Eurostat Treatment of Public-Private Partnerships

Purposes, Methodology and Recent Trends

epec
European PPP Expertise Centre

Eurostat Treatment of Public-Private Partnerships

Purposes, Methodology and Recent Trends

European PPP Expertise Centre

ABSTRACT

This report provides guidance on the definition, purpose and methodology of PPP accounting and statistical treatment and explains their impact on government deficit and debt. It provides an insight into the purpose and fiscal impact of as well as new trends in accounting and statistical treatment of PPPs.

The European PPP Expertise Centre (EPEC) is a collaboration amongst the European Investment Bank (EIB), the European Commission, Member States of the European Union, Candidate States and certain other States. For more information about EPEC and its membership, please visit http://www.eib.org/epec.

This publication has been prepared to contribute to and stimulate discussions on Public Private Partnerships as well as to foster the diffusion of best practices in this area.

Table of contents

Introduction

Since the introduction of the Stability and Growth Pact and the enactment of the Protocol on the Excessive Deficit Procedure under the Maastricht Treaty, EU governments have had to take into consideration the impact of PPPs on government debt and deficit.

This paper is designed to clarify the process for determining the impact of PPPs on government debt and deficit. We refer to this throughout as the *statistical treatment of PPPs*.

The Eurostat treatment of PPPs is closely related to the *accounting treatment of PPPs* at national level. This is why recent trends aimed at changing government accounting standards may ultimately impact on government debt and deficit. This interaction is explained below.

The purpose of this paper is therefore:

- To clarify the meaning and purposes of accounting and statistical treatment of PPPs (Section1);
- To explain the Eurostat rules dealing with the impact of PPPs on government debt and deficit (Section 2);
- To analyse Eurostat's treatment of government support measures on PPPs within the framework of the financial crisis (Section 3);
- To examine recent trends in the accounting treatment of PPPs and describe how these changes may affect in practice the process for determining the Eurostat treatment of PPPs (Section 4).

The statistical aspects of this paper were developed in dialogue with Eurostat, whose co-operation is gratefully acknowledged. The paper reflects the new "Manual on Government Deficit and Debt - Implementation of ESA 95 - 2010 edition" published on 29 October 2010[1].

[1] See the "Manuals" section of the Eurostat website:
http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/introduction

1 Reporting Methods for Government PPP Activities: The Foundation for Eurostat's Treatment of PPPs

1.1 Why does the public sector need to report PPPs?

There are many reasons why governments will wish to report on PPPs. These include promoting good governance and transparency of government activities, accountability, sound financial management, macroeconomic planning, international comparison, supervision and control. There are different ways of reporting, each serving a specific purpose.

The accounting treatment of PPPs serves primarily to promote good governance and accountability. Each PPP transaction is reported at the project or micro-level in central (or local/regional) government accounts and classified either as a government asset or a non-government (private) asset. This classification is done in accordance with national accounting standards for the public sector. These standards are applied on a country by country basis: each country is allowed to decide which standards it wants to use. In practice, the accounting treatment would normally be carried out by accountants of the central (or local/regional) government.

The statistical treatment of PPPs refers to the reporting of PPP activities for reasons of macroeconomic planning, international comparison, supervision and control. PPPs are reported in the "National Accounts", which EU Member States are obliged to prepare to a common format. The statistical treatment of PPPs provides the aggregate value of PPPs (i.e. the total capital value of all national PPP activity) in National Accounts in accordance with specific statistical rules defined at international level. For the EU, these rules are set out in the European System of Integrated Economic Accounts. The statistical treatment is carried out by national statistical offices (often with the involvement of representatives of national central banks and ministries of finance) and reported to Eurostat.

Budgeting procedures are a third way of planning and reporting government activities in PPPs. They are aimed at promoting a sound financial management. Budgetary procedures plan (ex-ante) and report (ex-post) government allocation of resources for capital investment programmes and operational expenditures in national (or local/regional) budget laws. This paper does not deal in detail with budgeting procedures.

It is therefore important to highlight that the accounting, statistical and budgeting treatments refer to different ways of reporting PPPs, to different audiences, in different formats and with different intentions.

1.2 The accounting treatment of PPPs

Central (or local/regional) government accounts may be compiled on a cash or an accrual basis[2]. EU Member States are tending to move away from a cash-based accounting system to an accrual-based accounting system. Many have adopted a hybrid system. This trend is aimed at assimilating public accounts to financial statements used by private entities.

[2] When accounts are compiled on a cash basis, income is not counted until cash is actually received and expenses are not counted until actually paid. When accounts are compiled on an accrual basis, transactions are counted when the order is made, the item is delivered or the services occur, regardless of when money (receivables) is actually received or paid. PPP asset classification on public balance sheet is based on the use of an accrual or hybrid accounting only.

PPP activities are reported in central (or local/regional) government accounts for scrutiny and decision-making purposes. Indeed, such reporting:

- fosters accountability and provides control means for supervisory bodies, legislators and public constituencies
- provides a source of economic and financial information and control for decision-making purposes when accounts are compiled on an accrual basis.

The PPP accounting treatment in central (or local/regional) government accounts is carried out through the *classification* of the assets established by the PPP transaction. The classification serves to determine whether or not the PPP assets should be recorded as central (or local/regional) government assets and registered on the central (or local/regional) government balance sheet with a corresponding public sector liability. While the majority of EU countries have based this classification on general public sector accounting standards, only a few have issued specific guidelines or advice to specifically tackle the classification of assets involved in PPPs[3].

From cash to accrual based accounting: moving toward private sector accounting

The original purpose of public accounting was to provide accountability, but its methodology limited the provision of information for decision-making purposes. Accountability has been normally provided via a single entry cash basis budget accounting, which did not offer information about assets and liabilities or charge for the cost of capital, depreciation and the maintenance of assets. It also did not provide information on the performance of services provided. Recent trends in public accounting intend to provide economic and financial information for decision-making purposes and to reduce differences between public and private accounting. The gradual introduction of double entry and accrual basis accounting, as well as the use of private-sector-style accounting (e.g. balance sheet, income statement) has enhanced the value of public accounting, particularly in relation to the control of the fiscal risk and the assessment of future commitments.

The classification of the assets of a PPP is based on accounting standards defined at the national level. Each country has adopted its own accounting system based on specific accounting standards. These systems have specific rules for identifying entities belonging to the government sector and for reporting operations.

In the absence of internationally adopted standards for PPPs, most EU countries have relied on the accounting standard used for leases. These standards, interpreted in the light of ad-hoc guidelines, have allowed public sector accountants and auditors to assess whether the assets created through a PPP belong "in substance" to the public sector. This assessment is based on an "economic risk and reward" test, or criterion.

[3] For England see the H.M. Treasury, *Government Financial Reporting Manual* "Section 6.50 Accounting for PPP arrangements, including PFI contracts, under IFRS" and "Section 5.4.59 Commitments under PFI contracts available at http://www.hm-treasury.gov.uk/d/2010_11_frem_full_version.pdf.

