3. Working Group Meeting

Item 5b

The role of On-budget and Off-budget finance structures in PPP projects

Vienna - April 24th, 2006
Introduction
Structure of Activities

Chair of Construction Economics
&
Knowledge Center @ Weimar

Alfen Consult GmbH
Introduction

National Clients / Projects

• Federal Government
  • Development of Guidelines for PPP in Public Real Estate (2003)
  • Development of Standard Documents for Tendering and Award of the F- and A- Models in Roads&Highways (2000-02)
  • Consulting for Tender&Award of 6 F- and A-Models in Roads&Highways (2004-06)
  • Scientific Support to the determination of the first Toll Ordinances in Germany

• State Ministries
  • Development of Guidelines for the application of the PSC in NRW (2003)
  • Evaluation mission on the first PPP schools in NRW (2004)
  • Support of Thuringian Finance Ministry in developing a PPP Task Force (2005)

• Municipalities
  • Consulting on PSC for a PPP schools project in Meschede (2003/04)
  • Consulting on PSC for a PPP school centre in Frankfurt (2006)
  • Consulting on Tender & Award of a PPP Sports Facility in Bestensee (2006)

• Public Real Estate Manager
  • Study on PREM of the federal government
  • Study on international best practice in the defence sector, g.e.b.b. (2005)
  • Consulting on Risk Management for the first federal PPP Pilot Project in defence, g.e.b.b. (2006)

• Private Real Estate Developer
  • market analysis on privately financed Education Buildings in Germany (2003)
  • Market analysis on PPP schools in Germany (2003)

• Facility Manager
  • Market analysis on FM for hospitals (2003)

• Federation of Contractors
  • Study on PPP and SMEs (2004-2006)
  • Study on the Privatisation of the German Autobahn, Highways (2004-2005)

• Construction Companies
  • Study on PPP Models for the German Autobahn, Highways (2003/04)
Introduction

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The political Point of View

Why to adjust the public Budget

• Public spending is growing over time
  • Disequilibrium of Budget growth and Economic growth

• Conflicts in public spending behaviour
  • Maximising political income vs. Equilibrium in balance of Payments
  • Short election Period vs. A Voter’s life
  • Wider Budget spending vs. Increase future Budgets
The political Point of View

Fiscal instruments

- **Budget restrictions and rules in fiscal procedures:**
  - Linking of decisions for budget spending and income
  - Linking income to specific sectors
  - Qualified majorities
  - Sunset legislation
  - Sequestration

- **Results of strong Budget rules:**
  - Lower interest margins on state debt
  - Price Level Stability
  - Prevention of „Crowding out effects“
The political Point of View

Strength Measurement of Budget rules

• Questions to consider:
  • Is there a consequent review of the strategic budget planning?
  • Are there sanctions introduced?
  • Are there special assets considered beside the usual budget?
  • What is the clear understanding of investment and does the investment increase the assets of the state?
  • Are there depreciations and capital gains to consider?
  • Are there kept in mind the wear and tear of public assets?

„The efficiency of budget rules is questionable if there are a number of specific exceptions existing.“
The Statistical Office of the European Community (Eurostat) sets:
  • Regulations, definitions, classifications
  • Accounting standards

based on the European System of Integrated Economic Accounts (ESA 95)

ESA 95 is consistent with the world-wide guidelines:
  • System of National Accounts (SNA, 1993)
  • The United Nations
  • The World Bank
  • The International Monetary Fund (IMF)
  • The OECD
The political Point of View

The criteria of convergence

• The member states stipulate the following rules for public budget:
  • The state debt has to remain under 60% of GDP
  • Annual new deficit has to remain under 3% of GDP
  • Member states have to achieve a mid-term balanced budget
  • EU will refer to the commitment, if a state is likely to fail the targets („Blauer Brief“)
  • EU has the right to claim penalties
  • There is a „no bail out clause“ in the contract
The political Point of View

Definition of On- and Off-Budget

• On-Budget:
  • Every direct public investment
  • Accounted in the sector of „General Government“
  • Increase in government deficit and debt

• Off-Budget:
  • Every investment without public support (subsidies)
  • Accounted in the sector „Non-Financial Corporations“ or „Financial Corporations“

„The definition of accounting for PPP´s was unclear. Therefore Eurostat defined in February 2004 how PPP projects should be treated in national accounts.“
The political Point of View

Eurostat criteria for classification of PPP projects

- Advance classification of the Assets as Off-Budget, if:
  - The private partner bears the construction risk
  - The private partner bears at least one of either availability or demand risk

