The Accounting of

Public-Private Partnerships

in the context of ESA 95 Manual

The different types of long term contracts between government units and non-government partners in the national accounts (ESA 95)

- Purchase of services on regular basis
- Equity stakes
- Guarantees
- “Build and delivery” contracts
- Concessions
- Leases
- Services purchased by government on the basis of dedicated assets *(the case of “Public-Private Partnerships”)*

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.
- 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.
- These annual payments will generally have an economic impact on the government deficit and debt.

Equity stakes

- This 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.
- The new company is creating managing a given infrastructure.
- ESA95 rule give quite explicit provisions as regards the treatment of flows between government and the new unit.
- In the case the participation is a strict equality stakes (a pure *“joint-venture”*), this unit should be considered as a public corporation, if government is assumed to exercise a control over the general policy of the unit.

Guarantees

- In order to support a project, government may grant a guarantee to the debt of the private partner.
- This operations are fully covered by the SEC-95 rules and, except in some exceptional cases, such guarantees are considered as “contingent liabilities”, not recorded in the system.
- Therefore the existence of public guarantees does not mean that said guarantees have an impact on both government deficit and debt, except in the case where the guarantee is call. In this respect the payments from the administration affect the public accounts in national accounting.

“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 requirement.

- 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. Such services are strictly related to the assets.

Concessions

- This term is used in the context of the ESA 95 rules to designate the agreements where a government asks a corporation, generally after a competitive procedure, to manage the construction, as well as finance and operate an asset throughout the life of the contract.
- The private society will charge directly the final users (who are not governments units) for the use of services linked with the asset.
- In this type of agreement most of the private corporation income arises from direct sale of services.
- Under these conditions the assets will be posted in the balance of the private corporation, without effect on the government deficit.

Leases

- Government is the user of an asset that is legally owned by a non-government unit over a given period of time.

- Depending on who is assuming the majority of “risks and rewards” its coming from the economic property of the equipment, the lease is considered either as an “*operating lease*” or as a “*financial lease*”, which gives rise to different treatments in national accounts .

- In “*financial lease*” the government deficit and debt will be affected by the full value of the assets, which will be registered at the time government takes possession of the assets.

Factors influencing the distinction between operating and finance leases

1. Who is responsible for the maintenance and insurance of the asset?
2. Who repays finance on early termination of a contract?
3. Who determines the nature of the asset?
4. Who bears the demand risk?
5. Are there any third party revenues?
6. Does government pay less if the quality of service in not enough?
7. Does government pay more if the corporation’s costs increase?
8. Who bears the residual value risk?

"Public-Private Partnerships"

(reference in national accounts)

- The expression "Public-Private Partnerships" (PPP's), initially is not included either in SNA-93 or in ESA-95.
- The first instance of PPP's being mentioned in the context of the national accounts was with the Eurostat Decision 18/2004 dated 11th February 2004 regarding PPP's accounting treatment in the ESA-95 framework and to the effect of the Excessive Deficit Protocol. The Eurostat Decision refers explicitly and exclusively to the accounting of certain contracts which must fulfil specific characteristics.
- In August 2004 Eurostat added a new chapter to the "*ESA 95 Manual on government deficit and debt"* replacing a previous chapter, and published the new wording of Part IV.4.2 titled *"Long term contracts between government units and non-government partners"*, where different types of existing contractual agreements are included together with the notion of PPP's.
- The National Accounts Expert Consulting Group for the reform of the SNA considers as relevant the factors included in the "ESA 95 Manual" since these have been established consistently with the principles of the SNA; the Group understands, however, that such factors need to be supplemented with additional guidelines.

“Public-Private Partnerships”

(recommendations of the Canberra II group)

- Due to the increasing importance of PPP’s for the public economy and financial policies, it is considered essential for the SNA-93 to include a description and general principles for the accounting treatment of PPP’s.

- The economic property of assets linked to a PPP’s contract will be ascertained through evaluation of the participation of the units in the assumption of risks, compensations and control of assets. To this end, it is considered that the termination of the works of the International Committee for Accounting Standards may provide useful guidelines for said evaluation, provided that these guidelines are always consistent with the SNA principles.