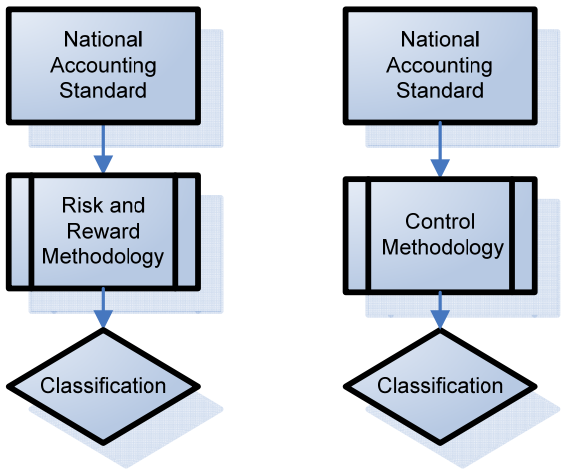
The fundamental principle of this criterion is that if "most project risk" has been transferred to the entity which is partner to the government in the PPP (the "non-government partner"), then the assets involved in the PPP should not be reported on the government balance sheet. To date, most EU countries have adopted this criterion. Yet, they use somewhat different methodologies to determine when sufficient (or most risk) is transferred to the non-government partner.

Lately however, some countries have changed, or are considering changing, accounting standards in a way that would require the application of a "control criterion" as the basis for the classification of PPP assets. Their objective is to increase transparency of government activity by also reporting in the central (or local/regional) government accounts those projects that are initiated and "controlled" by the government. This would apply even when the projects concerned are financed indirectly through the private sector and when the majority of risks are borne by non-government entities[4]. This criterion differs from the "risk and reward" criterion as it considers two features in particular:

- The control or regulation of the services the non-government partner must provide; and
- The control over the residual value of the PPP assets at early termination.

The logic behind this approach is that if a government initiates the construction of an asset, specifies its characteristics and retains the ultimate responsibility for it (i.e. the asset is unlikely to be of use to anyone else) then it "controls" the asset and should report it on its balance sheet[5].

Government financial reporting based on a "risk and reward" and "control" criterion



[4] Other non-EU public bodies have expressed disaccording opinions on this issue. The State of Victoria Public Account and Estimate Committee report on Public Private Partnerships (see http://www.parliament.vic.gov.au/paec/inquiries/infrastructureinvestment/Report/Private%20investment%20in%20public%20infrastructure.pdf) has considered the control criterion too simplistic and not properly suitable to address the substance of complex commercially negotiated arrangements. On the contrary, South Africa's Accounting Standard Board "Guideline on Accounting for PPPs", (see http://www.ppp.gov.za/documents/Guideline%20on%20Accounting%20for%20PPPs.pdf) adopted the control approach in determining whether the government should account for the asset and related obligation in a PPP agreement.

[5] Only the first criterion applies when the economic life of the assets coincides with the duration of the PPP contract.

Classification criteria

Both the "risk and reward" and "control" criteria are based on a "substance over form" approach looking at the economic substance rather than the legal appearance.

Economic ownership of an asset, which is the determining factor for the balance sheet treatment, is defined on the basis of the economic substance of the relations between the asset and the entity that exerts control over the asset and is exposed to the benefits and costs of its ownership.

Legal ownership and economic ownership often coincide. When they do not coincide, a "substance over form" approach should prevail for accounting and statistical purposes. National and international accounting frameworks have adopted several criteria to determine the economic ownership of an asset. The following are generally adopted:

"Risk and reward" criterion: the economic ownership of an asset lies with the party that possesses the asset and carries the risks, benefits and burden in connection with the asset[6].

"Control" criterion: the economic ownership of an asset lies with the party that (i) controls what services the non-government partner must provide and (ii) has control over the residual value of the asset in case of early termination of the PPP contract.

1.3 The statistical treatment of PPPs in National Accounts

EU Member States are obliged to prepare National Accounts to a common format as defined in the European System of Integrated Economic Accounts (**ESA 95**). These accounts are prepared by national statistical offices (often with the involvement of representatives of national central banks and ministries of finance) and reported to Eurostat. The production of public finance data in National Accounts is a legal requirement for Member States under European regulation, in particular under the Excessive Deficit Procedure (**EDP**).

ESA 95 sets out how PPPs are to be treated for the purposes of these statistical analyses, and notably whether or not PPP assets should be recorded or not as central (or local/regional) government assets with a corresponding public sector liability.

ESA 95 has specific rules for identifying entities belonging to the government sector and for reporting operations. Chapters VI.4 ("Public infrastructure financed and exploited by corporations") and VI.5 ("Public-Private Partnerships") of the "ESA 95 manual on government deficit and debt" (**ESA 95 Manual**) complement and clarify ESA 95[7].

[6] European System of Integrated Economic Accounts ESA 95, paragraphs 7.09-7.10

[7] The Manual is available at http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/introduction

ESA 95 requires that National Accounts are to be compiled on an accrual basis and use a "binary" reporting system: assets are to be classified either as wholly government assets or as wholly non-government partner assets (i.e. their ownership cannot be split between the government and non-government partner).

Under ESA 95 the assessment of whether a PPP asset is to be counted as governmental is based on a risk transfer test (i.e. a "risk and reward" criterion). Where "most of the project risk" has been transferred to the non-government partner, the assets involved in the PPP are deemed "off" the public sector balance sheet. According to ESA 95, most risk is transferred to the non-government partner when the project construction risk and either availability or demand risk are transferred.

Definition of primary PPP risks according to Eurostat

Construction risk covers events related to the initial state of the asset(s) involved in the PPP. In practice, construction risk is related to events such as late delivery, non-respect of specified standards, significant additional costs, technical deficiency and external events (including environmental risks) triggering compensation payments to third parties. It is considered that the government bears the majority of the construction risk when it covers systematically the majority of any additional cost incurred, for whatever reason, during construction or when it is obliged to make payments as a consequence of a default of the non-government partner in the management of the construction of the asset(s), either as a direct supplier or as a coordinator/supervisor.

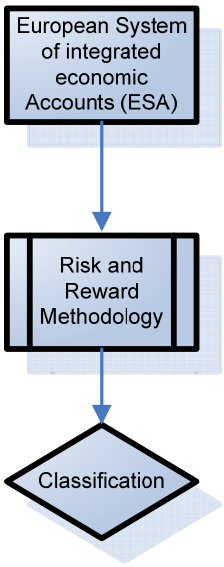
Availability[8] risk covers cases where, during the operation of the asset(s), the responsibility of the non-government partner is called upon, because of insufficient management performance, resulting in a lower volume of services than was contractually agreed or in services not meeting the quality standards specified in the PPP contract. Therefore, the government bears the majority of the availability risk, when (i) the PPP contract does not provide for automatic and significant non-performance penalties to be applied in case of non-performance by the non-government partner or (ii) when such penalties are not systematically applied.

