

Part IV

4.2 LONG TERM CONTRACTS BETWEEN GOVERNMENT UNITS AND NON-GOVERNMENT PARTNERS

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Summary

Government contracts with non-government units can take various forms, which normally do not raise difficulties as regards their treatment in national accounts. However, clear guidance is required on the treatment in national accounts of arrangements often referred to as “Public-private partnerships” (PPPs).

In many of these partnerships government agrees to buy services from a non-government unit over a long period of time, resulting from the use of specific “dedicated assets”, such that the non-government unit builds a specifically-designed asset to supply the service. The services bought by government might be to meet its own needs or to satisfy third party users (as seen notably for health and education services, and for the use of some transport infrastructures).

The key issue is the classification of the assets involved in the partnership contract - either as government assets (thereby influencing government deficit and debt) or as the partner’s assets. This is a similar issue to distinguishing between operating leases and finance leases, which is explained in annex II of ESA95.

As a result of the methodological approach followed, in national accounts, the assets involved in a public-private partnership can be considered as non-government assets only if there is strong evidence that the partner is bearing most of the risk attached to the specific partnership.

In this context, there was agreement among European statistical experts that the risk assessment should focus on the following three main categories of risk:

“construction risk” : covering events like late delivery, respect of specifications and additional costs

“availability risk” : covering volume and quality of output.

“demand risk” : covering variability of demand.

A PPP’s assets should be classified off-balance sheet for government if both of the following conditions are met.

The partner bears the construction risks.

The partner bears at least one of either availability or demand risk.

If these conditions are met, then the treatment of the contract is similar to the treatment of an operating lease in ESA95; it would be classified as the purchase of services by government.

If the conditions are not met, then the assets are to be classified on-balance sheet for government. The treatment is in this case similar to the treatment of a financial lease in ESA95 requiring the recording of government capital expenditure and borrowing.

In borderline cases it is appropriate to consider other criteria, and notably what happens to the asset at the end of its life, as well as the existence of any guarantees to support the partner’s borrowing.

A decision tree summarising the treatment of the PPP contracts in national accounts is annexed to this chapter.

1. Background of the issue

1. The development of long term contracts

In recent years, attention has focused on partnerships between government units and private units (frequently referred to as “Public-Private Partnerships” – PPPs) or, in national accounts sector classification terms, partnerships with non-financial or financial corporations.

Such partnerships imply a long term relation (by convention, at least three years) in the framework of contracts, where the obligations and rights of each partner are clearly specified.

From a general point of view, there are various types of long term contracts based on partnership agreements between government and non-government units; these have been observed for a long time in some Member States, their form depending on factors such as legal and regulatory factors. Most of them normally do not raise difficulties as regards treatment in national accounts. Recently, however, new kinds of arrangements have been made in a few Member States, and a significant increase in the number of these arrangements is expected in the coming years.

Moreover, the European Growth Initiative, approved by the European Council in December 2003, sets as one of its objectives to promote the use of such partnerships, notably to develop infrastructures that are judged to be needed for reinforcing the potential growth of the European Union. However, the “EGI” covers a large range of government supports for the development of growth-relating infrastructures for which the rules mentioned in this document apply only in part. As a result, it is expected that the large diversity of contractual structures currently observed among EU Member States will be significantly reduced. Most countries are expected to adapt their legal and regulatory framework accordingly.

The motives for developing partnerships are various. Government may, for instance, wish to take advantage of specific competences and skills of commercial units to increase the efficiency of public expenditure. It may also wish to improve the quality of public services through units which are more demand-oriented and sensitive to customers’ requirements, and are clearly profit-oriented.

EDP rules and other budget constraints may frequently push governments to look for alternative resources for developing collectively-used infrastructures, notably where such contracts allow for a spread of the cost of new assets over the time they are used, thus avoiding large initial government capital expenditure. Experience shows that in many cases these arrangements lead to a reduction in up-front public expenditure.

It is not the role of statisticians to examine the motives, rationale and efficiency of these partnerships, or to voice an opinion about the “economic viability” and the “financial viability” of the underlying projects. Their role is to provide clear guidance on their treatment in national accounts and, for EDP purposes, their impact on general government deficit and debt. Furthermore, it is important to ensure homogeneity of government statistics in all Member States, such that deficit and debt figures are fully comparable. In this respect,

ESA95 shows lack of clarity and does not provide clear guidance for more complex arrangements.¹

Similarly, it is not up to the statisticians to provide a strict definition of public-private partnerships, as the expression may in fact cover various arrangements, whereas a specific definition would not be appropriate in a context of complexity and innovation. Instead, they should spell out basic criteria which allow national accountants to clearly distinguish the different arrangements that may be observed.

