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Subject: **Ex-ante advice Welsh Mutual Investment Model (WMIM) for Public Private Partnership (PPP) Projects**

Reference: Your letter Case 2016-49, 5/04/2017,
Our letter on 22/12/2017
Our letter on 06/03/2018
Your e-mail 17/04/2018 and included documents

Dear Mr Bailey,

Thank you for your ex-ante advice request on the Welsh Mutual Investment Model (WMIM) for Public Private Partnership (PPP) Projects dated 5 April 2017. After having closely examined the arguments in the documents provided, further discussed the matter with your ONS' colleagues and your e-mail on 17 April 2018, including the amended version of the WMIM, Eurostat is now in a position to express a view on this matter.

1. THE CLASSIFICATION ISSUE

The issue is to analyse the provisional decision taken by the Economic Statistics Classification Committee (ESCC) of the ONS concerning the statistical classification of the Welsh Mutual Investment PPP Model (WMIM) and the concerned units. The WMIM is a policy proposal and shall be used for the next tranche of revenue funded Welsh infrastructure projects.

Documentation provided

The ONS provided to Eurostat a copy of the following confidential documents:

- Classification decision Letter from ONS to Welsh Government
- Classification case document considered by ESCC (ONS)
- WMIM Shareholders’ Agreement, in its original (2017) and amended (2018) version

- WMIM User Guide
- WMIM Accommodation Project Agreement
- Letters related to WMIM Reserved Matters from DLA Piper, PWC and the Welsh Government
- WMIM Data Sheet (as referenced in Shareholders' Agreement)

The documentation provided constitutes standard forms of agreements, which have to and will be adapted to each specific project.

The Eurostat analysis is based on these standardised documents.

2. DESCRIPTION OF THE CASE

The Welsh Government (WG) informed the ONS and subsequently Eurostat that it has developed a new PPP project model, taking into account the ESA 2010 regulation, Eurostat guidance and the Manual on government deficit and debt 2016 as well as the Guide to the statistical treatment off PPPs, published jointly by the EIB and Eurostat in September 2016 (PPP guide). After discussions between Eurostat and the ONS, the Welsh government provided in April 2018 an amended version of the WMIM taking into account Eurostat's observations on the initial version of the WMIM. The provided model agreements as well as the user guide will form the basis for future infrastructure projects for roads and accommodation. The Welsh Government intends to develop further templates of project agreements related to hospitals and schools. The model documentation will therefore be adapted to the specific project needs.

Each project will be subject to a public tender for the construction, the maintenance and the management of the project to be delivered through a dedicated consortium. A separate tender might be organised for additional equity investors, if any. The proposed procedure fulfils the criteria for Public Private Partnerships (PPP) in the statistical sense.

2.1. Legal structure

The projects will be delivered to the Welsh Government (the authority) through a group of project companies composed by the following units[1]: a Developer, a Third Party Equity Provider (TPEP), the Welsh Government Company (WGCo), a holding company (HoldCo) and a project company (SPV). The three latter units will be newly created on purpose.

a) Welsh Government Company (WGCo)

WGCo will be a company which will be a wholly owned subsidiary of the Welsh Government (classified in S.11), and the vehicle through which the WG may invest in each project. It should be assumed that WGCo will invest on the same market terms and at the same times as other shareholders. The details are included in the Equity Subscription Agreement. The intended level of investment of WGCo will be specified for each project in the procurement documentation, but any holding will always be a minority interest and not higher than 20% of issued share capital/subordinated debt.