Demand[9] risk covers the variability of demand for a particular service, like number of road users or volume of waste disposal (higher or lower than expected when the PPP contract was signed) irrespective of the performance of the non-government partner. In other words, there is demand risk when a shift in demand cannot be directly linked to an inadequate quality of the services provided by the non-government partner but is the result from other factors, such as business cycles, new market trends, changes in final users' preferences or technological obsolescence. Therefore, the government bears the majority of demand risk when it is obliged to make a given level of payment to the non-government partner independently of the actual level of demand. However, because the assurance of this level of payment is normally provided through minimum revenue guarantee or guarantee of minimum demand (provided by the government or third parties), such provisions need careful analysis.

In practice, few projects evidence a complete transfer of these risks from the public to the private sector. There is a large variety of explicit or implicit government support mechanisms that make projects more attractive to private investors and lenders. An assessment of these instruments and their impact on the statistical classification of the asset(s) is provided in chapter 3 below.

The conditions determining whether most of the project risk is transferred often differ between ESA 95 and national accounting standards i.e. between statistical and accounting treatments. Nevertheless, where national accounting standards require a 'risk and reward' test, the outcome of this analysis can usually be reasonably readily applied by national statistical offices for the purposes of ESA 95.

National Accounts reporting



Differences between Accounting and Statistical Treatment of PPPs
Summary table

	Accounting Treatment of PPPs	**Statistical Treatment of PPPs**
What is its level of reporting (micro/macro)	Refers to reporting of PPP activities at a *micro level*	Refers to reporting of PPP activities at a *macro level*
What is its rationale?	Good governance, accountability and sound financial management	Macroeconomic planning, international comparison, supervision and control
What is its purpose?	Micro accountability	Macro accountability Fiscal risk control required by international commitments
Where is it reported?	PPP activities are reported in central (or local/regional) government accounts	The statistical treatment of PPPs is reported in National Accounts
How is it carried out?	PPP accounting treatment is carried out through the *classification* of the PPP assets either as central (or local/regional) government assets or non central government (or local/regional) assets	The statistical treatment of PPP is carried out by collecting aggregate data of PPP assets and classify these as either as government or non-government assets
According to which rules are assets classified?	Assets are classified in accordance with accounting standards defined at the national level	The statistical treatment of PPPs is provided according to specific statistical rules defined at the international level. For the EU, these rules are the European System of Integrated Economic Accounts (ESA 95)
Who does it?	The accounting treatment is carried out by accountants in the government department (or at the local or regional level)	Statistical treatment is carried out by national statistical offices (often with the involvement of representatives of national central banks and ministries of finance) and is reported to Eurostat

1.4 The budget treatment of PPPs

Budgeting procedures are designed for planning and controlling the allocation of resources for capital investment programmes and operational expenditures, in line with national (or local/regional) budget laws. They may also be used for determining the impact of PPPs on fiscal policy and fiscal management.

Budgeting procedures need not replicate either the accounting or statistical treatment of PPPs. However, the accounting or statistical treatment may often influence the budget treatment, and in particular, how PPP transactions are recorded in the budget.

As noted above, the accounting treatment of PPPs is determined in accordance with standards set at the national level. The statistical treatment is defined at the European level. The national budget treatment of PPPs is defined at the national level and may follow either a "control" or a "risk and reward" approach to determine the asset classification.

In the United Kingdom for example, the budget treatment is aligned with the statistical treatment of PPPs. Therefore, off-balance sheet PPPs are not included in the capital budget of the relevant government department. However, the annual payments to the non-government partner are clearly recorded "on budget" independently from the "off" or "on" balance sheet treatment of PPP assets in national accounts. The budget treatment of on-balance sheet PPPs is similar to traditional capital protects (i.e. the full capital investment is reported upfront in the budget).

There is a fundamental difference between (i) budget procedures and (ii) PPP accounting and statistical treatments: the first are cash based, while the second follow accrual-based standards. This difference has a major impact on the recognition and budget control of financial commitments originating from PPPs and traditional capital projects:

- Investments costs: For traditional government-procured projects, the full investment cost of the projects is reported in the budget upfront. Off-balance sheet PPPs do not require such reporting.
- Annual charges: PPP projects require budgeting annual payments to the non-government partner (including a combined charge covering financing, operating and maintenance costs) as and when the charge is payable - usually starting once construction is completed. Traditional government capital projects often do not require project lifecycle costs (other than the initial capital investment) to be budgeted ex-ante (i.e. such costs typically need to be approved every year).

Because governments typically budget separately for (i) capital and (ii) operating (or revenue) items, differences in the budget treatment of PPPs and traditional government projects have an impact on both the allocation of budgetary resources and the management of fiscal space. An off-balance sheet PPP results in a shift in commitments from a capital budget (today) to an operating budget (over the years to come). This may "free up" space in the current capital budget for other (on balance sheet) projects.

The value for money assessment implemented by most EU countries generally requires that PPP projects demonstrate greater (or at least equivalent) value than the government-procured alternative. However, the fact that a project delivers value for money, is no guarantee of its affordability. For this reason, several countries have

introduced affordability tests which establish budget limits to annual PPP commitments (e.g. in Hungary), to avoid PPP commitments creating budget constraints and crowding out long-term fiscal space. Other countries (e.g. the United Kingdom) have also disclosed in their budget annualised PPP commitments over the medium and long-term[10].

2 Statistical Treatment of PPPs for the Purpose of Excessive Deficit Procedure: the Eurostat Treatment

2.1 Why does the Eurostat treatment of PPPs matter?

European fiscal stability is preserved under the Maastricht Treaty through the EDP of the Growth and Stability (the **Pact**). The objective of the EDP is to prevent excessive government deficits. The Pact establishes strict limitations to government deficit and debt of EU Member States and provides a comparative framework for overseeing Member States' public finances. Member States are expected to maintain both an annual budget deficit of less than 3% of GDP and a public debt less than 60% of GDP. The EDP provides a procedure for imposing sanctions on Member States exceeding these parameters.

To assess fiscal stability, the risks borne by the government activities (aggregating all government units) are taken into account. As noted above, the general rule is that a government should report in the National Accounts those assets for which it bears most of the risk. PPPs are relevant to the extent that they fall within the remit of this rule.

It is important to note that the Eurostat treatment of PPPs is not based on a cost-benefit assessment of the value for money consequences of PPPs. The Eurostat treatment of PPPs seeks merely to provide consistent debt and deficit figures that are comparable across all Member States. The objective is to analyse the financial stability of an economy with the determining factor being the risk to which a government is, in principle, exposed as a result of a particular project.

The impact of PPP projects on debt and deficit is measured against the limits provided by the Pact. This means that EDP rules and budget constraints may prevent governments from going ahead with an economically worthwhile PPP simply because of its debt and deficit consequences. This would apply even where the non-government partner is prepared to bear a significant (but not the majority) part of project risks.

The same constraints may induce governments to seek to tailor PPP structures simply to achieve statistical treatment outside of the debt and deficit provisions. This may be pursued by trading off higher project costs for increased risk transfer to the non-government partner, independently of the real value for money of the PPP structure adopted.