2. The different types of long term contracts

The expression “Public-private partnerships” has in the past covered various long-term arrangements, among which we have found the following cases:

a. Purchases of services on regular basis

Government is only purchasing services over a given long-term period but without fixing specific requirements as regards the assets, i.e. different from general regulatory standards. This contractual link may be important to ensure continuity in supplying, both in quantitative and qualitative terms. The treatment in national accounts, based only on flows occurring in one fiscal year, does not raise any specific issue.

b. Equity stakes

Such arrangements involve the creation of a new unit (a “joint-venture”) in which both government and non-government partners have equity stakes in a company managing a given infrastructure. ESA95 rules, as supplemented by the Manual on government deficit and debt, give quite explicit provisions, notably as regards the treatment of flows between government and this unit. A “pure” joint-venture with a strict equality in equity stakes should normally be considered as a public corporation if government is assumed to exercise a control over the general policy of the unit, which is generally the case.

c. Guarantees

In order to support a project, government may grant a guarantee to the debt of a non-government borrower, which may imply that government requires some specifications. This is fully covered by the current ESA95 (see 4.165 and 5.05) and, except in some exceptional cases, such guarantees are considered as “contingent liabilities”, not recorded in the system. There should be no impact on government accounts as long as the call of guarantee is not observed, with the exception of some fees that could be levied by government.

d. “Build and delivery” contracts

In this case, the non-government party is only committed to build an asset and deliver it to government, according to its requirements (normally checked by a third party). The asset will be used by government fully under its own responsibility. These contracts are normally treated as a “one-off” government capital expenditure that may nevertheless be recorded on an accrual basis under some conditions. This does not exclude an ancillary provision of services (that can be separately specified and which are treated adequately in national

¹ There are rules based on Generally Accepted Accounting Practice (GAAP) and on other International Standards, applied by private business to some of these arrangements. These seem to be quite consistent with the substance of ESA95 and, apart from borderline cases, they are likely to give similar results as regards the classification of assets. Therefore, national accountants could rely in many cases on analysis provided under these frameworks. However, the national accountants have the final responsibility as regards the treatment for EDP purposes.

accounts). Such services are strictly related to the assets, such as technical maintenance work.

e. Leases

Government is the user, during a given period, of an asset that is legally owned by a non-government unit. According to the “risks and rewards” borne by each party (that is the basis of the concept of “economic ownership”), the lease is considered either as an “operating lease” or as a “financial lease”, which gives rise to different treatments in national accounts, fully specified in ESA95 (Annex II). This concerns also cases of “Cross border leases” (which take the form of a set of interlinked lease agreements commonly referred to as “head” and “sub” leases). If government enters in a financial lease agreement, its deficit and debt would be impacted for the full value of the assets at the time government takes possession of the assets.

f. Concessions

This term is used² in this context for contracts where government asks a corporation, generally after a competitive procedure, to manage the construction, as well as finance and operate an asset during the entire contract (but this unit may sub-contract some tasks to other suppliers under its sole responsibility), while directly charging the final users who, predominantly, are not government users.³ For example a corporation might build a road and levy tolls on vehicles using it. The payments to government are treated as government revenue according to their nature, at inception and regularly all over the lifetime of the concession. In some cases, assets may also be transferred to government at the end of the concession.⁴

Under these contracts the major part of the partner’s revenue comes from a direct sale of services to a variety of units under fully commercial conditions, but possibly with specific government requirements (often compensated by government in the form of subsidies). It may also be the case that the price is not freely set by the private partner or agreed by the private partner and the end-users but is fixed in the bidding documents and only adjusted upon the occurrence of certain events. There may also be payments from the corporation to government. Payments may occur initially (as a purchase of a related licence) or during the lifetime of the contract (royalties, specific taxes, etc.).

g. Services purchased by government on the basis of dedicated assets

This refers more specifically to new forms of partnerships (frequently designed as “public-private partnerships” - PPPs) which, for EDP and National Accounts classification purposes, are of great interest. The Eurostat decision on 11 February 2004 covered explicitly and exclusively this case. (See News release 18/2004)

It tends to occur in areas of activity where government has a strong involvement (transport, education, health, and security)⁵. Government concludes with one or several experienced

² In some Member States a similar term may, in legal terms, cover a less restrictive set of arrangements.

³ Government units may of course use the assets and pay for that use, but this corresponds to the purchase of services for its own purpose as a “normal customer”.

⁴ It may happen that government transfers (without payment) an existing asset to the corporation that will exploit it or incorporate it into a wider project. This is recorded as a capital injection in kind in the “other changes in volume” account, with no impact on government surplus or deficit. If the infrastructure is given back to government at the end of the period of operation, it enters government’s balance sheet through the “other changes in volume” account, with no impact on government surplus or deficit. (See chapter II.1.2 of the Manual: “Payments by public corporations to government”)

⁵ Current examples of contracts cover building and exploitation of roads, tunnels, bridges, networks, schools, universities, hospitals, health centres, cultural buildings, prisons).

commercial partners, directly or through a special legal entity set up for the specific purpose of a PPP⁶, a contract for the delivery of services derived from a specific asset.

