International Seminar on Strengthening Public Investment and Managing Fiscal Risks from Public-Private Partnerships

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Accounting for PPP

The Eurostat approach (ESA1995)

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Menu for today

- Part 1 – Reminder of the European setup
- Part 2 – ESA 1995 principles – role of risks and rewards
- Part 3 – Eurostat Decision / Manual on PPP accounting
- Part 4 – Lessons to be drawn

Part 1

- Reminder on the European setup for fiscal statistics monitoring

EU fiscal monitoring: ESA 1995 based

- The EU Treaty defines fiscal targets (mainly) by reference to national accounts
    - Government Deficit: Net lending / net borrowing of general government
    - Government Debt: liabilities of general government (nominal value)
  - To ensure comparability across Member States (….)
- The Treaty foresees the Excessive deficit procedure (EDP) further precised by Europeans law
  - Council Regulation 3605/93 as amended notably 2103/2005
- The European national accounts manual: **ESA1995**
    - A legal act: Council and Parliament Regulation 2223/1996
    - European version of SNA1993 (close to GFSM 2001)
  - *ESA1995 Manual of Government Deficit and Debt (MGDD)*
    - Eurostat interpretation of ESA1995 ; not a legal act ; collective work

Role of Eurostat - Regulation 2103/2005

- Validating the data
  - The Treaty foresees that is is the Commission that submits the data to the Council
    - *Eurostat: statistical services of the Commission*
  - Regulation 2103/2005 explicitly regulates the powers of Eurostat to express reservations or to amend the data
  - Validation period – Request for clarification
- Dialoguing with Member States
  - Eurostat runs a dialogue with Member States
    - EDP visits
    - Request for advice – Letters on methodological advice to be published
- Establishing of standards:
  - active interpretation activity of ESA1995: MGDD

Active interpretation activity of ESA1995: MGDD

- When a methodological issue is identified, a task force is convened (PPP in 2003)
  - Initiative: Member States ; or Eurostat
  - Financial Accounts Working Party
- CMFB vote (PPP: 2004 – near unanimity: 26 to 1)
  - Committee on Monetary, Financial and Balance of payments statistics
  - Composition: NSI + Central bank
- Eurostat decision (PPP: 11 February 2004)
  - Press release – CMFB opinion attached
- Drafting of a chapter (PPP Chapter)

Part 2

- ESA 1995 principles – role of risks and rewards

Basic principles of ESA1995

- Economic accounts
- Accounting rules:
  - Accrual / market valuation
  - Flow / stock comprehensive articulation
- Notion of General Government
  - Market / nonmarket boundary
  - Not the Public Sector
- Integration of accounts across sectors
  - The grantor / the operator
- Substance over form
- Focus on the risks and rewards

Risks and rewards : leases

- ESA 1995 annex II on leases
- "ESA 1995 recognizes the economic reality behind financial leasing" / versus operating lease
  - Financial lease recognized as debts. Lease payments are then financial transactions and interest.
  - Main criteria: transfer of (substantially) all risks
    - some features that help classifying them:
      - Leasing period most of the economic life;
      - Often, option to buy at the end "at a nominal price"
      - Lessor need not have experience / does not offer maintenance
      - Lessor's role purely financial
    - Operating leasing with staff = another nature

Risks and rewards – some other cases

- Repurchase agreement
  - Assimilated to (cash) lending
  - Assignor keeps accounting the security as its asset despite having transferred it (and losing control of it)
- Securitization (MGDD)
  - Transfer of risk and rewards main criteria
- Recognition of equity stakes in entities
  - Equity ownership recognized even without formal instruments
    - Eurostat decision on Italian Gold (1998)
- The test of risks and rewards routinely applied during discussions

Part 3

- PPP Chapter

  "Long term contracts between government units and non-government partners (Public-private-partnerships)."

Scope

The Chapter

- Lists all sorts of long-term contracts
- Distinguishes:
  - PPP: when government is purchasing the services, possibly for use by others
    - Only those are considered in the Chapter
  - Concession: when (non-government) users purchase the services
- An asset must be built
- Allows a variety of operators
  - Public corporations ; SPV

What are we talking about?