1 This structure is a template structure. There might be no third party investor and the Welsh government might not be an investor.

b) Developer

The Developer is anticipated to be (however, this may not always be the case), a single sponsor/construction company related to the building contractor who will carry out the construction works, the operation and maintenance under the main Project Agreement. If the Developer is comprised of a number of parties, then each standard project form will require amendment. The formation of the HoldCo and Project Co is expected to be set up by the Developer, who will also be a shareholder in the HoldCo, and provide the required amount of shareholder debt by subscribing to HoldCo Loan Notes (subordinated debt).

c) Third Party Equity Provider (TPEP)

The Third Party Equity Provider will be considered by the WG on a project by project basis. The standard form anticipates that they will be an entity which is not related to the building contractor or facilities management (FM) contractor, so is likely to be a long term equity provider, such as a private pension fund. If third party equity participation is adopted, a funding competition will be run at preferred bidder stage, before financial close, run by the private sector with input and approvals from the public sector. The equity funding competition may result in a tranche of equity with lower equity return. Savings generated through this will be passed on in full through the Annual Service Payment. Gearing[2] may shift if third party equity is sought, from the traditional 90:10 to between 80:20 and 75:25, and each project's documentation amended accordingly.

d) Holding Company (HoldCo)

The Holding company (or HoldCo.) will be established as a jointly owned company, owned by WGCo, the Developer and the TPEP (or whoever the shareholders are for each project), and will carry out the business of the holding company for ProjectCo, to manage the shareholding and finances of each project. The HoldCo will enter into loan agreements and provide the financing to the Project Company (SPV).

e) Project Company (SPV)

The Project Co will be the special purpose vehicle (SPV) set up to manage the construction of the project and shall always be wholly owned by the HoldCo. It will manage the Project Agreement with the procuring authority and also the hard facility management contracts with the relevant sub-contractors. The SPV will be responsible, together with the developer, for the design and the construction of the asset.

2.2. Shareholder agreement (SHA)

a) Funding of the HoldCo and of the SPV and dividends

Equity and subordinated debt will be provided by the equity investors. At least a minimum of 80% will be provided by the private investors. The WGCo will not contribute to more than 20% of the equity and of the subordinated debt (MGDD 2016 VI .4.3.3.). The equity and subordinated debt will amount to 10% of the total financing needs. The PPP guide (theme 14.4) specifies, that a limited equity / subordinated debt participation of up to 20% has a moderate influence on the statistical treatment of the project. If a TPEP joins the project, the equity proportion to the financial needs might be increased to 20 – 25%.

[2] Gearing = relation between debt and equity

MGDD 2016 VI.4.3.3 §57 specifies that financial instruments may involve different degrees of risk. A simple method to value any government subordinated debt financing implies using a multiplier of 2.5 when government holds a higher risky instrument, which is the case for subordinated debt. More complex financings would require a specific analysis.

MGDD 2016 VI.4.3.3 §56 specifies that EU funding has to be excluded from the calculation of government financing, whereas financing from the European Investment Bank has to be considered to be provided by the private sector.

None of the shareholders is committed to subscribing any additional shares or providing any additional funding, any guarantee or other indemnity for the HoldCo or the SPV liabilities.

The remaining financial needs will be covered through bank loans and/or bond issues (i.e. EIB, private lenders, banks…).

The equity/subordinated debt participation of the WG gives the right to the authority to receive a pro rata portion of the distributed dividends and interest on subordinated debt. Dividend payments to the authority will be limited to a maximum of 20% of the profits (the planned maximum shareholding). The 20% has to take into account any TPEP shareholding/subordinated debt having a lower dividend/interest payment scheme. This has a moderate influence on the statistical treatment of the project (PPP guide theme 15.1), but any change in the distribution of dividends / interest due to the equity / subordinated loan participation of any TPEP should be assessed against the threshold.

b) *Appointment of directors and disputes*

Any shareholder holding 15% or more of the issued share capital in HoldCo will be known as a Material Shareholder and shall be entitled to nominate one Director for every 15% of the issued share capital held by it. However, WGCo shall, for as long as it holds shares in HoldCo, be entitled to nominate one Director irrespective of whether it holds 15% of HoldCo shares (although it would not then be a Material Shareholder). As WGCo will never hold more than 20% of the shares in HoldCo, it will never be able to appoint more than one Director.