This type of contract⁷ mentions specifically-designed assets which generally need a significant initial capital expenditure (which is precisely why government uses such arrangements in many instances), and the delivery of agreed services, requiring the use of these assets and according to given quality and volume standards that are specifically defined in the contract⁸. It is in this sense that these contracts differ from leases.⁹ The contract may refer either to a new asset or to significant refurbishment, modernisation or upgrading of existing assets, including assets already owned and managed by government but provided that the expenditure for renovation, etc., will represent a predominant part of the new value of the asset after renovation.

A key feature of these PPPs is that government is the main purchaser of the services, through regular payments, once the assets are supplied by the partner, whether the demand originates directly from government itself or from third party users (as for health and education services, and some types of transport infrastructures). There is no need to specify a given threshold on this point. Strictly speaking, it means just above 50% but in reality this percentage tends to be much higher, generally above 90%, because most contracts refer to “typed” economic models. The expression “shadow tolls” is frequently used in the case of transportation infrastructure and refers to remuneration by Government for a given usage volume of the transport infrastructure.

The use of the assets is specifically defined in the contract and the partner is necessarily limited as to how the assets may be used. For example, the partner cannot dispose of them at will, and in some instances, has to give priority to government users over other possible users. Note that many contracts do not rule out payments by “third parties”, but these are likely to represent a minor (even negligible) part of the partner’s revenue and frequently refer to a secondary activity associated with the dedicated assets (for instance “private” use of some infrastructure on given period or fees collected for telephone cables laid along, or under, a motorway).

In addition, it must be stressed that “government” in this context refers to the whole government sector (“General Government”, or sector “S.13” in ESA95) while different government units, even classified in different sub-sectors of government, take part in the contract at various degrees. This should have no impact on the treatment in national accounts.

3. The key issue in national accounts

In national accounts, long-term contracts raise questions where assets are in the core of the contractual agreement between the parties, and especially in the case of partnerships as described in 1.2.g). This refers to the advance (a priori, when the contract is signed, or enters into force) classification of the assets involved, either as government assets (“on balance-sheet”) or as partner’s assets (“off balance sheet”). In this case, business areas often use the expression “deconsolidation”.

⁶ This refers to the case where the contracting PPP partner is a Special Purpose Vehicle owned by the contracting company (ies) and where shares are held by construction companies and service providers, sub-contractors and any others involved in the contract.

⁷ For a part, this corresponds to what is frequently called “Build Own Operate Transfer” contracts.

⁸ Although this seems less frequent, the contract may also cover assets that are “readily” available in the market, or may be made available under similar conditions for non-government units.

⁹ It may happen that government makes available to the corporation a non-produced asset needed for the achievement of the project, such as land upon which an infrastructure is built.

The classification as government assets has important consequences for government finances, both for the deficit (the initial expenditure is recorded as government fixed capital formation in the non-financial account, under the category P.51), and for the debt (the financial account would record new government borrowing, that increases gross debt in the form of an “imputed loan” in AF.4, which is part of the “Maastricht debt” concept).

Moreover, according to ESA95 rules, when the assets (in the form of construction or other structures) are considered government assets, the capital expenditure is recorded on an accrual basis at the outset, and not at the end of the construction/refurbishment period. The existence of phased payments received by the constructor or manufacturer may indicate the appropriate time of recording.

There are also consequences as regards the classification of the flows that are observed between government and the partner during the lifetime of the contract. If an imputed loan has been recorded in the government balance sheet, the redemption of the corresponding principal must be spread over the entire period (with no impact on government surplus or deficit), while imputed interest must also be calculated and included in government expenditure together with the cost of services charged to government in the context of the contract.

2. Treatment in national accounts

1. Sector classification of the partner

The corporations involved in long-term contracts with government, and more specifically in the case of “PPPs” as described above in 1.2.g., can be either public or private. If the corporation is public, this means that according to national accounts rules, government determines the general policy of this market unit.

There is no reason to move the PPP assets onto the government balance sheet for the motive that the corporation is public, as long as the public partner acts as a market unit (50% cost coverage criterion) and payments by government may be considered as sales (counterpart of the provision of services for the community).

However, specific attention should be given to cases where the public corporation is 100% government-owned (or to a level close to 100%), and thus there is an absence of private investors in the public corporation who would exercise a significant influence to ensure commercial profitability and efficiency. In cases where payments by government under this contract are a predominant part of the partner’s revenue, such that for this public corporation this contract alone results in a significant change in the size or nature of its activities, this corporation could be reclassified as a government unit, depending on the application of the rules described in part I of this Manual.

As regards contracts with special units, created on purpose (frequently referred to as special purpose vehicle), the only case to be considered is where such unit is created mainly by government and is fully controlled by it.

