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EUROSTAT

Directorate D: Government Finance Statistics (GFS) and quality

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Subject: Ex ante consultation on the PPP project Panevezys County Police Headquarters Building with Lokups.

Reference: Your request SD-368 dated 14 May 2018

Dear Ms. Lapėnienė,

Thank you for the note analysing the treatment of the PPP project Panevezys County Police Headquarters Building with Lockups received on 14 May 2018.

During the EDP dialogue visit held on 17-18 May 2018 Eurostat and Statistics Lithuania (SL) had a first discussion on this issue. SL agreed to prepare a complementary note highlighting the differences between this contract and the PPP Vilnius County Headquarter and Custody Infrastructure which had been assessed by Eurostat in 2017. Eurostat received this complementary information on 1 June 2018.

Please find below Eurostat's view on the treatment of the PPP project Panevezys County Police Headquarters Building with Lockups (the PPP contract).

1. THE ACCOUNTING ISSUE FOR WHICH A CLARIFICATION IS REQUESTED

The issue to be assessed is the treatment of the proposed PPP contract.

1.1. Documentation provided

SL provided a note with its analysis on this case as well as a note highlighting the differences between this contract and a prior PPP contract assessed by Eurostat in 2017.

1.2. Description of the PPP contract

The object of the PPP contract is the design, construction and maintenance of the Panevezys County Police Headquarters. The duration of the contract is 15 years, including 3 years for the design and construction. The parties of the contract are the Police Department of the Ministry of Interior of Lithuania and a private entity which will be selected through a public procurement procedure.

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The total investment is expected to be around 23 million euro and it will be entirely funded by the private entity.

2. METHODOLOGICAL ANALYSIS

2.1. Accounting provisions

The general rules to be applied when assessing the statistical treatment of a PPP project are defined in ESA 2010 chapter 20 (20.276-20.290) and in Eurostat's Manual on Government Deficit and Debt (chapter VI.4).

Besides, the Eurostat analysis below is also based on the "Guide to the Statistical Treatment of PPPs" (the "Guide"), jointly released by Eurostat and the European PPP Expertise Centre (EPEC). The provisions in this Guide are applicable to PPP projects reaching financial close after the publication of the Guide (29 September 2016).

2.2. Eurostat's analysis

Construction risk.

The contract clearly states that the authority will only start to make payments after the construction period (in other words, no payments before the "commencement of operation"). The contract differentiates works in general with installation works by splitting the approval into two stages. First, upon completion of works, except installation works, the private Partner informs the authority which shall inspect the works within 15 days (article 9.3.5) and may establish non-conformities. A similar procedure is contemplated for installation works where upon completion; the authority has 10 days to inspect them. If the installation works comply with the requirements, the authority should issue a confirmation. The date of "commencement of operation" is the date of this confirmation.

In this regard, please note that the PPP contract does not contain objective and robust criteria to determine whether the construction of the asset is completed. We assume this issue will be addressed before the procurement of the contract and therefore have not considered it in our analysis.

SL assessed that the design and construction risks will be transferred to the private Partner. We do not have information to contest this assessment although we recommend addressing the points on force majeure discussed later.

Demand risk.

Eurostat agrees with SL that the demand risk is not transferred in this case as final users do not have free choice as regards the service provided by the private partner.

Availability risk.

The MGDD makes it clear that the government is not assumed to bear the "availability risk" if it can reduce significantly its periodic payments if certain performance criteria are not met. In the contract sent to Eurostat for review there are no performance criteria. We assume that, as we did for construction criteria, the criteria will be set before the procurement of the contract and have not considered this absence in our analysis.

a) Nature of the maintenance services

The Guide states that "in order for a project to be considered a PPP by Eurostat, the Partner must, as a minimum, be obliged to maintain the asset for the duration of the contract with a view to making it available to the Authority or other end-users. Projects on which the asset requires no or a negligible amount of maintenance or operation by the Partner need to be looked at carefully on a case by case basis, as Eurostat would normally consider these to be more aligned with conventional government expenditure."

The proposed PPP contract does not contain a description of the maintenance to be done including the performance standards. The lack of detail of the maintenance tasks does not allow Eurostat to assess whether the services to be provided by the private Partner are only "secondary" to maintaining the asset (e.g. cleaning, landscaping, parking management...).

b) Caps on responsibilities/deductions

The Guide states that "Eurostat's view is that any cap on deductions that undermines the principle of proportionality (which, for example, should result in 'zero availability, zero payment' over a meaningful period of time) **does influence the statistical treatment** and automatically leads to the PPP being recorded ON BALANCE SHEET for government."