Each of the Boards shall consist of at least 3 Directors. The quorum for both Board meetings shall comprise one Director appointed by each Material Shareholder, plus WGCo if not a Material Shareholder.

c) Voting rights

The SHA specifies the voting rules and in particular on specific matters. Therefore Eurostat places a particular attention to the specific provisions in the SHA, if the authority has the qualifying status of a material shareholder, in order to consider whether the HoldCo/SPV is controlled by the private sector or by government. The SHA includes some specific voting rights, which can be assimilated to veto-rights, for any material shareholder as defined in section 2.2 b above. These so called reserved matters concern decisions by the board of directors or in the shareholder meetings, when they have a material adverse effect on the rights of the minority material shareholder in question. The reserved matters apply to the HoldCo and the SPV where relevant. Taking into consideration the large number of reserved matters ruling the HoldCo and/or SPV, these might have an influence on the statistical treatment of the project.

These provisions intend to protect particular sensitive issues for the minority shareholders. Any decision on these matters decided by the majority in the shareholder meeting or in the board meeting needs therefore to be approved by any material shareholder (holding at least 15% of the shares) giving de facto a veto-right to the authority on defined matters. Such provisions are frequently used in the articles of association of private companies.

The fact that other shareholders hold the same veto rights has no influence on the impact of such veto rights of the authority on the classification of the unit (PPP guide: chapter 2).

General rules for the classification of the unit into the government sector are set out in ESA 2010[3] as well as in the MGDD 2016[4].

A more detailed guidance is provided by the PPP guide. In section 2, it is specified that if government holds veto rights on important decisions of the SPV, then the SPV should be classified within the government sector. Section 3 theme 15.2 clarifies the issue and the following reserved matters should be considered having no impact on the statistical classification of the HoldCo/SPV:

- changes to the dividend policy;
- political donations;
- giving deed of guarantees or indemnities not required for the proper operation of the Company;
- any amendments to the memorandum of articles;
- changes of the status of the company;
- a listing of the company;
- move the central management and control of the company or the tax residence outside the UK;
- changes in the statutory liability of directors (e.g. anti-bribery and corruption, health and safety, non-discrimination);
- increasing the remuneration or fees to directors;
- conflict authorisation to a conflict of interest situation.

The amended WMIM framework limits the Reserved Matters to topics which are specifically identified by the PPP guide and having no impact on the statistical classification of the units.

The provisions on insolvency, winding up or dissolution of the company are ruled in the framework agreement either as a matter of law or as a decision of the board of directors with no veto right attached to reserved matters.

3. METHODOLOGICAL ANALYSIS

Classification decision of the Economic Statistics Classification Committee (ESCC)

The ESCC considered the private investors into the WMIM as the economic owner of the assets and classified provisionally the legal entities (HoldCo and SPV) within the private sector (S11).

[3] § 2.38, § 20.309, § 20.316 – 318
[4] sections I.2.3, I.2.4, I.6.2, VI.4.3.1 and VI.4.4.1

Applicable accounting rules

Based on the documents provided and further discussions with the ONS, Eurostat carried out its analysis based on ESA 2010 and the Manual on Government Deficit and Debt (MGDD 2016) in particular part VI.4 Public-Private partnership (PPPs) as well as the Guide to the Statistical Treatment of PPPs, published jointly by the EIB and Eurostat in September 2016 (PPP guide), which are relevant for the analysis.

Analysis

3.1. Government control of the HoldCo/SPV

Before analysing the specific overall features of the contract, it is necessary to understand whether the PPP contract is signed between government and a private contractor. In this particular case, the SPV which will be the counterpart of government in the PPP contract has been set-up as partly owned by the private sector and partly owned by government. It is therefore necessary to understand whether the SPV can be considered as controlled by government or not.

