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Subject: Ex-ante advice on the statistical treatment of the Public Private Partnership (PPP) Project E67/A7 Kekava bypass.

Reference: Your letter Case 0601-10/439, 10/05/2018,
Your e-mail 10/05/2018 and included documents

Dear Ms Aija Žīgure,

Thank you for your ex-ante advice request on the statistical treatment of the Public Private Partnership (PPP) Project E67/A7 Kekava bypass dated 10 May 2018. 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 ACCOUNTING ISSUE FOR WHICH A CLARIFICATION IS REQUESTED

A clarification is requested for the statistical treatment of the Public Private Partnership (PPP) Project E67/A7 Kekava bypass. The key statistical issue is the classification of the assets involved in the PPP contract – either as government assets (thereby immediately influencing government net lending/borrowing (B.9) and debt) or as assets of the partner (spreading the impact on government net lending/borrowing (B.9) – and on imputed debt – over the duration of the contract).

1.1. Project description[1]

The Kekava Bypass project involves the designing, building, financing and maintenance of infrastructure and is intended to be implemented using a PPP model with availability payments. The total capital expenditure is estimated at 80 to 100 MEUR, and the contract value, according to the calculations from the feasibility study around 160 MEUR excluding VAT.

The project aims at the construction of the Kekava bypass on the E67/A7 road section making this road section a two-lane expressway. It entails a road with the total length of 17.5 Km,

[1] Information enclosed in the e-mail from 10/05/2018 sent from CSB to Eurostat, with general information and a methodological analysis on the statistical treatment of the Public Private Partnership (PPP) Project E67/A7 Kekava bypass.

including the construction of a new road (14.4 Km), the reconstruction of the existing road (3.1 Km) and associated infrastructures (ramps, tunnels, parallel roads, roundabouts and auxiliary roads) (hereinafter the Bypass). From the total length of roads, 11.1 km of them are planned as four-lane carriageway and 6.4 km planned with two lanes. The project includes also four multiple junctions, four tunnels, one bridge, seven roundabouts as well as parallel roads in total length of 16.2 km.

The PPP contract will be a long-term contract, including a design and construction phase of approximately three years (from the date of Financial Close until the date of issue of the certificate of availability), followed by a 20-year exploitation and maintenance period from the date of availability.

1.2. Documentation provided

CSB provided to Eurostat, by an e-mail from 10/05/2018, a letter with general information on the PPP Project E67/A7 Kekava bypass and a methodological analysis on the statistical treatment of the Public Private Partnership (PPP) Project E67/A7 Kekava bypass. The e-mail included the following annexes:

Annex A: Analysis according to the Eurostat guide 2016 (includes the table of typical PPP contract provisions that influence the statistical treatment);
Annex B: Draft of the PPP contract;
Annex B.1: Definitions;
Annex B.2: Payment mechanism;
Annex B.5: Compensation in the case of early termination.

Previously, in an e-mail from 01/09/2017, CSB provided Eurostat with a report from "Deloitte Latvia" containing general information of the project, indicative timeline and key facts on the payment and risk allocation principles (as they stood at the time).

1.3. Legal structure

For the Kekava bypass project the selected procurement procedure was the tender procedure with negotiations. The announcement of the procedure is expected to take place around August/September 2018 and the submission of the first bids by November 2018.

The PPP contract will be signed by:
- the Ministry of Transport of the Republic of Latvia (hereinafter the Authority);
- the State Joint Stock Company Latvian State roads (the Implementing Authority, 100% owned by the State) acting under delegation agreement with the Ministry of Transport; and
- the private partner.

- General terms of the contract

The PPP Contract enters into force and becomes binding on the Parties as of the Contract Date (the date on which is signed by both parties). The scheduled commencement date should be 180 calendar days following the Contract Date. As of the Contract Date until the Commencement Date all conditions precedent to the Financial Close shall be fully and timely fulfilled, and amendments to the Contract should be done. Financial Close shall take place on the Commencement Date.

"*The Authority remains the legal owner of the land and the bypass for the whole duration of the PPP contract.* Nevertheless, *under domestic Latvian laws, legal term "possession"* [economic ownership] *differs from the legal term "ownership". It is possible to own an asset, which is transferred into the possession of a third party, and therefore is not available for use (exercising the possession) by the owner. At the end of the PPP contract, the asset will be transferred into the possession of the Authority"*[2]

- Changes to the PPP contract

"The final wording of the PPP contract will only be available following the Financial Close."[3]

Sections which are crucial to maintain off-balance sheet treatment of the assets are closed sections for any negotiation, both during the procurement procedure and at the Financial Close (Chapters 7 and 8 of the draft PPP contract).