- The text of the SNA must indicate that the complexity and variety of the PPP’s contracts impedes enumerating detailed rules concerning the operations that have be registered relative to the control and use of the assets. For accounting treatment it is desirable that the text shows the residual interest of the public units in the assets of private economic property, the purchase of operating assets used by the public units as economic proprietors and the measure of the production.

The main characteristics of PPPs

in the contex of Eurostat rules (1)

- It must be long term contracts that, by convention, have a duration of at least three fiscal years.

- The contract must cover both the creation (or renewal) of a specific asset and a significant supply of linked services.

- The assets involve an initial capital expenditure. In the case of renewal, improvement or modernisation the initial expenditure must be a predominant part in the new asset value after the reform.

- The contract will clearly mention the specific assets which will be used for supplying the agreed services, under the conditions stated in the same, according to specific quality and quantity standards.

The main characteristics of PPPs
in the contex of Eurostat rules (2)

- The partner or the group of partners must have sufficient experience in the area of activity to which the object of the contract refers.

- The key feature of these agreements (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.
- There can be direct payments from the users, but these should represent a minor part (almost insignificant) of the partners' income; if this is not so, however, the contract should be dealt with as another type of agreement (award or other).

- The areas of activity in the contracts cover those public services where government normally has a strong involvement, such as: health, education, transport and security.

Accountant treatment of PPP’s
in the framework of ESA 95 Manual

- The key issue is the classification of the assets involved in the partnership contract, either newly created or existing and reformed:
  - *In the balance sheet of the government*
  - *In the balance sheet of the private partnership*
- A PPP’s assets should be classified off-balance sheet for private partnership, if the two following conditions are met:
  - *The private partner bears the construction risk and, furthermore*
  - *The private partner bears at least one of the two other risks: availability risk of or demand risk.*
- A PPP’s assets should be classified off-balance sheet for government if:
  - *The government bears the construction risk, or*
  - *The private partner bears only the construction risk but none of the other two*

Risk types for classifying the assets of a PPP's within the ESA 95 Manual

- **Construction risk**
  - Delays in delivery, execution of the contract without meeting specified standards, significant additional cost, technical deficiency, external negative effects, mandatory payments the government without taking into account the real situation of the assets.
- **Availability risk**
  - Non-compliance with the contractual conditions with respect to quality, quantity, security standards or public certifications concerning rendering of the services to the final users. Dependence on the public payments in terms of effective availability level. Automatic application of penalties with important effect on the partners' income.
- **Demand risk**
  - Variability of the demand due to factors outside the partners' activity. Payments guaranteed from the government independently of effective demand level. These principles will be analysed bearing in mind the effects originated by the initiatives adopted by the private partner.

When in a PPP's contract the partner of the government is a public corporation

- Previous analysis to ascertain whether the already existing public corporation (or newly created with regard to the PPP's) must be reclassified (or classified from scratch) in the Public Administrations sector. To this end:
    - *Evaluate whether the public partner develops (or is going to develop) its activity as a market unit or a non market unit, in national accounting, by application of the 50% rule: sales/production costs.*
    - *Analysis of government payments to ascertain its economic nature: sales revenues (economically significant price) or transfers.*
- If the government payments to the public partner, as set out in the contract, are a significant part of the global income of the public corporation, this should be analysed in these terms:
    - *does it condition the dimension of the public company?*
    - *does it condition the nature of its activities?*
- Analysis of the economic nature of the guarantees and financing of the government to the public partner, both implicitly and explicitly.

Application of the Eurostat methodology to PPP’s contracts (1)

- In Spain, the major push for using systems of cooperation with the private sector for the execution of projects which have generally been carried out by the government has been put into practice by the autonomous communities (state government), and to a lesser degree by the local government.
- Normally, the main objective for making use of formulas permitting PPP’s-type contracts is that different administrations may supply quality public services without the high infrastructures cost falling on the government deficit and debt, by means of financing techniques and private management control.
- The restrictions in our country of the General Law for Budgetary Stability, as well as the compliance with the rules of the Excessive Deficit Protocol (EDP) in the EU, are putting pressure on the government to find alternate resources for the development of infrastructures for collective use.