The WMIM framework includes the possibility for the WG through the WGCo to acquire up to 20% of the HoldCo shares. The equity participation and the attached right to appoint a member of the board of directors gives the WG some influence on the business of the HoldCo and the SPV. However, as long as the equity participation remains between 10% and 20% of the issued shares, the influence on the statistical classification of the HoldCo/SPV will be moderate. If the equity holding of the WG will be at least not higher than 10%, there will be no influence on the statistical classification of the HolCo/SPV (PPP guide section 3 theme 15.1). Subordinated loans completing equity holdings should be considered in the same way.

In the amended WMIM framework agreement Eurostat notes that:

The authority has the qualifying status of a material shareholder. The SHA includes numerous specific voting rights, which can be assimilated to veto-rights, for any material shareholder, holding at least 15% of the share capital. The so called reserved matters concern decisions by the board of directors or in the shareholder meetings. The reserved matters apply to the HoldCo and the SPV where relevant.

All reserved matters included in the framework agreement are analysed in the PPP guide (Section 3 theme 15.2) and can be considered having no influence on the statistical treatment of the PPP as mentioned in the previous section.

The in the framework included financing through equity and subordinated debt provisions as well as the governance of the HoldCo/SPV might as a result determine the fact that the SPV is deemed not to be controlled by government.

3.2. Construction risk

a) Construction of the project

The design, following authority specifications set out in the tender, is the responsibility of the partner. 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 (MGDD 2016 VI.4.4.2 §96/ PPP guide theme 2.1 – 2.2).

The authority starts payments only after the Payment Commencement Date. This date shall be clearly specified in the legal documentation. The authority will start to make payments only when the construction is completed and when the asset is available (MGDD 2016 VI.4.4.2 / PPP guide theme 2.3).

b) Additional financial risk

The authority grants no loan or financing, other than the equity and subordinated loan, to the project nor guarantees any of the private financings made available. Therefore no additional government risk will be borne (ESA 2010 20.283.e / MGDD 2014 VI.4.4.2. §97).

3.3. Availability risk

a) Financial flows

The SPV invoices the authority with an annual service payment, payable as a monthly unitary charge i.e. monthly availability payment less deductions (MGDD 2016 VI.4.4.2. §99/PPP guide theme 2.3). The possible indexation of any payment to be made by the authority should be based on an index (or indices) generally recognised. The documentation does include the possibility of indexation of the annual service payment by reference to the retail price index.

The documentation includes clear rules for the calculation of unavailability and poor service deductions. Unavailability of the whole asset would lead to a 100% deduction. Deductions are clearly specified in the documentation giving the possibility to assess the monthly deductions presumably to be made. Although there is no right to fine the SPV, the authority has the right to terminate the contract as persistent breaches are included in the definition of default (MGDD 2016 VI.4.3.2 §49).

b) Financial surplus flows

The WMIM, states that any surplus realised through any qualified refinancing will be shared between the shareholders, although the authority will receive 1/3 of the realised surplus (ESA 2010 20.283 / MGDD 2016 VI.4.3.3 §61). A qualified refinancing is defined as a refinancing, which leads to a refinancing surplus. The MGDD 2016 states that:

> *"... Under these conditions, if government was entitled no more than one third of the gain the assets should not be reclassified in government at inception of the PPP contract. ..."*

The PPP guide follows the same approach in theme 14.6.2 and thus the sharing of financial surplus as described will have no influence on the statistical classification of the project assets.