Finally, whenever government deliberately offers support to a partner that has clearly to be classified outside government sector, as compensation for events that were not mentioned as clear commitments when the contract was signed with the partner, this support must be recorded as a transfer affecting deficit/surplus of the government at the time this decision is taken.

A reclassification of the assets to the government’s balance sheet could result from the reclassification of the partner as government unit if a recurrent support results in a shift of the unit from a market activity to a non-market activity (the majority of the production costs no longer being covered by payments considered as “sales”, but instead by transfers from government).

2. Assessment of the risks borne by each contracting party

a. General principle

In national accounts, the assets involved in a long-term contract between a government unit and a non-government unit can be considered as non-government assets only if there is strong evidence that the non-government partner is bearing most of the risks attached to the execution of the contract.¹⁰

¹⁰ ESA95 states (see notably annex II, §4) that “all risks” must be transferred. But this is not observed in reality and on principle there is in partnerships between government and its counterparts a share in risks that must result in an imbalance in one sense or the other. However, as mentioned further, it may be seen as normal that some risks are taken by government (for instance in the case of very exceptional events or for government action that change the conditions of activity that were agreed previously).

Therefore, this analysis of risks borne by the contractual parties is the core element as regards classification of the assets involved in the contract, to ensure the correct accounting of the impact on the government deficit of this type of partnerships.

As a result, the assets are recorded as non-government assets only if there is strong evidence that the non-government partner is bearing the majority of all the risks attached to the contract.¹¹

For the purpose of classifying PPPs in the EDP Manual, in order to simplify the analysis, three main categories of risks have been selected:

- “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.
- “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.
- “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.

Therefore, the analysis of the risks borne by each party must assess which party is bearing the majority of the risk in each of the categories mentioned above.

However this assessment does not consider risks that are not closely related to the asset (s) and that can be separated from the main contract, as is the case where part of the contract might be periodically renegotiated, and where there are performance or penalty payments that do not significantly depend on the condition of the main assets or on service quality.

b. Guidance for contracts relating to purchase by government of services based on the use of dedicated PPP assets (as described in 1.2.g)

The assets involved in such public-private partnerships must be classified as non-government assets, and therefore recorded off balance sheet for government, only if BOTH of the following conditions are met:

1. the private partner bears the construction risk,

And

2. The private partner bears at least one of either availability or demand risk.

Therefore, if the construction risk is borne by government, or if the private partner bears only the construction risk and no other risks, the assets are classified as government assets.

¹¹ National accounts exclude “split accounting”, as these arrangements deal with a single asset or a set of assets that are not contractually divisible. Therefore, the rule is that one asset appears in the balance sheet of only one economic agent, for its total value.

A key criterion is the possibility for government to apply penalties in cases where the partner is defaulting on its service obligations. Application of the penalties should be automatic (i.e. clearly stated in the contract) and should also have a significant effect on the partner's revenue/profit and, therefore, must not be purely symbolic. As a corollary, if the partner is in a position to provide services, according to conditions specified in the contract, at lower costs than expected, it should be entitled to keep all or most of the subsequent profit.

c Special consideration for leases

The most relevant part of ESA95, concerning leasing of durable goods, is Annex II where the distinction between finance leases and operating leases is made. This is based on whether the lessor or the lessee is exposed to most of risks and rewards inherent in the asset, and stresses the economic reality of these arrangements, rather than their legal features.¹² The existing lease chapter in this Manual does not give detailed explanations on how to assess the balance of risks. The classification of risks provided above might therefore be applied in this context, notably as regards the demand risk that seems to be particularly relevant in this case, and, to a lesser extent by the availability risk relating to the quality of services possibly provided by the lessor.

Different criteria are proposed in national accounts in order to decide on whether the lease must be considered as an operating lease or a finance lease. Their relevance must be judged for each particular case.

In this context, a comparison between the term of the contract and the expected economic life of the asset(s) would be a rather strong indication of a finance lease if this term covers all or a predominant part of the economic life. This would mean that the lessor would not be in a position to lend the good to another lessee or to use it otherwise at the end of the contract.

Similarly, where government pays directly for most of the maintenance¹³ of the asset, and is bearing the risk of variations in such costs, this suggests a finance lease. It would be also the case if government was committed for repayment of the corporation's debt in the event of early termination of the contract.

On the contrary, an operating lease should be considered where the leasing corporation has significant and ongoing power on how to fulfil the contract, makes the key decisions on the design and construction of the asset, and decides how it is to be operated and maintained to provide the services required.

In addition, the nature of the partner could give an indication for classification where government enters into a lease contract with units that are clearly specialised either in operating leases or in finance leases. Examples are units providing only operating leases for equipment such as transportation, computers or, on the contrary, institutions specialised in financial leasing either in the form of property leasing (offices occupied by government units) or in equipment leasing. In all cases, it is important to check whether government is contracting according to normal commercial/market conditions.