Article 47 of the contract on mutual responsibility of parties covers the compliance with the requirements for the provision for services specified in the contract. Article 47.1 indicates that if a deduction is applied, no other penalty or compensation may be applied for the same violation. Article 47.5 **limit the amount of responsibility applied to any party during the entire period of validity to a maximum of 10% of the value of investments** (excluding VAT).

Section X of Appendix 3 "Settlement and payment procedures" states that deductions are applied monthly and that the deductions for a reporting month may not exceed the monthly part of the Annual remuneration. Furthermore, Article 37 seems to indicate that the amounts of deductions applied in a given month are limited to guarantee that the private Partner receives a payment which is sufficient to cover the payment of the debt incurred (or "M1 credit flows"). It is not clear to us how these provisions can be reconciled with the principle of zero availability – zero payment mentioned in Section X of Appendix 3.

Overall, these provisions have the effect of guaranteeing a minimum revenue for the private Partner in the sense that it is guaranteed to receive at least 90% of the value of the investment and it should be able to cover the debt payments. This would lead to the PPP being on balance sheet for government.

c) Compensation resulting from early termination of the agreement

The Guide states as a general principle applicable to all early termination scenarios that "the payment of compensation should not cancel any liabilities of the Partner to the Authority that pre-date termination (e.g. an indemnity claim that the Authority has against the Partner). PPP contract provisions that do not preserve pre-termination liabilities **do influence the statistical treatment** and are issues of HIGH importance."

Articles 43, 44 and 45 cover different early termination scenarios. For all of them, the provision establishing the compensation formula states **that the compensation payment may not be less than 100% of the outstanding debt (FI).**

Overall, the condition that the compensation payment cannot be less than 100% of the outstanding debt introduces a limit to deduction of pre-termination liabilities. This is because if the sum of all other elements that the amount of outstanding debt included in the formula is negative, the compensation is fixed at the level of outstanding debt.

This provision does not respect the principle stated in the Guide that "if the methodology for calculating the estimated fair value of the contract establishes a value that is less than zero, the contract provides for the possibility of a negative compensation payment (i.e. a payment that would be due by the Partner to the Authority)" which is established in section 12.1.3.

Lastly, the Guide states that "PPP contract provisions that base the compensation payable on Partner default on the senior debt outstanding (or a percentage of it) are akin to a financing guarantee (see Theme 14.4) **and do influence the statistical treatment**" (section 12.1.5).

d) Force majeure, dismissal events

Finally, the current drafting of Article 42 on force majeure would lead to automatic classification on balance sheet for government as the list of events considered to be force majeure is not exhaustive. In particular, the expression "force majeure events **mean any event** which is beyond reasonable control of the Party..., could not be reasonably foreseen or prevented and which makes fulfilment of aforementioned obligation...fully or partly impossible" is not acceptable. While the Article contains a list of such events, this list is considered to contain examples of such events (the list is preceded by the abbreviation e.g.). Besides, the list contains events which cannot be considered as force majeure. For example, strikes or lockouts are included among the events to be considered force majeure. The Guide refers to industry-wide strikes highlighting the point that a strike or a lockout at company level cannot be considered force majeure. More precision would therefore be needed in this respect.

Article 21.1.6 on dismissal events, excuses the private Partner of its obligations under the contract in the case of strikes at the building when not considered force majeure. The exception stated in the article of employees of the private Partner and associates will also need to be expanded to clarify that strikes by employees of subcontractors are not considered dismissal events.

3. CONCLUSION

Eurostat's view has been expressed in the previous section and is summarised below:

1. The absence of robust and objective criteria for the construction works and the maintenance automatically lead to the PPP being on balance sheet for government if not corrected before the procurement.
2. The cap on the responsibility of the private Partner to 10% of the value of investments would lead to the PPP being on balance sheet for government.
3. The constraint that the compensation for the termination of the agreement may not be less than 100% of the outstanding debt would automatically lead to the PPP being on balance sheet for government.
4. The current definition of force majeure events in the contracts is not exhaustive which would automatically lead to the PPP being on balance sheet for government.

It is recalled that Eurostat's role is limited to the assessment of the statistical treatment of existing PPP contracts and that it is out of the scope of Eurostat's mandate to advise on the drafting of PPP projects.

4. PROCEDURE

This preliminary view of Eurostat is based on the information provided by the Lithuanian authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information currently available and the assumptions made above, 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 and the note on ex-ante advice. Eurostat therefore publishes all official methodological advice (ex-ante and ex-post) given to Member States on its website.

Yours sincerely,

(e-Signed)

Luca Ascoli
Acting Director