- Other considerations:

The European Investment Bank (EIB) and the Nordic Investment Bank (NIB) conducted a mission and agreed on the Kekava bypass project financing approval, being the final decision subject to successful completion of the due diligence process of the winning bidder. The documentation pack has been also submitted to the European Bank for Reconstruction and Development (EBRD) approval.

Currently is also under consideration to submit the Kekava project for the CEF-Connecting Europe Facility grant financing (CEF Transport Multi-Annual Work Programme 2014-2020).

2. METHODOLOGICAL ANALYSIS

2.1. Applicable accounting rules

The general rules to be applied when assessing the statistical treatment of a PPP project are defined in ESA 2010 chapter 15 - *Contracts, leases and licences, §15.41 Public-private partnerships (PPPs)* and chapter 20 – *The Government accounts, §20.276 to 20.302 Public-private partnerships* and in Eurostat's Manual on Government Deficit and Debt (MGDD), Part VI - *Leases, licences and concessions - VI.4 Public-Private Partnerships (PPPs).*

In addition, the Eurostat analysis below is also based on the "Guide to the Statistical Treatment of PPPs" (the PPP Guide), jointly released by Eurostat and the EIB in 29 September 2016.

2.2. Availability of national accounting analysis

[2] Information enclosed in the e-mail from 10/05/2018 sent from CSB to Eurostat, with general information and a methodological analysis on the statistical treatment of the Public Private Partnership (PPP) Project E67/A7 Kekava bypass.
[3] Ibid.

CSB in cooperation with the SJSC "Latvian State Roads" (implementing authority) and LLC "Deloitte Latvia" (consultant for the implementing authority) have evaluated the draft version on the Kekava PPP contract, according to the MGDD and the PPP Guide.

The Latvian authorities provided to Eurostat a detailed analysis of the draft PPP contract according to the three steps methodology for the assessment of the statistical treatment of a PPP referred in the PPP Guide. CSB provided also to Eurostat the table of PPP contract provisions that influence the statistical treatment.

Regarding step 1 and the identification of the issues that typically influence the statistical treatment, the Latvian authorities have concluded that:
- no automatic on balance sheet items have been identified;
- no items with very high importance have been identified;
- no items with high importance have been identified;
- no items with moderate importance have been identified.

In step 2, concerning the analysis of the degree to which each of the provisions identified in the previous step could impact on the economic substance of the project, no provision for re-categorization were identified.

Their conclusion of the statistical treatment assessment in step 3 was that, since the draft PPP contract has no very high, high or moderate or automatic on-balance sheet items, the PPP contract is off-balance sheet for the authority.

2.3. Methodological analysis and clarification by Eurostat

2.3.1 Characteristics of PPPs:

The Kekava bypass project has the features of a PPP. It is a long-term contractual arrangement for the provision of a public asset and related services in exchange for performance-based payments linked to the asset's availability and use and the delivery of the related services.
The government is the main purchaser of the services from the partner and government payments constitute a majority of the fees received by the partner under the contract. It is not foreseen to include revenues from third parties (§2.2.j of the draft PPP contract).

The asset has an economic life that is longer than the duration of the contract and the PPP contract covers a meaningful part of the asset's economic life (the contract foresees 3 years of construction and 20 years of maintenance).

2.3.2 Statistical sector classification of the private partner

Eurostat's definition of a PPP requires that, for statistical purposes, the Authority is classified inside the General Government sector and that the Partner is an entity classified outside the general government sector.

According to the information provided by the CSB in the e-mail from 10/05/2018, *for the purpose of the execution of the PPP contract, the private partner will set up a Special Purpose Vehicle (SPV). No participation of any kind (including but not limited to via capital contribution, guarantees or decision making) is expected from the Authority in the SPV.*

The SPV is controlled by private entities and is an entity, for statistical purposes classified outside the general government sector.

2.3.3 Assessment of the allocation of risks and rewards borne by each contracting party

According to the MGDD, part VI.4.1, the assets involved in a PPP can be considered non-government assets, in national accounts, only if there is strong evidence that the partner bears simultaneously most of the risks and rewards attached to the assets (directly and linked to its use) involved in the specific partnership.