3. Final allocation of the assets

An analysis of the clauses relating to the disposal of the PPP assets (as defined in 1.2.g) described at the end of the contract can be used as a supplementary criterion for determining overall risk transfer, notably where the risk analysis mentioned above, does not give clear conclusions (for instance if risk distribution is estimated as balanced or is based on fragile

¹² ESA95 in this respect fully follows the System of National Accounts 1993. (See notably § 13.23)

¹³ And also, for some types of durable goods (like productive equipment) the insurance.

hypotheses). However, as such, the final allocation of the assets could not be the single and straightforward criterion for the classification of the PPP assets but, notwithstanding this, it might give in some cases additional insight into risks among the contract partners as the clauses concerning the final allocation of the asset might help to assess whether a significant risk remains with the private partner.

If the assets remain the property of the partner at the end of the project, whatever their economic value at this time (but frequently their future economic life remains quite significant, notably in cases of infrastructure that are slightly depreciated over time), then classification on the partner's balance sheet would have an additional justification.

In other contracts government may hold merely an option to buy the asset at the current market value. In these cases, the partner bears the risks associated with the continued demand for the asset and its physical condition. This also reinforces the classification of the assets "off" government balance sheet.

On the contrary, government may have the firm obligation to acquire the assets at the end of the contract at a pre-determined price.

Recording the assets as government assets would be appropriate in the following case:

- the pre-determined price is obviously higher than the economic value of the assets;
- the price paid by government is lower than the economic value (or even nil) but government has already paid for the right to acquire the assets throughout the contract by making regular payments that reached a total amount very close to the full economic value of the assets.¹⁴

Note that, in some cases, at the end of the contract, the unit managing the asset and providing services to final users is wound up, or is absorbed by government. This transfer of the assets to government at the end of the contract should be recorded as "other change in volume". However, this is more likely to be observed in the case of "concession contracts" than for PPPs arrangements.

4. Government financing

Normally, an important aim of government's long-term partnerships with non-government units is to avoid immediate capital expenditure, and related borrowing.

However it is not unusual that government takes part itself in the financing. This is different from a possible capital injection in a given structure in the form of equity stake. This may be justified by the fact that frequently a private partner is not able to borrow at the same rate of interest as government, thus increasing the cost of the project.

Therefore, government may offer a certain level of financing for the PPP project, to entice greater interest by private sector entities in the project and/or to reduce the total cost of financing.

If, at inception, or during construction, the capital cost is predominantly covered by government, this would be an indication that market operators doubt the financial viability of the project, such that it can be realised only if government bears a majority of risks. This may trigger a re-classification of the assets to government accounts. One could argue that this "financing risk" is an integral part of "construction risk", since the absence of suitable

¹⁴ In part 4, numerical examples are given as regards the allocation of assets under "concession" contracts.

financing means that the asset cannot be created, or cannot be created to required standards.

Government may also provide a guarantee, partially or fully covering the project-related borrowing of the partner. Generally, this helps the partner to raise funds at lower cost on markets and improves its credit rating. This alone is however not a criterion for the classification of assets, because in ESA95 such guarantees are considered as contingent liabilities.¹⁵

In some cases, a debt guarantee can trigger a classification of the partner's debt as government debt, such as the existence of legal provisions transferring to government all or part of the debt service, or an obvious inability of debt servicing by the partner.

Moreover, consistent with the treatment of securitisation and sale and lease-back operations with public corporations, guarantees should be used in risk analysis, especially where the majority of the value of the PPP assets (including any refurbishment cost) results from a transfer of assets from government.

In this respect, the scope of a guarantee, depending on how it is structured (notably when its coverage is wider than just one specific, project-related debt instrument), may influence the classification of PPP assets. It may result in the assumption by government of some of the risks analysed in the paragraphs above. For instance, government could ensure a given return on equity, whatever the performance of the partner or the effective level of demand from final users.¹⁶

Finally, where the guarantee is effectively called, there may be a reclassification of the assets (at their remaining value), especially if this event profoundly changes the share of risks borne by the parties. This could be the case if government takes control of the partner, and pays no longer on the basis of the asset availability and demand, but mainly on the basis of operating costs.

5. Classification of some transactions between a corporation and government

In this respect, two cases must be distinguished.

If government does not make payments to the corporation or only as a normal customer for a minor part of the revenue of the corporation from this contract, the output is produced by the corporation by means of the infrastructure. Users of the infrastructure consume this output.

Where the infrastructure is a new one built by the corporation, possible payments from the corporation to government can arise either because government provides something in return, and in this case the classification of the payments depends on what government provides (for instance rents D.45 if government provides the land upon which the infrastructure is built), or on the basis of the "sovereign power" of government, demanding a payment simply for allowing the corporation to undertake the operation (the payment should be classified as other taxes on production D.29).