The provided documentation implies, that the authority, although holding only up to 20% of the shares in the HoldCo, would not only benefit from the profit sharing of refinancing gains (1/3), but also of 20% of the remaining 2/3 through dividend payments.

c) Revenues from third party

The standard form project agreement in general does not plan to include any revenues from third parties. However some WMIM projects may charge for services or activities which are ancillary to the primary use of the assets. The WG self-assessment of the projects indicates that there might be in some projects third party revenues below 20% but above 5%. Following the PPP guide (theme 5.5) this has a moderate influence of the statistical classification of the assets.

d) Termination

After the term of the contract, the asset is transferred to the authority but without any purchase price payment (MGDD 2016 4.3.7). The agreement puts penalties if the assets have not been maintained as part of the handback procedure (assessed two years prior the termination date). The MGDD 2016 4.3.7 §84 states that:

> *"The following cases would strongly reinforce the analysis of other characteristics of the contract and would point to a recording of the assets as government assets: …the predetermined price is lower than an expected market value at the time of transfer or the assets revert back to government at no cost, but government effectively prepays for the acquisition of the asset throughout the contract by making regular payments that reached a total amount very close to the full market value of the asset…"*

However, the PPP guide (theme 13.2) specifies, that if there is evidence that the Partner's forecast investment and lifecycle costs will be recovered through the revenues it will receive throughout the period of the PPP contract and if the operational phase is at least 10 years or longer, the statistical treatment is not influenced.

3.4. Demand risk

The authority is the only/main customer of the project company. No payment is related to the demand. Therefore, the demand risk is to be considered as borne by the authority (MGDD 2016 VI.4.4.2 §102).

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

The contract defines 5 termination events:

- Authority default and voluntary termination by the authority
- Force Majeure
- SPV default
- Persistent breach by the SPV
- Corruption gifts and payments.

The standard form project agreement provides detailed provisions to the triggering and calculation of any sum to be paid or the way of retendering the contract of any early termination mentioned above including detailed conditions and handling of disputes.

a) Authority default and voluntary termination / force majeure

The standard form project agreement follows the PPP guide (theme 12.2 - 12.4) to set the terms of the indemnity to be paid to the private partner, based on the senior debt amount at termination, redundancy payments and subcontractor losses as well as the share value of the SPV/HoldCO, less authorised and in detail specified deductions in accordance with the termination event, having no influence on the statistical treatment.

b) SPV default / persistent breach by the SPV / corruption gifts and payments

In the case of a SPV default, the standard form project agreement gives two options. Either the contract is retendered or if the authority chose not to retender the contract for whatever reason the compensation is based on the estimation of the potential market value based on the forecasted costs and revenues less specified deductions in accordance with the termination event. If no agreement is reached the dispute resolution provisions of the standard agreement will apply. The panel is composed by independent experts either nominated jointly by the authority and the SPV or, if not, by the President of the Institute of Chartered Arbitrators in England and Wales (PPP guide theme 12.1.3, having no influence on the statistical treatment).

3.6. Other contractual risks and rewards

a) Dispute resolution

Any dispute between the SPV and the authority should be solved through a mediation process by a panel of three independent adjudicators appointed by both parties or if there is no agreement by the President of the Institute of Chartered Arbitrators in England and Wales (PPP guide theme 16.1).

b) 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 SPV has been aware of such misleading information.

c) Increased costs

If the authority requests a modification of services (subcontracts, changing materials); the SPV should take all reasonable endeavours to adhere to these provisions. If these lead to increased costs the authority will pay the occurred costs as invoiced or the annual service payment will adapted accordingly. Any increased cost due to the authority and borne by the authority does not have any influence on the statistical treatment of the assets (PPP guide theme 7.1).

d) Changes introduced by the SPV

The SPV has to introduce a Notice of Change to the authority, which accepts; amends or rejects the proposed changes. If the proposed changes lead to increased costs or to reduced services, the prior written consent of the authority is mandatory. Otherwise, any increased costs due to the changes introduced by the SPV will not lead to an increased annual service payment. If the change leads to reduced costs, the annual service payment has to be adapted accordingly. Any savings will be shared equally between the SPV and the authority. These provisions will have no influence on the statistical treatment (PPP guide theme 7.2).

e) Increased costs due to change in law

The annual service payment will be adapted accordingly, if the SPE is required to incur additional costs due to a change in the law. This provision has no influence on the statistical classification of the asset (PPP guide theme 7.2).

f) Insurance

The insurance costs, after approval by the authority, are directly passed through to the authority and are included into the annual service payment. This provision has a high influence on the statistical treatment of the assets (PPP guide theme 9.3).