As a basic rule, for the PPP assets to be classified in the partner's balance sheet and not in the government balance sheet, the following conditions need to be met:

- the partner bears the construction risks.

- the partner bears at least one of either availability or demand risk, as designed in the contract and in some cases, at the same time both availability and demand risks.

- the risks are not incurred by government through other means, such as through (e.g.) government financing, government guarantees and early redemption clauses.

a) Construction risk

The "construction risk" covers events like late delivery, respect of specifications and increased costs (MGDD VI.4.1).

According to the specifications set out in the tender, the design and construction risk is transferred to the private partner. Private partner takes the risk of obtaining permits for construction (§2.2 and §10.2 and 10.3 of the draft PPP contract); and, there are no provisions, that the authority will be responsible for any construction delays or deficiencies, increased construction, maintenance or operating costs, or any operational failures (§11.3 to 11.10 of the draft PPP contract).

The authority starts payments only when the construction is completed and when the asset is available, i.e., after the available date Payment Commencement Date (§2.3 of the draft PPP contract[4]). The completion criteria are clearly specified in the legal documentation and are subject to receiving completion and availability certificates. Issuance of the availability certificate does not release the private partner from its obligations of maintenance and availability of the bypass during the entire operation period (chapter 13 and 14 of the draft PPP contract).

b) Availability risk

The "availability risk" covers the volume and the quality of output (linked to the performance of the partner) (MGDD VI.4.1).

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[4] "*2.3.The Private Partner is entitled to receive from the Authority full amount of the Availability Payment only for the timely and full performance of the Private Partner's obligations hereunder and only after the Bypass in whole has become Available. As of the Availability Date, Private Partner shall be entitled to receive 90% (ninety per cent) of the Availability Payment. As of the Completion Date, Private Partner shall be entitled to receive 100% (one hundred per cent) of the Availability Payment.*"

The MGDD VI.4.1 states that the government is assumed not to bear such a risk if it is entitled to reduce significantly its periodic payments, like any “normal customer” would be entitled to, if certain performance criteria were not met. Under these conditions, government payments must depend on the effective degree of availability ensured by the partner during a given period of time.

The availability-based payments are set in the draft PPP contract on the basis of objective criteria and not open to negotiation between the parties (chapter 4 and Appendix 2 – Payment mechanism of the PPP contract). The private partner is responsible for meeting deadlines and will be subject to deductions for non-compliance with availability and performance requirements throughout the contract.

- Availability-based payments

The quarterly availability payments commence as of the availability date, which are subject to the issuance of an availability certificate by the Authority (§2.3 and §13.2 to 13.5 of the draft PPP contract). To ensure that the private partner respects the quality and availability requirements, a penalty regime is defined in the draft PPP contract, consisting on a mechanism of availability adjustments and performance deductions, which are proportionate and clearly defined in the contract (non-availability events and non-performance are set, respectively in §15.13 and 15.18 of the draft PPP contract). When the unavailability adjustment and performance deduction exceed respectively the amount of the gross availability payment and the net availability payment, the draft PPP contract provides for a carry-forward system, making the deductions respectively on the gross availability payment and the net availability payment for the next directly following quarters[5], until the total amount of these deductions is fully paid (§4.5 of the draft PPP contract).

For the assessment of the quality control *"the Authority does not rely on self-reporting by the Private Partner and has the right to monitor and audit the Bypass."*

Chapter 19 of the draft PPP contract anticipates an exhaustive list of supervening events, that are recognized and permitted under the contract and that, depending on their nature, scope and cause, fall into one of the three categories: relief events, compensation events or force majeure events.

"In the event of delay in making the Bypass available due to the fault of the private partner, the availability date will be postponed, and having a total contract term of maximum 23 years, this term will not be extended and delay in availability certification may result in the reduction of the availability term at the expense of the private partner.

The amount of the gross availability payment is fixed at the moment of the Financial Close without possibility of revision (except for indexation of components during maintenance period as specified in the Draft PPP contract). Therefore, the private partner will assume all risks of cost overruns and delays related to design and construction defects, including the risks of additional maintenance costs and other adjustments that would occur as a result of these defects at inception. [§15.5 of the draft PPP contract]

[5] According to theme 4.7 of the PPP guide, the roll-forward period for accumulated deductions to be recovered is typically one year.