Where government transfers an existing infrastructure to the corporation, a capital injection in kind is recorded in the other changes in volume of assets account, with no impact on government surplus or deficit. The situation can be regarded as a restructuring of fixed

¹⁵ As a reminder, as in the case of securitisations (see Manual) the guarantee can take various forms (including use of some financial derivatives) and can be granted by another government unit than the one taking part in the contract.

¹⁶ On the contrary, in cases where the exercise of a government guarantee for the debt incurred by the private partner implies a transfer of the assets to government, the existence of the guarantee would not have an influence on the initial classification of the assets.

assets, property rights and obligations; it is an exchange of a non-financial asset for a financial one (government's equity in the corporation, AF.5, that must be imputed whatever the effective legal situation), to be recorded according to the rules defined in part II. 3. 2 (paragraph 2.b.) of this Manual. Because of this equity, it is relevant to classify possible payments from the corporation to the government as dividends (D.421), even though part of them could be regarded as rents.

Reversion of the infrastructure to government is recorded symmetrical to the initial transfer: exchange of non-financial asset for a financial one (AF.5) shown in the other changes of volume in assets account.

If government makes regular payments to the corporation, the treatment depends on the classification of the asset.

If the asset is considered as "off" government balance sheet, the corporation provides a service to government that constitutes government intermediate consumption expenditure, valued by the payments to the corporation.

If the asset is considered as "on" government balance sheet, it is government which provides a service to the community by means of the infrastructure. Its acquisition by government is recorded as a "standard" financial leasing contract. Government payments over the whole life of the contract must be split between redemption of principal (F.4), payment of interest (D.41) and, possibly, purchase of service fees for the tasks performed by the corporation and purchased by government (P.2)."

3. Rationale of the treatment on some issues

1. Sector classification of the partner

A partnership with a public corporation should fulfil certain conditions.

The public corporation should show a clear competence in the area of activity covered by the PPP (directly or in the case of creation, from the unit(s) controlling it), and the PPP contract with government should be but one among several commercial activities of the public sector partner.

In case of a 100% public-owned corporation, the fact that a contract with government is almost exclusively the source of its revenue would not imply a reclassification as government unit if it is evidenced that market-oriented payments (meaning of a similar kind to that observed between other market units) are made to the partner, and if government bears only risks that a commercial entity could not normally be expected to bear (very high political or security risks, for instance).

In some contracts, the execution of the contract takes place under the legal umbrella of a special purpose vehicle (SPV). Normally, such a legal entity would have a finite life limited to the length of the PPP contract, or just to the construction period. It can be expected to have been created solely for legal purpose or for optimizing the tax position of the partner.

If one or several private partners that are the operational contracting parties control this unit, there is no question as regards its classification as a non-government unit. This may be observed in the case of building innovative and complex assets that need the close cooperation of firms in different technical areas. But this may also take the form of a pooling of banks where the financing requirements are quite significant. Therefore, an SPV generally does not itself play an operational part in the execution of the contract, neither as a project manager, nor as the builder or operator of the PPP asset.

Complications arise when such a special unit, which is the government's counterpart in the contract, is created directly by government. In this case it must be closely checked whether the unit can be considered as an independent institutional unit according to ESA95¹⁷, and whether the unit is a true market producer. It could be a case of classifying it as an "ancillary" unit, notably by reference to SNA §4.40 to §4.44 (also implicitly in ESA95), such that it might be more appropriate to say that the fees paid by government are not sales receipts for a "real partner", but just transfers within the general government sector.

2. Assessment of the risk

This part refers more specifically to the case of "public private partnerships" as described above in I.2.g but may be applied in some cases to other kinds of contracts.

The core issue is the share in all risks that are associated to the contract and are directly related to the state of the assets involved or depends on some management tasks that must be carried out by the partner in the framework of its contractual obligations. This refers to the concept of "economic ownership", clearly distinguished from "legal ownership" used in most accounting standards, both for national accounts purposes and in business accounting.

¹⁷ This does not refer to "daily management", but to the main decisions relating to the activity, notably the acquisition and disposal of assets, the incurrence of liabilities, and the full capability of contracting with non-government units.

As regards **the construction risk**, a government's obligation to start making regular payments to a partner without taking into account the effective state of the assets that are delivered would be evidence that government bears the majority of the construction risk and is acting de facto as the final owner of the assets since the inception. This is also true where payments are made by government to cover systematically any additional cost, whatever their justification.

The magnitude of the different components of this risk can be estimated by the amount that each partner would be obliged to pay if a specific deficiency were to occur. This risk might be quite significant where the assets involved major research and development or technical innovation, whereas it could be more limited for conventional structures.

An important point is that government should not be obliged to pay for any event resulting from a default in the management of the construction phase by the partner, either as a direct supplier or only as a coordinator/supervisor.

