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Subject: Ex-post advice Aberdeen Western Peripheral Road Project (AWPR)

Dear Mr Bird,

Thank you for the E-mail sent on 4 October 2016 including the request for an ex-post advice from Eurostat and the ONS (Office for National Statistics) assessment of this project. After having closely examined the arguments and the documents provided, Eurostat is now in a position to express a view on this matter.

1. THE CLASSIFICATION ISSUE FOR WHICH A CLARIFICATION IS REQUESTED

The issue is to analyse the decision taken by the National Accounts Classification Committee (NACC) of the ONS concerning the classification of the Aberdeen Western Peripheral Road (AWPR) asset as well as the statistical sector classification of the Aberdeen Roads Holdings Limited (HoldCo), the Aberdeen Roads Limited (operating company) and the Aberdeen Finance Plc (Issuer).

Documentation provided

The ONS provided to Eurostat a copy of the classification decision, taken by the ONS, of the AWPR, together with the clarification request of the Scottish government and the ONS reply to the Scottish government. The Eurostat analysis is based on these three documents.

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Description of the case

The Scottish Ministers, through Transport Scotland, the Aberdeen City Council and the Aberdeenshire Council, have decided to build a peripheral road bypassing the City of Aberdeen. For this purpose, the Scottish Ministers launched a public tender in January 2013 and the project has been awarded in December 2014 to the consortium composed by Balfour Beatty, Galliford Try and Carillon. All three companies are part of the private sector.

The project consists of the construction, management and maintenance of a bypass road surrounding the city of Aberdeen. The construction has started in February 2015 and the completion is scheduled for winter 2017. After completion, the consortium will manage the asset over 30 years. The construction cost is estimated at £ 500m and private financing has been available up to £ 600m. No public financing or public guarantee have been made available.

This project fulfils the criteria for a Public Private Partnership (PPP) in the statistical sense.

The consortium has set up three legal entities. One holding company, owned at 100 % by the members of the consortium, holds the shares of the operating company and of the issuer. These three entities are tightly linked together through so-called 'stapling' agreements. The Scottish government holds one share in the operating company. This share enjoys significant privileges over the other shareholders with some specific veto rights on the main corporate policy. These privileges include inter alia:

- *"Powers of directors, maximisation of the financial performance, application of revenues, 'proceedings' of directors and conflict of interest;*
- *Appointment and removal of directors, remuneration and expenses;*
- *Asset lock, transfer of loan stocks and shares;*
- *Proceedings at General Meetings and votes."*

The project is legally designed under the Scottish Non-profit-distributing (NDP) model of PPPs. This NDP model foresees that the established Special Purpose Entity (SPE) does not distribute any dividends and that most of any economic surpluses generated by the SPE are distributed to the Scottish government ("the Authority").

Unitary payments by the authority will start only after completion of the construction and are, as expected, subject to the availability of the road. Deductions from the monthly unitary charge for unavailability are closely linked to the portion of unavailability.

At the end of the contract, the asset will be taken over by the Scottish government against no payment of any purchase price.

2. METHODOLOGICAL ANALYSIS BACKGROUND

Classification decision of the National Accountings Classification Committee (NACC)

The NACC considered the Scottish government to be the economic owner of the project asset and classified the institutional unit composed by the three legal entities within the central government sector (S1311).

Applicable accounting rules

Based on the documents provided, EUROSTAT carried out its analysis based on ESA 2010 and the Manual on Government Deficit and Debt (MGDD 2014) in particular part VI.4 Public-Private partnership (PPPs) which is relevant for the analysis.

2.1. Construction risk

2.1.1. Construction of the project

The construction risk (MGDD 2014 VI.4.3.2.33) for the SPE's subcontractors is capped at 150% of the construction contract value amounting to approximately £ 800m. The SPE incurs the risk above this amount.

In case of a complete failure during the construction period, the "Authority" pays no availability fee as any payment to be made by the "Authority" is contingent on the availability (MGDD 2014 VI.4.4.2). As a consequence the road under construction would be handed over to the "Authority" against a compensation payment. If a liquid market exists, a new SPE takes over the contract against the payment of the difference between the estimated cost to finish the road and the initial contract price of £ 500m to the defaulted SPE. If there is no liquid market for such projects, the "Authority" will compensate the value to the SPE in default. This compensation will be determined by an independent third party based on realised work to date and the estimated cost to complete the road.

Any delay in the finishing the construction will have to be borne by the SPE. The "Authority" will pay only for the periods were the road is available. And the final handover date of the construction to the "Authority" is the 13 November 2047. So the SPE bears the risk of the construction delay, the associated reduced availability period and the implied reduced unitary payments.

2.1.2. Financial risk

The "Authority" grants no loan or financing to the project nor guarantees any of the private financings made available. Therefore no government risk will be borne (ESA 2010 20.283.e / MGDD 2014 VI.4.3.3. - VI.4.3.6).