The Eurostat treatment may also have an impact on the room for manoeuvre that governments would have in providing support measures (e.g. direct lending, guarantees, favourable contractual terms) in times of market distress, such as the present financial crisis. This important issue is explored further in this paper.

Key issue in National Accounts for PPPs

Classification as government assets has consequences for:

- **Deficit** - the initial expenditure is recorded as government fixed capital formation;
- **Debt** - the financial account would record new government borrowing.

2.2 Measuring the impact of PPPs on government debt and deficit: the Eurostat treatment of PPPs

The Eurostat treatment of PPPs serves to measure *whether* and *when* under current Eurostat rules (a) the whole of the capital investment of a given PPP project should be computed as public expenditure and therefore added to government deficit/surplus and (b) the totality of the debt issued to finance the investment should be reported as government debt and added to general government debt.

The Eurostat treatment of PPPs requires the classification (as "on" or "off" government balance sheet) of assets of individual PPP projects in accordance with ESA 95. In theory, this classification should be based on the aggregate data composing the statistical treatment of PPPs in National Accounts. In practice, national statistical offices normally rely on adjusted data derived from the accounting treatment of PPPs.

Under ESA 95, the balance sheet reporting of PPP assets and impact on deficit and debt is aligned with that of leases:

- If the non-government partner does not bear most of the project risk, the statistical treatment of the PPP assets should be similar to that of "financial leases" under ESA 95 (i.e. on the government balance sheet). The initial capital investment will have a negative impact on the deficit/surplus and on the debt because it will be treated as an "imputed loan" from the non-government partner (i.e. an indirect borrowing by the public sector). The payment of the service charge (if any) made by the government to the non-government partner will have an impact on the deficit/surplus only for the part relating to purchase of the services and "imputed interest".
- If the non-government partner bears most of the project risk, the statistical treatment of the PPP assets should be similar to that of an "operating lease" under ESA 95 (i.e. off the government balance sheet). The initial capital investment will not have an impact on the deficit/surplus and will not have an impact on the debt. The payment of the service charge (if any) made by the government to the non-government partner will have an impact on deficit/surplus only for the part relating to purchase of the services but not as "imputed interest".

2.3 The three-step process for determining the Eurostat treatment of PPPs

The Eurostat treatment of PPPs depends on the classification of the assets of individual PPP projects. This classification requires a three-step process:

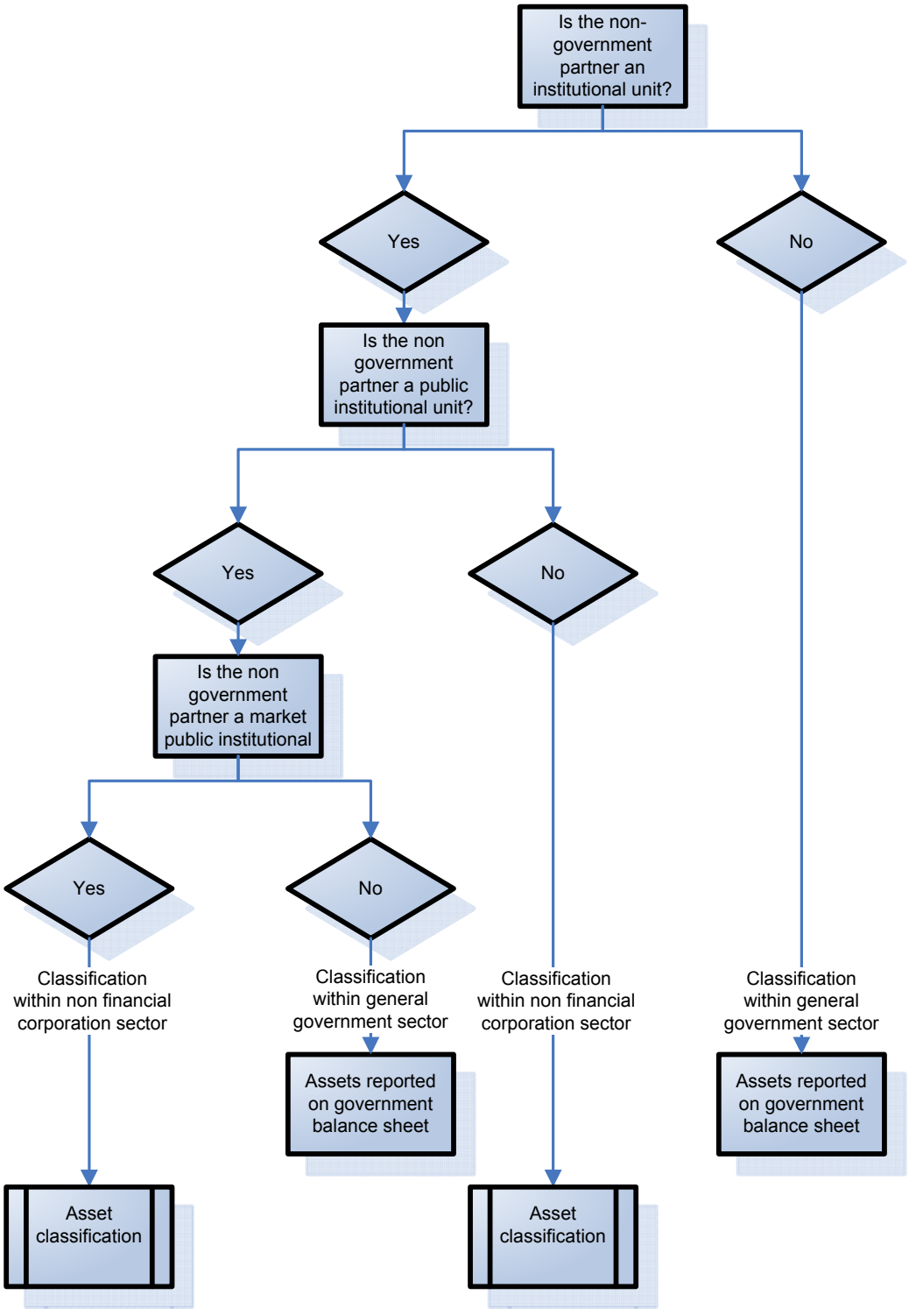
(i) to distinguish PPPs from other long-term public private arrangements that have a different accounting and statistical treatment (e.g. design-build-operate or outsourcing contracts);

(ii) to determine if the partner unit developing the project is part of the general government. This determination is based on real economic flows, independently from any legal structure (the so-called “institutional sector classification” illustrated below);

(iii) to assess the risks borne by the public and the private partners. The asset classification determines which partner (government or non-government) is bearing most of the project risk such as to determine which partner has economic ownership of the assets involved in the PPP.

When the non-government partner does not consolidate its accounts with the government, asset classification needs to follow the “institutional sector classification”. When the non-government partner does consolidate its accounts in the government accounts, asset classification is not required and total investment will be computed as government deficit and debt.

The "institutional sector classification" decision tree



(Note: a re-classification is possible if the non-government partner loses its autonomy of decision or becomes a non-market public unit.)