By contrast, the responsibility of the partner can be excluded for unexpected exogenous events, beyond normal coverage provided by insurance companies. This risk must not be confused with the appropriateness of the "design" of the assets, where the degree of initiative of the partner may be very limited. The main point here is that a partner normally would not agree to bear risks relating to the construction, if government's requirements are unusual, and alter the commercial viability of the asset. In addition, the partner should not be taken as responsible in case of a government action such as changing specifications in the course of the construction or modifying some standards requirements.¹⁸

As regards the **"availability risk"**, government is assumed not to bear such a risk if it is entitled to reduce significantly its periodic payments, like any "normal customer" could require if certain performance criteria are not met. Under these conditions, government payments must depend on the effective degree of availability ensured by the partner during a given period of time.

This would mainly apply where the partner does not meet the required quality standards, resulting from a lack of performance. It may be reflected in non-availability of the service, in a low level of effective demand by final users, or low level of user satisfaction. This is generally reflected in performance indicators mentioned in the contract, for instance, a number of beds in a hospital, of classrooms, of places in a prison, of lanes of a highway opened to traffic, etc.

Normally, the partner is assumed to be in a position to avoid the occurrence of this risk. In some cases, the partner could invoke an "external cause", such as a major policy change or "force majeure". But such exceptions should be accepted only under very restrictive conditions such that they must be explicitly stated in the contract.

The application of the penalties where the partner is defaulting on its service obligations must be automatic and must also have a significant effect on the partner revenue/profit. They must affect significantly the operating margin of the unit and could even exceed it in some cases, so that the partner would be heavily financially penalised for its inadequate performance. It may also take the form of an automatic renegotiation of the contract and even, in an extreme case, of dismissal from the contract of the original partner.

It is important to check that penalties for inadequate performance would not be purely "cosmetic" or symbolic. The existence of marginal penalties would be evidenced by a reduction in government payment far less than proportional to the amount of services not

¹⁸A specific case to be considered is where the partner receives an existing government asset as a necessary part of the project (either as an element or for a significant refurbishment). The construction risk applies only to the new capital expenditure under the responsibility of the partner, whatever the conditions in which the asset has been transferred.

provided, and such a situation would be in opposition to the basic philosophy of a significant transfer of risks to the partner. Furthermore, the existence of a maximum amount or percentage of penalties that could be applicable in the event of defaulting performance would also suggest that this risk has not been significantly transferred to the partner.

As regards the “**demand risk**,” government is assumed to bear this risk where it is obliged to ensure a given level of payment to the partner independently of the effective level of demand expressed by the final user, rendering irrelevant the fluctuations in the level of demand on the partner’s profitability.

However, the variability of demand is not due to the behaviour (management) of the private sector partner, which is already covered by the provisions above. In other words, the availability standards stated in the contract are fulfilled. Therefore this risk covers a direct change in final users’ behaviour due to factors such as the business cycle, new market trends, direct competition or technological obsolescence.

For the asset to be classified off the government’s balance sheet, when there is an unexpected decrease in the partner’s revenue, the partner must be able to manage the situation by various actions under its own responsibility, such as increasing promotion, diversification, redesign, etc. In this respect, the partner is carrying out its activity in commercial manner. Thus, the existence of contractual clauses allowing the partner to use the assets for purposes other than those that have been agreed with government (of course, within certain limits) is frequently an indication that the partner is effectively bearing the demand risk, as defined here.

Where the shift in demand results from an obvious government action, such as decisions by government (and thus not necessarily only by the unit(s) directly involved in the contract) that represent a significant policy change, or such as the development of directly competing infrastructure built under government mandate, the absence of adjustment in regular payment or even a compensation payment to the partner would not imply the classification (or the reclassification) of the assets on government’s balance sheet.

Finally, like for the previous category of risks, some exceptional “external” events might have a significant impact on the level of the demand. They must be considered under very restrictive conditions and should be limited to those for which insurance coverage is not available on the market at reasonable price. Normally, the partner is contractually required to subscribe to an insurance policy.

4. Accounting examples

1. Regular payments by government (“PPP case”)/ Assets “off” government balance sheet

- The asset is built by a corporation (GFCF=1 000). It depreciates by 40 in first year.
- Government makes regular payments to the corporation during the period of exploitation according to availability (payment is 100 for the first year)
- The infrastructure is purchased by government at the end of the period of exploitation (for an amount of 200).

