the asset. The revenue obtained by government directly from the use of the asset by third party users (including for secondary use of the asset), will have to be considered in the analysis of the share of rewards obtained by government and by the private partner. Whenever government will obtain from third party users an income higher than that which the private partner will receive from government, the project will not be considered as a PPP anymore.

Completeness, signature and duration of the contract

The examination of a PPP for accounting purposes should be undertaken using the signed version of the contract, or a version equivalent to the one which is going to be signed. The completeness of the contract, including all its annexes, will also have to be carefully checked. Sometimes a contract may be signed before all details of the financial agreement are established, on the understanding that this would happen at a later phase. The examination of the financial arrangements is very important in the classification of PPP contracts, especially when it refers to issues such as the level of financing that government will provide to the private partner via various means. It must be therefore an integral part of the contract.

As far as the duration of the PPP contract is concerned, the period of maintenance of the asset should be long enough that the construction costs would be paid by government progressively through availability or demand fees. Although it is not possible to fix a minimum length for a contract to be considered as a PPP contract, cases where the period of maintenance of the asset would be very short should be carefully analysed. In normal circumstances, a PPP contract would be expected to cover at least a considerable part of the economic life of the assets.

Once the contract is signed and examined, a decision on whether the assets will be classified in the balance sheet of government or in that of the private partner will have to be taken. The precise rules to be applied for this purpose will have to be those at the moment of the signature of the contract, and not those applying prior to this time (such as the moment when negotiations between the partners started) or following it. In normal circumstances, such a decision will be expected to apply for the whole duration of the contract, bar cases in which the contract will be amended. In such cases a new examination of the contract will be necessary for accounting purposes.

3. Financing

Direct financing by government

As far as the issue of financing is concerned, it will have to be ascertained whether government is providing financing to the private partner, directly or indirectly, in the context of the PPP contract. It is to be underlined in this respect that the degree of financing provided by government can take different forms, such as:

- equity in the private partner;
- loans provided to the private partner;
- subsidies to the private partner;
- lump sums paid to the private partner during or at the end of the construction phase (to be deducted in most circumstances from future payments of availability or demand fees);
- exemptions provided to the private partner for the payment of amounts which in normal circumstances the private partner would have to pay, such as the payment of VAT;
- other possible forms of financing.

All financing provided directly by government (or indirectly by public units) to the private partner in different forms will have to be considered cumulatively in the context of the calculation of whether the majority of the capital cost is covered by government financing.

The financing provided by government should be weighted according to the nature of the debt incurred by the private partner towards government, compared to the debt incurred towards other creditors. Precise guidance in this respect is provided in the 2016 version of the MGDD.

It is to be underlined in this respect that, for the purpose of the analysis of the accounting implications of the contract, financing provided by the EIB is not to be assimilated to government financing, but to financing provided by private financial institutions, unless such financing from the EIB would come with an explicit government guarantee. It is however the understanding of Eurostat that such government guarantees appeared only very sporadically in the past and do not feature anymore in the context of PPP contracts involving EIB financing.

Financing provided by the EU in the form of grants will neither be assimilated to government financing nor to financing provided by financial institutions, but simply excluded from the analysis, as it will not change the relative proportion of risks and rewards taken by government and by the private partner, but simply decrease the total capital cost of the project to be paid by government and not be reflected in the regular unitary payment of the availability or demand fee.

Finally, government financing could be admissible in the specific circumstance of a limited amount of time in case of severe market disruption.

The provision of guarantees by government

As specified in the MGDD, government can provide a guarantee to the private partner, which would cover partially or in total the borrowing of the private partner related to the PPP project. The existence and nature of such guarantees should be closely examined, including guarantees provided by government in the context of refinancing.

Such guarantees provided by government could refer not only to the repayment of debt of the private partner, but also take other forms, such as a minimum rate of return for the private partner. Special attention should be given to arrangement which, although not being formally considered as explicit guarantees provided by government, would have in practice the same effect.

Finally, it is to be underlined that government financing and government guarantees must be considered jointly.

4. Termination clauses

In the case of an early termination of the contract due to the fault of the partner, the key question here would be to examine how compensation should be determined. In the case of termination due to a specific fault of government or simply by the sovereign decision of government to terminate the contract, it would be normal that the private partner would be compensated for an amount so as to be able to repay the outstanding debt (unless the partner would have incurred higher debt than originally planned due, for instance, to higher than foreseen construction costs) and incur a reasonable profit.

On the contrary, in the case of termination due to the fault of the private partner, it will be necessary to check that if the termination occurs during the construction phase, the amount to be refunded to the private partner would be not higher than the capital expenditure incurred. Should the termination occur during the operating (maintenance) phase, the private

partner should be compensated according to the market value of the asset and not according to the present value of future flows for the partner as foreseen in the contract (without taking into account the costs necessary to bring back the asset to an adequate condition) or on the basis of some other amount not reflecting the current value of the assets. More details on this issue are included in the latest version of the MGDD.

Towards the end of the construction phase, the market value of the assets would be close to the cost of construction. However, it could be difficult to determine such market value during the course of the contract, due to the fact that assets deteriorate and it could be complex to establish their precise economic value especially in the context of assets with a long economic life and a long period of depreciation. A determination of the market value through retendering would be fully acceptable, especially if undertaken towards the end of the contract, even if in practice the value would be determined in this case on the basis of the amounts that the new private partner could obtain from government for the remaining period of the contract more than on the real market value of the assets.