Risk distribution

The assets involved in a PPP can be considered as non-government assets only if there is strong evidence that the non-government partner bears most of the risk related to the specific PPP project. The ESA 95 Manual specifies that the party

bearing "most of the risks" attached to the execution of the contract has economic ownership of the assets involved in the PPP. The "Excessive Deficit Procedure Manual" (the **EDP Manual**) provides simplified criteria to determine whether the non-government partner is bearing most of the risks.

As explained in paragraph 1.3, the general rule is that assets should be classified as non-government assets only if the non-government partner bears both the construction risk and at least one of availability or demand risk. Risk is transferred only if the non-government partner faces sufficient financial consequences. To demonstrate a clear risk transfer, the costs that accompany a risk occurrence should generate financial consequences for the non-government partner. Such financial consequence should be sufficient to put at risk not only the non-government partner's operating margin but also expose its equity to significant losses. When a risk is also allocated to third parties (lenders, insurers, guarantors, etc), the PPP assets should be classified off the government balance sheet if most of the risk is borne by the non-government partner and the third parties together.

The risk of residual value of the PPP assets may be relevant for classification in borderline cases. Where strong evidence that the non-government partner bears most of the project risk is lacking, it is necessary to consider who bears the residual value risk of the project as this is deemed an additional indicator of economic ownership of the PPP assets. If the assets remain the property of the non-government partner at the end of the PPP contract period (irrespective of their economic value at the time) then they should be classified on the non-government partner's balance sheet. Similarly, the assets should not be recorded on the government balance sheet if the government has an option to purchase the asset at market value. On the other hand, if either (i) the government commits to purchase the PPP assets at a pre-determined price which is higher than their economic value or (ii) the price to be paid by the government is lower than their economic value (or even nil) but the government would have already paid an amount close to the economic value of the assets through regular payments throughout the contract life, then these assets should be recorded on the government balance sheet.

As previoulsy noted, "on-balance sheet" treatment implies the recording of expenditure in the initial phase of the project. As for "financial leases", the initial investment in PPP assets should be fully recorded from the outset as gross fixed capital formation and has an impact on government deficit. It should also have an impact on debt derived by an imputed loan for the same amount.

Off-balance sheet recording implies a delayed impact on government deficit and eventually no impact on debt. As for "operating leases", off-government balance sheet recording may imply government expenditure only at a later stage, at the time when the government pays service charges (e.g. availability payments or demand fees) to the non-government partner, with no recognition of debt. Therefore, if the government has transferred project construction risk to the non-government partner and either the project availability or demand risk, the cost of the infrastructure-related assets would be spread over the time in which assets are used, avoiding large initial capital expenditures.

3 The Eurostat Treatment of PPPs in the Financial Crisis

3.1 The impact of the crisis

With the present financial crisis, governments have significantly extended their support to PPPs. Limited liquidity in the PPP financing markets, increased risk-aversion of lenders and sponsors and a higher cost of capital have led governments to take a more active role in providing direct and indirect financial support to PPP programmes. So far, government support has often been provided through financing non-government partners' capital costs, granting extensive guarantees to creditors as well as agreeing to more generous PPP contract termination clauses.

Government commitments designed to provide direct or indirect financial support during the lifecycle of the project as well as at on termination of the PPP contract may substantially influence the risk allocation between the parties to a PPP. Therefore, the nature and degree of government support may become factors which cause assets to be reported on government balance sheets.

The Eurostat principles are such that where the impact of government support results in most of the project risk being borne by the government, the asset underlying the PPP should be reported on the government balance sheet. However, the impact assessment of the support mechanisms introduced by governments in the context of the crisis has raised a number of practical issues (e.g. temporary nature of the measures, economic and financial complexity) such that a deeper risk transfer analysis is required.

Three separate issues (i.e. capital contributions, guarantees and termination payments) are considered below. However, government support measures should be considered jointly in assessing the degree of risk transfer. A combined effect of government support measures may lead the government to cover a clear majority of the capital cost, while individual measures may not.

3.2 Government support through capital and debt contributions

Government financing of the capital costs of a PPP project affects the transfer of construction risk between the parties to the contract. The government may finance capital costs through loans, grants, milestone or bullet payments. This government financing is normally provided with a view to reducing the project's financing cost or to meet a liquidity shortfall. Such financial support may have an impact on the transfer of the construction risk as Eurostat considers financing risk as an integral part of construction risk. Indeed, the EDP Manual does not consider the financing risk as one of the major project risks on which asset classification is based, the rationale being that a PPP is a contract for a particular service and the provision of the underlying asset and its financing is the responsibility of the private partner.

If a government finances the majority of the capital costs associated with a PPP asset, Eurostat considers that the government implicitly bears the majority of the construction risk. For asset classification purposes, an assessment needs to be made as to whether the total percentage of financing provided by the government exceeds fifty percent of the capital cost associated with the asset.

When a government bears the majority of the financing risk (whether through debt, equity or direct or indirect guarantees), the PPP assets should be reported on its balance sheet. This does, however, not apply to government undertakings towards the re-financing of a PPP project post-completion as, in this case, the financing risk refers to the original financing put in place to deliver the project assets. This is clearly

an important point in the context of a number of PPP support measures put in place by Member States.

3.3 Statistical treatment of government guarantees

As a general principle, government guarantees do not normally influence the classification of PPP assets on a government balance sheet. This is because guarantees are considered contingent liabilities which are not normally accounted for by governments unless and until they are called.

However, Eurostat considers that guarantees covering more than fifty percent of the capital cost of a given PPP project have an impact on the distribution of most of the project risk between the parties to contract. In such cases the PPP assets should be recorded on the balance sheet of the government.

In Eurostat's view, when classifying PPP assets it is necessary to look at the individual and aggregate impact of guarantees in order to test whether these cover more than fifty percent of the capital cost of the project. Relevant guarantees include:

- partial or total credit guarantees;
- minimum revenue guarantees; and
- guarantees of minimum demand provided to the non-government partner.

The aggregate impact of these guarantees will determine if the related PPP assets should be recorded on the government balance sheet, irrespective of the guarantee's probability of being called.

The same rule applies where governments commit to reimburse all or part of the project's debt service through direct or indirect contractual provisions (e.g. payment of a minimum percentage of the service charge irrespective of the non-government partner's performance, guaranteed repayment of banks at early termination).

However, as noted above, these provisions apply only to guarantees applied to the original financing. Refinancing guarantees are excluded from this calculation.

Availability payment as a *de facto* guarantee

In theory, where the availability risk in a PPP project is completely transferred to the non-government partner, the government should make no payment of service charge if and when the PPP asset becomes unavailable. In practice, PPP contracts normally provide for deductions to the service charge when the non-government partner fails to meet specific service standards. Contracts often explicitly provide for acceptable levels of asset unavailability (e.g. acceptable levels of highway lane closures). When these limits are too lenient, the non-government partner will *de facto* rarely be liable for deductions or fines as a result of the asset unavailability. Therefore, Eurostat treats these *de facto* limits in the same manner as it treats guarantees.