If a risk becomes uninsurable (not due to any action by the SPV) the parties will consult and the authority has either the possibility to terminate the contract by using the force majeure clause or to bear the risk on its own. This provision has no influence on the statistical treatment of the assets (PPP guide theme 9.4).

4. EUROSTAT'S VIEW

Sector classification of the HoldCo and the SPV

Considering the legal and economic framework of the standard form project agreement of the WMIM, the HoldCo and the SPV should presumably be considered as institutional units (ESA 2010 2.12). However, the tight relationship between the HoldCo to maintain 100% ownership in the SPV, and the sharing of the board of directors, which means that they cannot take decisions independently of each other, these two entities should in fact be considered as one institutional unit. The adjudication of the project is realised by a public tender for the operations, so it might be considered as a market producer (ESA 2010 20.25).

Eurostat put a particular attention to the specific provisions in the SHA, concerning the fact that the authority might have the qualifying status of a material shareholder. In such cases it is important to consider whether the HoldCo/SPV is controlled by the private sector or by government. The SHA includes numerous specific voting rights, which can be assimilated to veto-rights, for any material shareholder. A material shareholder is defined as any shareholder holding at least 15% of the share capital, therefore potentially including government. The so called reserved matters concern decisions by the board of directors or in the shareholder meetings. The reserved matters apply to the HoldCo and the SPV where relevant. The reserved matters included in the framework agreement have no influence on the statistical treatment following the PPP guide.

The further aspect of the indirect equity holding of WG in the SPV will following the PPP guide (theme 14.4) have a moderate influence as long as the equity holding/subordinated loans remain between 10% and 20% of the total issued shares/subordinated loans. If, by any action (repurchase or new issuance of equity/subordinated loans), the equity holding of the WG increases above 20%, the influence on the statistical treatment will be high.

Considering the foregoing, Eurostat agrees with the ONS that of the HoldCo/SPV shall be classified into the private sector (S.11). However, any change to the framework agreement should lead to the reassessment of the final documentation against the relevant statistical rules.

Classification of the SPV assets

For the classification of the asset off government balance sheet, the analysis should conclude that the private partner i.e. the HoldCo/SPV should bear simultaneously most of risks and rewards (ESA 2010 VI.4.1 §4). The analysis shows that most of the risks and rewards are either borne by the HoldCo/SPV or equally shared proportionally according to the equity shareholding by the WG.

Three elements need to be considered further:

The right of the WGCo to receive dividends proportionate to its equity stake in the HoldCo. This right has an influence on the classification of the assets. As long as the authority's portion of dividends remains of a maximum of 10%, there is no influence. However, the WMIM framework allows WG to take an equity share of up to 20% and subsequently WG is entitled to receive up to 20% of the dividend payments, this has a moderate influence on the statistical classification of the asset. If by any action, the dividend payments exceed these 20%, the influence will become high.

The WMIM framework agreement gives the SPV the right to generate up to 20% of its revenues from third parties. This will have also a moderate influence on the classification of the SPV assets.

Finally the provision that the insurance costs are passed directly through to the authority, leads to the fact that the WG will bear the insurance risk, having a high influence on the statistical treatment of the assets.

However, the PPP guide states that if there is no very high importance, no more than one high importance and no more than four moderate importance provisions included in the agreement, the asset should not to be considered as on government balance sheet. The information provided by the ONS leads to the conclusion that the provisions included in the WMIM framework agreement and related documents will not include more than one high importance provision and three provisions of moderate importance. Therefore, Eurostat agrees with the ONS that the assets should be classified off government balance sheet.

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,

(e-Signed)

Luca Ascoli
Acting Director