Application of the Eurostat methodology to PPP’s contracts (2)

- The main issue is managing to design PPP’s contracts which allow the distribution of new asset costs across the time they are being used, avoiding, if possible, the imputation of the large initial capital cost to the government.
- Respecting the PPP’s contracts analysis within the application context of the methodology, the *“ESA 95 Manual”* indicates that the role of the statisticians is not to examine the motives, rationale and efficiency of these partnerships, or to voice an opinion about the economic viability of the underlying projects, but that their role is to provide an accurate guideline for a technically correct treatment in national accounts and, as regards the EDP, to ascertain the impact on the government deficit and debt. What is important with the accurate application of the rules is to ensure the homogeneity of public statistics in all the State members, so that the government deficit and debt figures are fully comparable.

Procedure for the application of the methodology for PPP’s contracts: (the case of Spain)

1. Individualised analysis of each contract prior to the start of the PPP’s activity to classify the asset object of the contract. A comprehensive examination of the “Articles of Private Administrative Clauses” (SPAC) and of the “Articles of Technical Specifications” (ATS) is required in order to define the application of the ESA-95 criteria and rules.
2. The study of every PPP’s contract is carried out by the expert accountants belonging to the National Accounting Inter-institutional Work Group of our country, composed of representatives of the National Institute of Statistics (INE), Bank of Spain (BE) and the General Audit of the State Administration (IGAE).
3. After the analysis of the Work Group, Eurostat will be formally consulted in those cases where justified doubts are found making it difficult to apply the methodology in an accurate way in order to ascertain the economic nature of the contracts and the classification of the assets.

The Public-Private Partnerships contracts in the Spanish legal framework

- The concept of PPP does not exist in Spanish legislation and the same is true in the majority of the EU States, although the different legal regulations do not exclude its possibility. Concerning this, Eurostat considers that most countries are expecting to adapt their legal systems in accordance with the requirements of these new systems of cooperation.
- The common Spanish legal framework which regulates all contractual relations between public units and private units is further developed in the Revised Text of the Law of Contracts of the Public Administrations which includes the Law 13/2003 regulating the contracts awarding public works.
- Therefore, the analysis of contracts (PCAP and PPTE contracts) by the Work Group (INE, BE and IGAE) is carried out taking into account the legal scope of said legal framework and the underlying economic reality which imposes the application of national accounting criteria.

Construction risk evaluation

- The Spanish legislation does not prevent the transfer of construction risk to the private partner: “*the construction will be carried out at the grantee’s risk”.*
- Confirm that the contract does not provide for payments from the government to the private partner until the construction is ended and the rendering of services linked to the asset has begun.
- Check the existence of penalties due to non-compliance with the contractual conditions relative to the construction: delivery times, technical standards, etc.
- Verify that possible increase of construction costs, as compared with the initial costs forecast, does not translate into higher costs than the services supplied by the private partner, except cases of *force majeure* or by actions directly imputable to the administration.

Demand risk evaluation

- Verify that the payments from the public administration to the private partner are specified in the contract in terms of effective demand level.
- Confirm that no minimum payments are guaranteed to the private partner, and that there are no contractual limitations to the possibility that the private partner carries out additional benefits.
- Check that the fees by service use sections are calculated on the basis of quality studies of demand variability.

Availability risk evaluation

- Verify that the contract specifies parameters allowing the evaluation of the quality of each service supplied (individually checked) by the private partner and the availability level of the service.
- Confirm that the contract provides for the application of reductions, clearly and precisely determined, for each parameter used to measure the quality and availability of the services.
- Check that the contract specifies the periodicity (monthly, quarterly, …) of effecting measurements on possible quality failures or on the availability level.
- Verify that the contract clearly states that the amount of the resulting reductions is automatically applied to the payments which the administration has to effect to the private partner.
- Confirm that the amount of reductions represents a genuinely significant part of the partner’s income.

Maintenance of the economic balance of the contract

- The legal framework states as a basic principle that any contract relative to a PPP's must keep its economic balance on the terms under which it was awarded, taking into account the general interest and the grantee's interest.
- The transfer of risks to the private partner, as regards the Eurostat Decision, requires that the contract includes the clause relative to maintaining the economic balance only in the following two cases:
  - When cause of *force majeure* appears, or
  - When the public administration carries out any action directly effecting demand level or having repercussions on the quality of the services supplied by the private partner.