2.1.3. Construction risk insurance

The construction risk has to be insured by the SPE. All claims against the SPE above £ 50m for each single event (£ 155m in case the third party is likely to be Network Rail) should be covered by the SPE. If this left the company insolvent, there would be a company default termination.

However, the "Authority" covers the excess insurance for nationally significant oil / gas pipelines which the new road will cross. The mechanism put in place three levels of insurance cover: a) The SPE takes out pipeline specific insurance for up to £ 175m, b) the SPE covers up to £ 3m above this amount, and c) the "Authority" covers exceeding claims. The "Authority" can terminate the project agreement, if pipeline insurance becomes unavailable. In this case the "Authority" will compensate the SPE under the 'Force Majeure' termination.

In addition, the "Authority" may provide insurance to the Operation and Maintenance contractor, if such insurance is no longer available at commercially reasonable rates.

Overall, the ONS considers that the insurance risk taken by the "Authority" covers only uninsurable risks (MGDD 2014 VI.4.4.2.98).

2.2. Availability risk

2.2.1. Financial flows

The SPE invoices the "Authority" with a monthly unitary charge i.e. monthly availability payment less deductions (MGDD 2014 VI.4.4.2.82). Although there is no right to fine the SPE, the "Authority" has the right to terminate the contract as persistent breaches are included in the definition of default. The potential default is defined as a percentage of deductions in the monthly unitary charge the SPE can incur before it is considered as an actual default. These deductions have only to reach 5% to 7.5% before leading to possibly triggering a default event.

2.2.2. Financial surplus flows

The Scottish non-profit distributing model, states that any surplus realised during the lifecycle of the project will remain with the "Authority"[1]. Surpluses may be realised by:

- Improved operations management;
- Improved service management contracts (when renegotiated);
- Renegotiation of financing contracts.

These surpluses will remain with the SPE after having paid all operational costs and will be used to reduce the unitary charges. By this mechanism almost any surplus will be awarded to the "Authority" (ESA 2010 20.283 / MGDD 2014 VI.4.3.2.30).

The likelihood of any refinancing is very low for the bond issue, traded on the bond market, but such a refinancing can be achieved on the Bank of Tokyo Mitsubishi loan. Then, the profit sharing will apply, outside the NPD model.

Senior debt requires the authorities consent for any refinancing. Any gain realised will be shared between the "Authority" and the private shareholders of the SPE. The public sector takes:

- 50% of gains up to £ 1,0m
- 60% of gains between £ 1,0m and £ 3,0m
- 70% of gains exceeding £ 3,0m

Any surplus out of the refinancing of the subordinated loan remains with the private lenders of these subordinated financings, i.e. there is no additional profit out of refinancing

[1] This surplus is calculated after having respected any coverage ratio, i.e. 120 % of forecasted payments.

to be used to offset unitary charges. The sale of subordinated debt (linked to equity) is only allowed after one year post completion.

2.2.3. Termination

After the 30 year term, the "Authority" has the choice to either retender the provision of the operations to the current SPE or to cease operations. In the latter, the asset is transferred to the "Authority" but without any purchase price payment (MGDD 4.3.3.49).

2.3. Demand risk

There is no demand risk

2.4. Early termination clauses and change in the nature of contract

The contract defines 5 termination events:

- "Authority" default and voluntary termination by the "Authority"

If the "Authority" either is in default or voluntarily decides the termination, the same compensation payments apply for

  - ✓ senior debt termination amount;
  - ✓ redundancy payments;
  - ✓ Subcontractor breakage costs (safe the SPE is in breach of any agreement with subcontractors),
  - ✓ Aggregation of share capital and outstanding amounts under the subordinated debt agreement.

- SPE default

In the case of a default during the construction and if a liquid market exists for such projects, a new SPE buys the contract and the difference between the estimated cost to finish the road and the initial contract price of £ 500m will be paid to defaulted SPE. If there is no liquid market for such projects, the "Authority" will compensate the value to the SPE in default.

During the exploitation of the project, a potential default is defined as a percentage of deductions in the monthly unitary charge the SPE can incur before it is considered as a default event. In this case, the road constructed will be handed over to the "Authority" against a compensation payment.

The compensation will be determined by an independent third party based on yet realised work and the estimated cost to complete the road (MGDD 2014 VI.4.3.4.51 – 52.).

- Force majeure

Following the ONS analysis, force majeure events include typical and precisely defined events. The applicable compensation will include:

- ✓ the base senior debt amount
- ✓ Amounts equal to subordinated debt less an amount equal to the aggregation of interest payments on subordinated debt
- ✓ Redundancy payments and subcontractor breakage costs, excluding from any claims for loss of profit.

However, if at the time the SPE is in breach of any agreement with subcontractors, then the "Authority" shall not cover the subcontractor breakage costs.