3.4 Statistical treatment of termination payments

PPP contracts normally include termination clauses which may be triggered at the initiative of the government or non-government partner. Termination rights may be exercised by the government when the non-government partner fails to comply with its obligations or when it decides to voluntarily end the contract. Termination may also be called by the non-government partner in the case of a public sector default. Finally, there may be termination of the PPP contract following the occurrence of *force majeure* type (no-fault) events.

Termination usually entails that the PPP assets are handed back to the government. Depending on the termination cause, the government may also be liable for the payment of part or all of the non-government partner's outstanding debt and/or the equity invested. The hand-over of the PPP assets to the government is usually justified by the "dedicated" nature of the assets (i.e. they have no, or a limited, resale value on the market) or the government's interest in retaining them. The compensation due by the government on termination is the application of the general principle at law that no party should benefit from an unjust enrichment.

Eurostat considers that termination provisions may have an impact on the risk allocation and should be considered when determining the statistical asset classification. Compensation may constitute legitimate reparation for the non-government partner but it may also have effects similar to other guarantees: the non-government partner (or its lenders) would recoup its investment under all circumstances. This will therefore have an impact on the risk distribution between the parties.

Termination provisions which provide that following a default of the non-government partner, the government is liable for compensation sums calculated on the basis of the capital or operation costs of the PPP assets (rather than the market value of the assets at termination) imply that most of the project risk is borne by the government. Therefore, these termination provisions should be treated as guarantees.

Equally, contractual obligations providing that, following a non-government partner default, the government is liable for the payment of part or all of the debt outstanding, should be treated as partial (or full) credit guarantees by the government.

3.5 Statistical treatment of contract renegotiation

Renegotiations of PPP contracts after financial close may trigger a reclassification of the asset when the allocation of "most of the project risk" between the parties is altered.

4 Future developments in Eurostat's approach

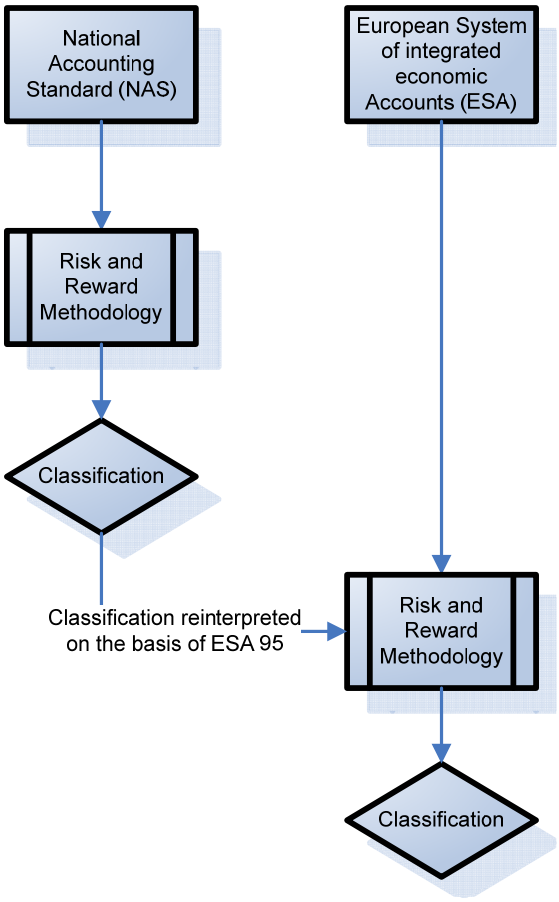
4.1 Using the accounting treatment of PPPs for Eurostat's purposes

National statistical offices do not generally have sufficient resources to analyse and classify each PPP transaction entered into in their jurisdictions. For this reason, they are often constrained to rely on adjusted figures derived from the accounting treatment of PPPs.

The statistical offices normally rely on the work of national accountants for the asset classification carried. Asset classification for the purposes of the accounting treatment of PPPs has historically been based, in the majority of EU countries, on a "risk and reward" criterion. In principle, this is not dissimilar to the requirements set

out in ESA 95. However, whilst the rules of ESA 95 are often similar to that of accounting, they are not necessarily identical: each country has a methodology to determine when "sufficient" or "most risk" is transferred to the non-government partner. This potentially undermines the principle of comparability between countries which ESA 95 is seeking to achieve. For this reasons, the data derived from the accounting treatment of PPPs has to be adjusted to reflect such differences. This adjustment is carried out by national statistical offices.

Practical application of ESA 95
using data provided by the accounting treatment of PPPs
at the national level



4.2 Recent trends in international accounting standards

The continued use of the results of the accounting treatment of PPPs for statistical (i.e. Eurostat) purposes is being challenged by changes to the guidance on the accounting for service concessions produced by the International Accounting Standards Board (**IASB**).

The argument for a new accounting standard has focused on the differences and novelty of PPP transactions, as well as on the lack of clear accounting guidance for these transactions. Surrogate standards, such as "in-substance leases" were considered too rigid to reflect the substance of PPPs. A number of other factors have been put forward to justify the introduction of a new standard, such as:

- the lack of certainty for both the public and private partners in PPP transactions often leading to arbitrage in the reporting;
- the frequency of changes introduced into PPP contracts in development - normally at a late stage - to meet accounting (and statistical) requirements; and
- the distortion of commercial incentives brought in PPP transactions to respond to accounting imperatives.

4.2.1 International Financial Reporting Standards (IFRS) rule 12

In November 2006, the IASB's International Financial Reporting Interpretation Committee issued "Interpretation 12, Service Concession Arrangement" (**IFRIC 12**).

IFRIC 12 provides guidance to the private sector on the reporting of assets associated with service concession agreements. It defines service concession agreements as including both arrangements where the non-government partner directly charges the public (as third party users) and agreements where the non-government partner charges the government for the service provided. In the latter case, the government may pay the non-government partner either on behalf of the public (as third party users) or because it receives directly the service. In other words, IFRIC 12 deals in part with PPPs.

This interpretation provides accounting and financial reporting guidance for "operators" of PPPs. In other words, IFRIC 12 addresses only accounting by the non-government partner.

IFRIC 12 requires the reporting of PPP assets on the basis of a "control" test or criterion. In particular, IFRIC 12 is applicable to PPPs where the government controls or regulates (i) the asset-related services that the non-government partner provides, to whom it must provide them, and at what price and (ii) any significant residual interest in the assets at end of the PPP[11].

Critically, IFRC 12 requires the non-government partner not to report PPP assets on the private partner's balance sheet if the private partner does not control use of the assets. The test, therefore, is wholly based on control and is independent of which party holds the legal title to the assets. It should be noted that IFRIC 12, as a private sector standard, does not require that the assets should be recorded by a government in this case.

4.2.2 International Public Sector Accounting Standards (IPSAS) ED 43

As noted above, the guidance contained within IFRIC 12 applies only to the private sector partner. However, as a result of the publication of the standard, the International Public Sector Accounting Standards Board (**IPSASB**) has started a consultation process on the treatment of PPPs within the public sector. This led to the publication of a consultation paper in March 2008. In December 2009, a task force of the IPSASB developed an exposure draft "ED 43 Service Concession Arrangements: Grantor" (**ED 43**) which was published in February 2010.