Capital expenditure and first year of exploitation

General government				Enterprise			
Current accounts							
U		R		U		R	
P.2	100					P.12	1 000
B.8 net	-100			K.1	40	P.11	100
				B.8 net	1060		
Capital accounts							
ΔA		ΔL		ΔA		ΔL	
		B.8 net	-100	P.51	1 000	B.8 net	1 060
B.9	-100			K.1	-40		
				B.9	100		

Purchase by government at the end of exploitation

General government				Enterprise			
Capital account							
ΔA		ΔL		ΔA		ΔL	
P.51	200			P.51	-200		

B.9 -200 |

B.9 +200 |

Closing balance sheet

A		L	
AN.11	200	AF.4	200

A		L	

2. Regular payments by government (“PPP case”)/ Assets “on” government balance sheet

- The asset is built by a corporation (GFCF=1 000). It depreciates by 40 in first year.
- Government makes regular payments to the corporation during the period of exploitation. (Payment is 100 for the first year)

Capital expenditure

General government				Enterprise			
Current accounts							
U		R		U		R	
K.1	40					P.11	1000
B.8 net	-40			B.8 net	1000		
Capital accounts							
ΔA		ΔL		ΔA		ΔL	
K.1	-40	B.8 net	-40			B.8 net	1 000
P51	1000						
B9	-1000			B.9	+1000		

Capital expenditure

General government				Enterprise			
Financial account							
ΔA		ΔL		ΔA		ΔL	
		F.4	+1 000	F.4	+1000		
		B.9	-1000	B.9	+1 000		

Closing balance sheet

A		L		A		L	
AN.11	1 000	AF.4	1 000	AF.4	1000		

First year of exploitation of the infrastructure

Payment of partner of 100 is split into:

D.41 = 50

P.2=30

F.4 = 20

General government				Corporation			
Current accounts							
U		R		U		R	
D.41	50					P.11	30
P.2	30					D.41	50
K.1	40						
B.8 net	-120			B.8 net	+80		
Capital account							
ΔA		ΔL		ΔA		ΔL	
K.1	-40	B.8 net	-120				
B.9	-80	B.10.1	-120	B.9	+80		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-100	F.4	-20	F.2	100		
		B.9	-80	F.4	-20	B.9	+80
Closing balance sheet							
A		L		A		L	
AN.11	960	AF.4	980	AF.4	980		
ΔAF.2	-100	ΔB.90	-120				

3. Regular payments by final users (“concession case”)/ New asset

- The asset is built by a corporation, value 1000. It depreciates by 40 in first year.
Final users paid 200 on the first year
- Rents/taxes are paid by the corporation to government (payments are 100 the first year).
- The infrastructure reverts to government at the end of the period of exploitation (residual value of 200).

Capital expenditure and first year of exploitation

General government				Enterprise			
Current accounts							
U		R		U		R	
		D45/D29	100	D.45/D.29	100	P.12	1000
B.8 net	+100			K.1	40	P.11	200
				B.8 net	+1060		
Capital accounts							
ΔA		ΔL		ΔA		ΔL	
		B.8 net	+100	P.51	1 000	B.8 net	1060
B.9	+100			K.1	-40		
				B.9	+100		

Reversion to government at the end of exploitation

General government				Corporation			
Capital account							
<u>ΔA</u>		<u>ΔL</u>		<u>ΔA</u>		<u>ΔL</u>	
P.51	+200	D.99	+200	P.51	-200	D.99	-200
B.9	0			B.9	0		
Closing balance sheet							
<u>A</u>		<u>L</u>		<u>A</u>		<u>L</u>	
AN.11	200						

4. Regular payments by final users (“concession case”)/ Existing government asset

- The asset is transferred by government to a corporation at the beginning of the exploitation (for an amount of 1 000).
- Dividends should be paid by the corporation to government (not reflected in the example below).
- The asset reverts to government at the end of the period of exploitation (residual value of 200) and the corporation ceases to exist.

Initial transfer of the asset

General government		Corporation	
Opening balance sheet			
A		L	
AN.11	1 000		
Other changes in volume of assets account			
ΔA		ΔL	
AN.11(K.12.1)	-1 000		
AF.5(K.12.1)	1 000		
Closing balance sheet			
A		L	
AN.11	0		
AF.5	1 000		

First year of exploitation

K.1 = 40

General government				Corporation			
Capital account							
ΔA		ΔL		ΔA		ΔL	
				K.1	-40	B.10.1	-40
Revaluation account							
ΔA		ΔL		ΔA		ΔL	
AF.5(K.11)	-40					AF.5(K.11)	-40
		B.10.3	-40			B.10.3	+40
Closing balance sheet							
A		L		A		L	
AF.5	960			AN.11	960	AF.5	960
		$\Delta B.10$	-40			$\Delta B.10$	0

Reversion to government at the end of exploitation

General government				Corporation			
Other changes in volume of assets account							
ΔA		ΔL		ΔA		ΔL	
AN.11(K.12.1)	200			AN.11(K.12.1)	-200	AF.5(K.12.1)	-200
AF.5(K.12.1)	-200						
Closing balance sheet							
A		L		A		L	
AN.11	200						

ANNEX: DECISION TREE FOR PPP CONTRACTS (see 1.2.g)