- ➢ Breach of refinancing or NPD requirements

The "Authority" has the right to terminate the contract if the non-profit distribution requirement is breached by the SPE or if any refinancing agreement is put in place without the "Authority's" prior consent. In addition, the "Authority" has a large control over all existing lending agreements and any amendment is subject to the "Authority's" prior consent.

The compensation under breach of refinancing or NPD requirements are reduced to the outstanding amounts at the termination date of the senior debt (including termination and breakage costs), less any positive amount on such breakage costs.

2.5. Other contractual risks and rewards

2.5.1. Dispute resolution

Any dispute should be solved through a mediation process by an independent adjudicator appointed by both parties or if there is no agreement by an independent mediator.

2.5.2. Withdraw of consent

The "Authority" is entitled to withdraw consent without any liability if the initial consent has been given on misleading information or if the SPE has been aware of such misleading information.

2.5.3. Increased costs

If the "Authority" requests a modification of services (subcontracts, changing materials), then the SPE should take all reasonable endeavours to adhere to these provisions. If these lead to increased costs and the SPE cannot finance these additional costs from the market, the "Authority" may pay for up to £ 5m.

2.5.4. Changes introduced by the SPE

The SPE has to introduce a Notice of Change to the "Authority", which accepts, amends or rejects the proposed changes. If the "Authority" accepts the modification, the "Authority" can accept to share the potential surplus with the SPE.

2.5.5. *Increased capital expenditure*

If the SPE is required to incur additional capital expenditure due to a change in the law, then the SPE shall first use all reasonable endeavours to procure this finance from capital markets to the reasonable satisfaction of the senior lenders. However, if finance cannot be secured within 60 days of the determination, then the "Authority" shall pay the SPE an amount equal to that capital expenditure.

3. EUROSTAT'S VIEW

Eurostat agrees with the view of the ONS that the asset of the project has to be classified on government balance sheet and that the three units constitute one unique institutional unit, in the meaning of ESA 2010, which has to be classified within the central government sector.

Classification of the asset

The NDP model foresees that there will be no dividend payment from the SPE to the legal shareholders. Any surplus generated, either through an improved management of the asset or through the renegotiation of service contracts, will thereby remain with the "Authority".

For any surplus generated through the renegotiation of senior loan contracts will mainly remain with the "Authority" following a precise profit sharing agreement. Such surpluses will be transferred to the “Authorities” through reductions in the monthly unitary charge to be paid by the authority.

As a consequence, government clearly reaps most of the rewards potentially accruing on the asset, and on this sole criterion, one can conclude that the partner cannot be deemed to be bearing the majority of the risks and receiving the majority of the rewards of the assets (ESA 2010 20.383). Thus, the asset must be recorded on government balance sheet.

Sector classification of the units

The three companies should be considered as one institutional unit, given the stapling agreement, which ties them closely together, in such a way that the activity of each entity should be seen as ancillary to the others. The concerned entities are therefore to be considered as an artificial subsidiaries (ESA 2010 § 2.24-2.26).

This institutional unit belongs to the public sector, being de facto controlled by government. Indeed, the single share held by the "Authority" procures to it significant veto rights and, in such way, the control over the main aspects of the corporate policy of the SPE: powers of directors, maximisation of the financial performance, application of revenues, asset lock, transfer of loan stocks and shares.

In the light of the MGDD 2014 Chapter VI.4 § 26 and 28 as well as implied by § 74, Eurostat agrees with the ONS that this institutional unit has to be classified within the general government sector given that this unit is *de facto* a Special Purpose Entity that is controlled by government and is created for the purpose of delivering and managing one unique PPP.

4. CONCLUSION

The economic ownership of the assets being built remains with the central government. The Scottish non-profit distributing model allows no distribution of dividends and most of the potential surplus flows remain with the government. Therefore, the asset has to be classified on government balance sheet.

The Authority has a large influence on the corporate policy by established veto-rights and control over the financing activities of the unit. As a consequence, the unit should be classified in the public sector.

Being a dedicated SPE controlled by government (in the meaning of ESA 2010) created to deliver a unique PPP, it is to be classified within central government (S1311), according to MGDD rules, thus confirming the analysis of the ONS and the classification decision made by the NACC.

5. PROCEDURE

This view of Eurostat is based on the information provided by the UK 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.

In this context, we would like to remind you that Eurostat is committed to adopt a fully transparent framework for its decisions on debt and deficit matters in line with Council Regulation 479/2009, as amended, and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC.

Eurostat is therefore publishing all official methodological advice (ex-ante and ex-post) given to Member States on its website.

Yours sincerely,

(eSigned)

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Director

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Electronically signed on 21/03/2017 15:01 (UTC+01) in accordance with article 4.2 (Validity of electronic documents) of Commission Decision 2004/563