The reasons for the production of ED 43 were the same as for the introduction of IFRIC 12. In addition, IPSASB noted that the lack of specific guidance on PPPs for the public sector had occasionally resulted in PPP assets being reported on neither the government nor non-government partner's balance sheet. This has been considered an incentive for the public sector to use PPPs as a means to fulfil their infrastructure needs while not recognizing the assets and related liabilities in their

financial statements. This was deemed an inappropriate means of meeting fiscal targets.

The proposed international public sector accounting standard contained in IPSAS ED 43 addresses the issue as it is modelled on IFRIC 12. Indeed, it precisely mirrors the PPP accounting rules applicable to the private sector.

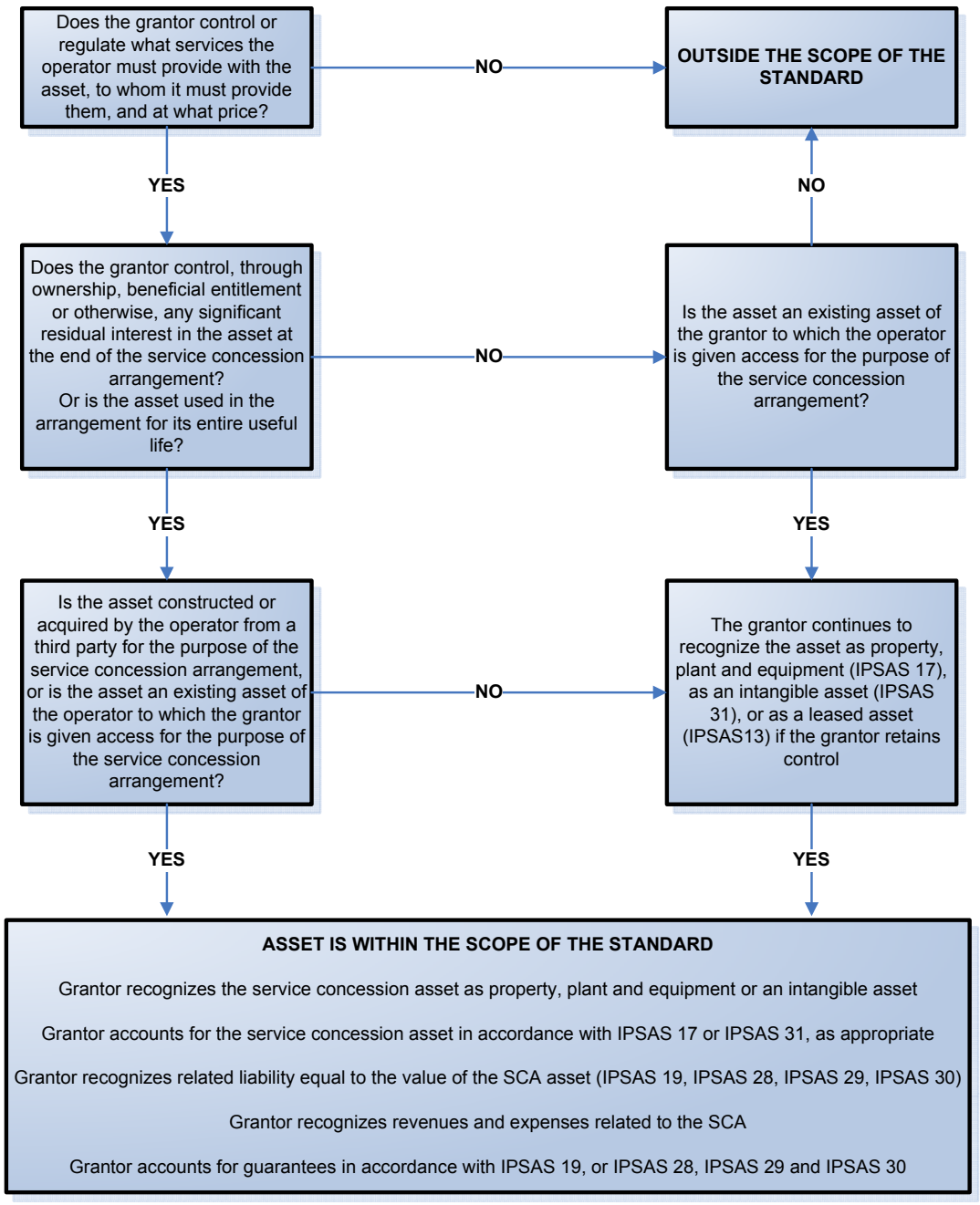
Service Concession Agreement under IPSAS ED 43

A service concession arrangement typically involves an operator constructing or developing the asset used to provide the public service or upgrading an existing asset and operating and maintaining the asset for a specified period of time. The operator is compensated for its services over the period of the arrangement. The arrangement is governed by a binding arrangement that sets out performance standards, mechanisms for adjusting prices and arrangements for arbitrating disputes. The service concession arrangement is binding on the parties to the arrangement and obliges the operator to provide the public services on behalf of the public sector entity.

IPSAS ED 43 addresses the government partner (grantor) accounting issues which correspond to the non-government partner (operator) accounting issues addressed in IFRIC 12. If IPSAS ED 43 were adopted, the symmetry between it and IFRIC 12 would significantly limit “off-off balance sheet” reporting. In other words, IPSAS ED 43’s approach would require both the grantor and the operator to apply the same principles in reporting the asset underlying the PPP contract. IPSAS ED 43 would minimise the possibility of an asset being accounted for by neither (or both) parties[12].

Like IFRIC 12, IPSAS ED 43 requires the reporting of PPP assets on the basis of a “control” criterion. A more detailed description of how IPSAS ED 43 works is provided in the diagram below.