5. Analysis of risks

As specified in the MGDD, the analysis should focus on whether the *construction risk* and the *availability* or *demand risk* (whichever of the two would be applicable) would be incurred by the private partner or not.

As far as the construction risk is concerned, this would cover events such as higher construction costs than expected and late delivery. In this respect, it is necessary to underline that cases of payments by government to the private partner before the asset would be available for use (even in the case that, as a consequence, the amount of availability payments would be readjusted and reduced), would point to a classification of the asset in the balance sheet of government. In the case of PPP contracts, the private partner is deemed to obtain revenue from government exclusively through the payments of availability or demand fees.

In some cases, the contract might mention payments based partly on demand and partly on availability. In such cases the analysis of risks should include both elements unless one of the two amounts would be preponderant (see detailed explanation in the MGDD).

As far as the precise formula for availability or demand payments is concerned, it will be necessary to check its plausibility and whether the payments would be really strictly linked to availability or demand of the asset. Payments should exclude any element which the private partner would not be allowed to obtain just through its activity of maintaining the asset to a standard which would allow its use. Particular care should be addressed in this case to the examination of any foreseen change of the availability or demand fee that would not be determined simply by an indexation of the amounts to be paid, but result from other circumstances such as higher construction fees or other factors which would either reduce or increase the profitability of the partner compared to the assumptions undertaken at the moment of the signature of the contract.

In this context, it will be necessary to check that the availability fee would be set to zero in case of non-availability of the asset. This principle of zero payments for zero availability

could possibly lead to negative payments by government in the case that other penalties (for instance for bad management or for provision to government of faulty or incomplete information) would at the same time be imposed by government on the private partner, according to the specifications of the contract. Reductions in availability payments should at the same time be automatic, proportional and not purely cosmetic. Moreover, as specified above, they should not be capped to maximum amounts, or cancelled at the end of the year (or at any other moment) or reduced through other possible mechanisms. Furthermore, penalties should not be applied at the discretion of government, but applied automatically according to the mechanisms set in the contract. Obviously, penalties should be explicitly mentioned in the contract so to allow their thorough examination.

6. Analysis of rewards

ESA 2010 has explicitly included the analysis of rewards as a very important element in the analysis of the accounting implications of PPP contracts. In order for the asset built to be classified off government balance sheet, it will be important to assess that most of the rewards (and not all of the rewards) deriving from the use of the assets will be for the private partner.

In this context, it will be necessary to check first of all that no provisions exist in the contracts which would cap the benefit of the partner to a pre-determined maximum level of profitability. However, government could be entitled to receive part of the "unforeseen" excessive profits obtained by the private partner, if evidence shows they would result from a deliberate and explicit action or decision of government (such as a change in some provisions of the contract determined by government). It is to be underlined in this respect that increased rewards obtained by the private partner due to its increased efficiency or due to external macro-economic or financial events should be appropriated exclusively by the private partner.

The same principles described above should also be applied in the case of refinancing gains, where government might even claim all refinancing gains obtained by the private partner if resulting from explicit decisions or actions taken by government which would make it possible for the private partner to obtain better refinancing conditions from financial institutions. On the contrary, refinancing gains due to an increased efficiency of the private partner or due to external macro-economic circumstances should be fully appropriated by the private partner. However, given the fact that an analysis of this kind might be complex, it is accepted, as a practical rule, that up to one third of refinancing gains could be appropriated by government for the assets built not to be classified in the balance sheet of government

Finally, any exceptional rewards (compared to those initially foreseen) obtained by the private partner in the context of sub-contracting part of its activities to sub-contractors, should be appropriated by the private partner and not by government.

7. Allocation of the recording of the assets at the end of the contract

As specified in the MGDD, whenever assets would be transferred for free to government at the end of the contract, this would be an element pointing towards the recording of the assets in the balance sheet of government. However, this element would not, by itself, be a sufficient condition for classifying the assets inside government.

8. Force Majeure and insurance premiums

As specified in the MGDD, the risk of events of "*force majeure*" (frequently also called "relief events") can be incurred by government, provided that:

- the list should be exhaustive and precise, avoiding terminology such as "and any other event impossible to foresee" or similar expressions;
- the events in the list would be impossible to insure[2];
- the list would exclude any macro-economic risk, market risk or similar circumstances which consequences must form the risk of the owner of the asset (i.e. the private partner);
- the absence of responsibility of the private partner should be unquestionable.

9. Financial advantage and disadvantage compensation clauses

It is recalled that, for the asset in a PPP project to be classified in the balance sheet of the private partner, the majority of risks and rewards must be carried by the private partner. In this case, the PPP contract may sometimes mention financial advantage and disadvantage compensation clauses which would bring the availability fee (and hence the profit of the private partner and the costs for government) to a more "normal" level (specified in the contract at the outset) through adjustment of the availability or demand fee. These clauses are incompatible with the classification of the assets in the balance sheet of the private partner, as they have the effect, in practice, of capping risks and rewards for the private partner.

For further information please contact: Luca Ascoli, Eurostat, Unit D-1.

Email: luca.ascoli@ec.europa.eu

[2] Government can bear the risk of uninsurable risks. However, the risk of an increase or decrease of the insurance premium should be borne by the private partner and not transferred to government, possibly through an adaptation of the availability or demand fee.

Electronically signed on 04/03/2016 10:37 (UTC+01) in accordance with article 4.2 (Validity of electronic documents) of Commission Decision 2004/563