- PPP contract mentions
  - Output of some specifically designed assets
    - Needing a capital expenditure at the onset
  - Delivery of agreed services requiring using the asset and according to given quality and volume standards
- In areas of activity where government normally has a strong involvement
- Diversity of areas: transport (roads); education; environmental protection; hospitals; housing; prisons
- European Growth Initiatives (Dec 2003)

Basic rules

- Fundamental: The asset is on the private sector balance sheet if sufficient (most) risks and rewards have been transferred to the private sector
- Practical rule agreed:
  - When:
    - The construction risk;

      and
    - The availability risk or the demand risk have been transferred
  - Some other criteria might be relevant
- Common quick test: are financing providers at risk (AAA ratings)

Construction risk

- "covers events related to the initial state of the involved asset(s). In practice it is related to events such as late delivery, non-respect of specified standards, significant additional costs, technical deficiency, and external negative effects (including environmental risk) triggering compensation payments to third parties."
  - Is the cost overruns/savings passed to government in the form of higher/lower fees or of lower/higher services?
  - Are there penalties for delays or for missing specifications?
  - Who loses if the asset is not effectively built?

Availability risk

- covers cases where, during the operation of the asset, the responsibility of the partner is called upon, because of insufficient management ("bad performance"), resulting in a volume of services lower than what was contractually agreed, or in services not meeting the quality standards specified in the contract.
  - Is the reduction in fees substantial enough? Does the non-availability of the asset lead to zero fee (or less)? Are deductions definitively lost or recoverable?
  - Are deductions immediately deducted or are there caps (and delays for the remainder) to protect a level of cash flow?
  - Are cost of maintenance susceptible to be transferred to government (other than by way of general indexes)? Notably in case of obvious changes in costs determined by independent parties ('independent engineer")?

Demand risk

- covers the variability of demand (higher or lower than expected when the contract was signed) irrespective of the performance of the private partner. In other words, a shift of demand cannot be directly linked to an inadequate quality of the services provided by the partner. Instead, it should result from other factors, such as the business cycle, new market trends, a change in final users' preferences, or technological obsolescence. This is part of a usual "economic risk" borne by private entities in a market economy.
  - Is the formula such that zero demand leads to zero fees? Is the fee capped above a certain traffic?

Other aspects

- Judging whether there is transfer of risks/rewards
  - Genuine and substantial
  - Not all risks and rewards, but “most”
    - The Manual uses the term “majority”
- Guarantees / Financing by government
  - In principle would put at risk the “construction risk” transfer

The operator

- The operator must be also sectorized in national accounts
- Operator can be an SPV
  - If SPV originated by government, might be included in government
- Operator can be a public corporation
  - In case of 100% public, special monitoring needed
- Complication: operator must pass the market/nonmarket criteria, if public: specific rules for classifying government payments to public entities exist

Existing asset and return of asset

- Return of asset to government:
  - A capital transfer, if the return of asset for free (or for the difference with the market value)
    - Artificial recording
- Provision of an asset (e.g. land)
  - Must be limited, otherwise not a PPP
  - Asset provided transit via an other change in volume (without impact on the deficit); and its return same

Part 4

- Lesson of the experience

Practice – emergence of a new industry

- Emergence of PPP units in ministry of finances
- National laws often undertake to regulate PPP/concessions practices ; often with an eye on the Eurostat rules
- Eurostat requires Member States (National institutes/MOF) to pro-actively follow national developments
- Eurostat follows the Member States activities: institutional arrangements, accounting criteria, size of the phenomenon

Emerging activity

- The original advice was that the Eurostat criteria were restrictive.
  - Some voices considered the Eurostat criteria insufficiently strict (IMF…).
- The experience shows that a large number of PPP are realized and off-government balance sheet
- UK example:
  - Cumulated 55 billion pounds (796 projects since 1987)
- Spanish example (40 projects):
  - Most PPP meet the availability risk transfer
    - Most do not meet the demand risk transfer
  - PPP with public corporations all put on government balance sheet

Strains on statistical resources

- PPP create a considerable burden
  - On national statisticians, not equipped to assess each case, and ill-equipped to monitor the soundness of the application of general principles across government departments;
  - On Eurostat, flooded with complex contracts
- Soon emerging as the biggest challenge to statistical reporting ; comparability of statistics might be at risk

Accounting-world initiatives: important to statisticians

- Statisticians use accounting as source information
  - An ability to rely on the reporting of accounting systems would be an advantage
- Accountants' perspective to balance sheet recognition important to statisticians
  - IASB/IPSASB promote an (alternative for) international standard to SNA/ESA
    - Real debate on best concepts
- Credibility towards the public at large: where is the asset?