Accounting framework for Service Concession Agreement
According to IPSAS ED 43



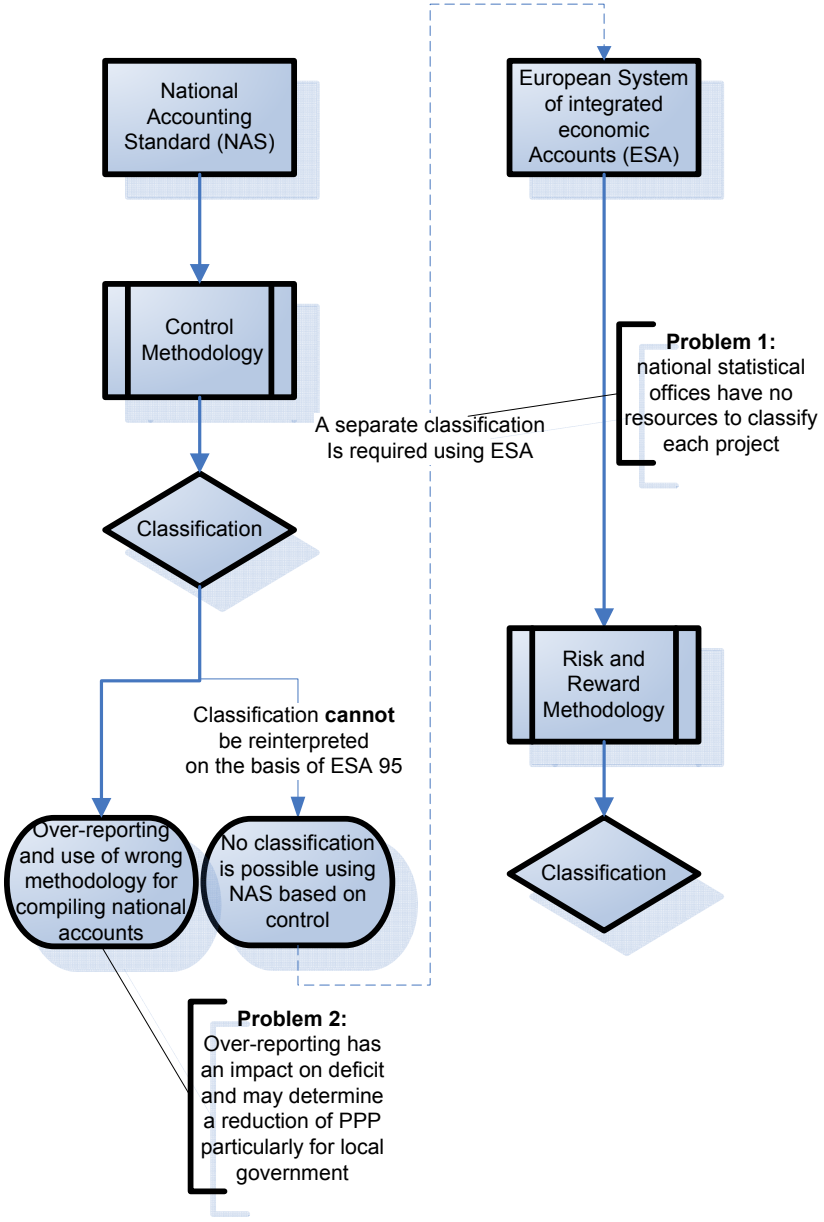
4.3 Impact on the statistical treatment of PPPs in National Accounts

The introduction of government financial reporting based on a “control” criterion, in line with IPSAS ED 43, is being considered by a large number of EU countries. This would create a number of challenges for national statistical offices as the “control” criterion used in IPSAS ED 43 is not conceptually consistent with the “risk and reward” criterion used in ESA 95. The difference of criteria adopted for accounting and statistical treatment of PPPs would therefore make it more difficult for the national statistical offices to use data derived from the accounting treatment of PPPs for ESA 95 purposes.

4.3.1 Over-reporting government debt and deficit

In particular, the use of data derived from the accounting treatment of PPPs based on a control criterion would generate substantial over-reporting for Eurostat (and thus debt and deficit) purposes. Indeed, the switch to a "control" criterion could be expected to bring on government balance sheet almost all PPP assets. Unless this issue is addressed, a significant reduction in PPP activity could take place as governments would discontinue (for reasons debt and deficit reporting impact) PPP programmes which could otherwise have passed the tests of economic value, affordability and value for money. The issues are summarised in the graphic below.

Impact of changes in government financial reporting on practical application of ESA



4.3.2 The need for double reporting

In practice, addressing this issue would require the introduction of separate reporting of PPP transactions for accounting and statistical purposes. This is the approach being adopted by the UK, which has applied the principles of IPSAS ED 43 for public sector accounting purposes since 2009. The UK now reports separately the:

- Accounting treatment of PPPs, based on a "control" test; and
- Statistical treatment of PPPs, based on a "risk and reward" test.

The effects of the recent changes for each of the different Parliamentary controls over expenditure (in the UK)

National Accounts are an integrated set of economic accounts covering the whole of the economy produced by the Office for National Statistics. They are used to determine fiscal performance. They are based on ESA 95 and use the balance of risk to determine the treatment of PPPs.

Departmental budgets are set by Treasury and used to control public spending. They mostly follow the treatment in the National Accounts and thus use ESA 95's approach to PPPs.

Supply Estimates. The House of Commons agrees the individual budgets and spending limits of each department annually (and revisions to them through supplementary estimates). At the moment estimates are closely aligned to the Financial Reporting treatment. The Alignment Project aims to align estimates with budgets to improve control over public spending. Thus from 2011–12 it is expected that estimates will be based on the ESA 95 approach to determining PPP expenditure.

Resource Accounts are audited by the National Audit Offce and set out how Departments have used the resources granted by Parliament. They will follow IFRS focus on control to determine the treatment of PPP.

Source: House of Lord, Private Finance Projects and Off-Balance Debt, Volume II Evidence, 2010, available at http://www.publications.parliament.uk/pa/ld200910/ldselect/ldeconaf/63/63ii.pdf

There are, however, certain disadvantages with this approach, as for example:

- The costs (or resource consequences) of "double reporting";
- Politically, this approach may appear difficult to justify, leading to suggestions that the true cost of future government liabilities is being, in some way, hidden.

For these reasons, Germany has opted for a single reporting notwithstanding the negative impact on debt and deficit generated by the substantial over-reporting.

4.4 A possible change in Eurostat's rules?

One of the consequence of changing accounting standards in both the public and private sectors has been the emergence of a debate over the consistency between these standards and the Eurostat statistical treatment of PPPs.

A logical possibility for "harmonising" accounting and statistical treatments would be for Eurostat to move to a "control" test for the statistical treatment of PPPs. A number of central banks have argued for this change on the grounds that they

believe this would increase the transparency of future fiscal commitments by governments.

It is clear that, without a revision of the Maastricht rules and a subsequent major change in the operation of the EDP, such a development would severely limit the growth of the PPP market. It is difficult to see how such a limitation could be justified. In particular, it is unclear why an essentially definitional change should disadvantage PPPs if and when these promote infrastructure investments which are economically justified, affordable and good value for money for the public sector.

In practice, should Eurostat change its rules in favour of a “control” approach, the solution (if worthwhile PPPs are not to be lost) will almost certainly require modification to the EDP. A “carve out” from the application of the EDP for long-term infrastructure investment is one option, albeit one that could be both politically controversial and complex to implement.

Eurostat references

ESA95 is available from the Eurostat website at:

http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/introduction under "Manuals".

The **ESA 95 Manual** on Long term contracts between government units and non-government partners (Public-Private Partnerships) is available from the Eurostat website at:

http://epp.eurostat.ec.europa.eu/portal/page/portal/product_details/publication?p_product_code=KS-BE-04-004

For information:

EPEC Secretariat
(+352) 43 79 - 85434
(+352) 43 79 - 65499
epec@eib.org

98-100, boulevard Konrad Adenauer
L-2950 Luxembourg
(+352) 43 79 - 1
(+352) 43 77 04
www.eib.org/epec