Finally, the Draft PPP contract provides for a mechanism to determine the contract value in the event of the failure of the private partner, determined according to the method of retendering or the market value method."[6] (Annex B.5: Compensation in the case of early termination)

c) Demand risk

The "demand risk" covers the variability of demand (the effective use of the asset by end-users).

As regards the demand risk, government is assumed to bear this risk where it would be contractually obliged to ensure a given level of payment to the partner independently of the effective level of demand expressed by the final users, making irrelevant the fluctuations in the level of demand on the partner's profitability. No demand-based payments are considered. (MGDD VI.4.1)

The draft PPP contract doesn't foresee any payment to the private party related to the demand that do influence the statistical treatment.

d) Other contractual risks and rewards

- Land acquisition risk

"Land acquisition process is expected to be completed by Contract Close, and risk associated with the land acquisition is fully borne by the Authority."[7]

"Authority shall take responsibility for making the selected land plots available to the Private Partner, and shall bear all costs related to their acquisition, expropriation, lease or obtaining of the right to use them for the needs of the Construction Area and Land Necessary for Construction Works." (§ 11.6 of the draft PPP contract)

According to theme 1 of the PPP Guide, "the fact that the Authority takes some or all responsibility and/or risk under the PPP contract for obtaining site ownership or access, necessary for the delivery of the project, does not influence the statistical treatment."

- Changes in Law

Authority takes no risk for changes in Law, except for VAT and for substantial changes in Law[8]. In case substantial changes in Law occur, upon notification by the private partner to the Authority, the parties shall mutually agree on the use of one or more remedying instrument listed in the contract: "*(a) postponement of the Scheduled Availability Date, Scheduled Completion Date, date for the Initial Hand Back Inspection, or Scheduled Hand Back Date;(b) amendment to the Contract and/or any other document required for the full performance of any Works to reflect necessary changes in the Works;(c) exemption from the unilateral withdrawal from the Contract by the Authority due to the Private Partner Default."* (§ 7.10, page 35, of the draft PPP contract)

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[6] Letter enclosed in the e-mail from 10/05/2018 sent from CSB to Eurostat, with general information and a methodological analysis on the statistical treatment of the Public Private Partnership (PPP) Project E67/A7 Kekava bypass.

[7] Ibid.

[8] "*Changes which substantially affect the amount, quality, and/or regularity of the obligations of any party under the contract or works to be performed.*"

According to the PPP Guide, theme 8, Authority takes the risk of changes in law that affect the project, when is required to compensate the Partner for costs incurred or revenues lost as a result of changes in law. And where there is this case, the issue is of moderate importance to the statistical treatment.

In the draft PPP contract and for the case of substantial changes in Law, the mentioned provisions seem more to point to a shared risk between the parties that would not influence the statistical treatment.

- Insurance

There are no provisions in the contract for the Authority to take or share the risk/benefit of insurance costs (other than in situations of uninsurability – §17.26 to §17.28 of the draft PPP contract) that influence the statistical treatment.

The reinstatement obligation is envisaged in §17.23 of the draft PPP contract, but "*no occasion leading to or causing reinstatement shall constitute a basis for any of the Parties to unilaterally withdraw from the Contract*."

- Additional financial risk

The authority grants no loans or financing, nor are any guarantees provided in favour of the private partner, including but not limited to debt repayments. Therefore, no additional government risk will be borne.

"Between the dates of the contract close and the financial close, the interest rate (base rate) risk is borne by the authority."[9]

According to the PPP Guide, theme 14.2, the provisions for adjusting the Operational Payments to reflect the interest rate set through the initial hedging process (whether at financial close or at a later key milestone during the Construction Phase) do not influence the statistical treatment.

- Refinancing gains

The private partner can enter into a new Financing Agreement, except if the new financier had been subject to any exclusion or refusal during the tender. For the refinancing, the private partner shall obtain prior written consent of the Authority, which shall not be unreasonably withheld. In case of refusal, the Authority needs to submit to the private partner the written arguments substantiating the refusal. In case Authority approves the new financing, the private partner will pass on to the Authority 30 % (thirty per cent) of the financial gain before tax generated from Refinancing (§2.4 of the draft PPP contract).

Concerning refinancing gains, the provisions in theme 14.6.1 of the Guide state that: "A right for the Authority to withhold its approval to a proposed refinancing does not influence the statistical treatment if its approval cannot be withheld or delayed unreasonably or if the grounds on which it can withhold its approval are limited to circumstances where the refinancing would have an adverse impact on the Authority (e.g. an increase in the Authority's potential liabilities on early

[9] Letter enclosed in the e-mail from 10/05/2018 sent from CSB to Eurostat, with general information and a methodological analysis on the statistical treatment of the Public Private Partnership (PPP) Project E67/A7 Kekava bypass.

termination) or on the performance of the project. Where this is not the case, the issue is of HIGH importance to the statistical treatment;"

And theme 14.6.2 of the Guide refers that refinancing gain sharing do not influence the statistical treatment when "the PPP contract states that the Authority is entitled to a specified share (no greater than one third) of any refinancing gain. Under this approach, no assessment is made of whether the refinancing gain results from the actions of the Authority or the Partner or other factors."

Following the above, Eurostat understands that the provisions for refinancing gains as described in the draft PPP contract have no influence on the statistical treatment of the project assets.

- Other rewards

Apart from the benefit sharing mechanism in place in case of debt refinancing, the draft PPP contract does not provide for any other benefit sharing mechanism in the event of excessive profits and it seems that there are in the draft PPP contract no limitations on the rewards to the private partner such as a cap on profits or a minimum revenue guarantee.

- Early termination of the contract

Regarding early termination scenarios, the provisions set at theme 12 of the PPP Guide refer 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.

§20.1 of the draft PPP contract establish that: *"Early Termination of this Contract may only take place on the occasions exhaustively listed in this Contract or Laws. In any event Early Termination shall not release Parties from full and timely performance of all obligations and/or exercising of all rights under the Contract following the Early Termination Date, should these obligations or rights be of such character."*

§20.2 to §20.6 of the draft PPP contract define the conditions, deadlines and procedures for early termination pertaining to the failure of Private Partner. §20.7 to §20.9 of the draft PPP contract define the grounds, deadlines and procedures for early termination due to the Authority default.

The draft PPP contract document follows the PPP guide (themes 11 and 12 of the Guide). The triggers for early termination for Authority default do not result in the Authority taking risks that influence the statistical treatment. Parties shall mutually pay and receive Compensations in the case of Early Termination according to §20.13 of the contract PPP and its appendix 5.

The draft PPP contract recognises the right for either party to terminate the contract in case of force majeure and adjusts the Authority payments and the project timetable for defined risks (§19.21 to 19.25 and appendix 5 of the draft PPP contract).

The compensation for early termination due to the private partner default shall be calculated and paid based on one of the two methods: re-tendering or estimated market value of the contract, to be selected by the Authority. The compensation for early termination due to the Authority default or due to Force majeure event or insurability shall be composed of three components:

senior debt, shareholder equity and subordinated debt, and payments due to the third parties. These provisions seem aligned with the principles of theme 12 of the Guide.

- Expiry of the contract clauses and hand-back inspections

Theme 13.4 of the Guide establishes that, on expiry of the PPP contract, when the responsibility for the asset will revert to the Authority, the Partner must take the risk that the physical condition of the asset on expiry of the PPP contract meets a standard that is consistent with it having been maintained in accordance with the contract. Failure to transfer this risk to the Partner under the PPP contract does influence the statistical treatment and is an issue of HIGH importance.

The Kekava Bypass contract, stipulates that at the end of the contract, the asset will be transferred into the possession of the Authority according to hand-back requirements (§11.14 and chapter 16 of the draft PPP contract). Based on hand-back inspection results, hand-back bank guarantees should be submitted by the private partner to ensure timely and fully compliance of the asset with the technical requirements set forth in the hand-back requirements at the end date of the contract. No additional compensation is due by the authority to the private partner, including (but not limited to) compensation in the event that, at the draft PPP contract end date, the asset is transferred to the Authority in a better condition than was required under the hand back requirements.

3. EUROSTAT'S VIEW

On the basis of the above considerations and analysis, Eurostat is of the opinion that the private partner bears most of the risks attached to the asset during the whole duration of the contract and is also entitled to receive most of the current benefits from the assets.

Eurostat has carefully analysed the table of draft PPP contract provisions that influence the statistical treatment, provided by the Latvian authorities. Following the analysis of the draft PPP contract according to the PPP Guide, Eurostat agrees with the Latvian authorities that the PPP assets should be classified off government balance sheet.

4. PROCEDURE

This view of Eurostat is based on the information provided by the Latvian 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,

(e-Signed)

Luca Ascoli
Acting Director