- Risk analysis is the core element in the classification of Assets

- Main categories of risk were set:
  - Construction risk
  - Availability risk
  - Demand risk

- Each main category contains specific risks and agreements (e.g. warranties or subsidies)
The political Point of View

CBO* criteria for classification of U.S. PPP projects

• Advance classification of the Assets as Off-Budget, if:
  • The fixed Asset serves a general purpose
  • The fixed Asset has a market also in the private sector
  • During the term of the contract, the private partner has ownership title to the Asset, which is not transferred to the government subsequently either
  • The contract does not stipulate a bargain-price purchase option
  • The contractual term does not exceed 75% of the estimated economic life of the Asset
  • The present value of the minimum rent payable during the contractual term may not exceed 90% of the fair market value at the beginning of the contractual term

*CBO – Congressional Budget Office
Agenda

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The project is recorded as On-Budget:

- Degradation of net borrowing account and debt increase amounting to gross investment
- Pre-financing by the private partner and the time shift of public expenditures does not change these consequences

The project is recorded as Off-Budget:

- Only the periodical public expenditures are meant to be considered in the public deficit
- The gross investment is not accounted in the public debt
The economic Context

Accounting PPP projects – Public Sector Comparator (Traditional Project approach)

Investment

Payment

Depreciation

Impact on Public Deficit/Surplus

1st period 2nd period 3rd period 4th period 5th period

150 90 30

150 90 30

55 30 5

60 90 30 90 90

60 90 30 90 90

150 60 60 60 60

April 24th, 2006
The economic Context
Accounting PPP projects – On-Budget

Impact on Public Deficit/Surplus

April 24th, 2006
The economic Context

Accounting PPP projects – Off-Budget

Investment

Operation

Payment

Depreciation

Impact on Public Deficit/Surplus
The Maastricht criteria just consider public monetary accounts:
- The interexchange of monetary Assets (Money) and non-financial Assets (Property) decline the public debt account
- The actual value of the property will not be deducted in the gross national debt

The public expenditure commitment in PPP projects is not treated as debt in the sense of public budget rules:
- Differentiation in debt liabilities and administration liabilities
Agenda

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The microeconomic Implementation

Risk allocation

Motivation of decision makers

Conflict of interest

Main principle of risk allocation

Project specific risk evaluation and allocation!

Classification by Eurostat criteria

ex ante

ex post
The microeconomic Implementation

Risk allocation

1. Low risk transfer:
   No interest of the partners to realise efficiency gains.

2. Optimised risk transfer:
   Each partner is risk carrier in its profession.

3. High risk transfer:
   Raise of the total project risk price.

Efficiency

common public realisation
project with optimised risk allocation
high risk transfer to the private sector

Risk transfer
The microeconomic Implementation
Risk & Resource allocation

• Goal: To increase the economic power within a community
  • Economical perspective:

  National economy
  private sector
  public sector

  On-Budget

  National economy
  private sector
  public sector

  Off-Budget

• Microeconomic efficient project:

  National economy
  private sector
  public sector

  Off-Budget

  Space for additional investments
Agenda

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**Conclusion & Example**

**Example – ESA 95**

Realisation of an additional project: Yes

Project is within EUROSTAT Off-Budget: Yes

Investment expenditure: 10

Public subsidies: 1

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<th>Total</th>
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<td>B.9 Net lending (+) / Net borrowing (-)</td>
<td>- 36</td>
<td>2,6%</td>
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<tr>
<td>AF Financial assets / liabilities</td>
<td>- 736</td>
<td>53,5%</td>
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\[ \text{Gross domestic product} = 1.376 \]

<table>
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<th>No project</th>
<th>On-Budget</th>
<th>Off-Budget</th>
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<tr>
<td>Net lending (+) / Net borrowing (-)</td>
<td>2,6 %</td>
<td>3,3 %</td>
<td>2,6 %</td>
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<tr>
<td>Financial assets / liabilities</td>
<td>53,8 %</td>
<td>54,2 %</td>
<td>53,5 %</td>
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<tr>
<td>Gross domestic product</td>
<td>1.365</td>
<td>1.376</td>
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Conclusion & Example

Results

• The classification of projects is linked to several criteria

• The nature of PPP is set in the economic mixture of private and public business

• If a statement could be made that a project belongs to the private or the public sector, then it should be treated as a private or public asset in the accounts
Conclusion & Example

Next steps proposed

- Risk analysis of typical risk allocation in the different funding models
- Proposal if the funding model would be in general accounted as On- or Off-Budget
- Provide case studies of the different funding models within several infrastructure sectors (roads, railways, energy, waste etc.)
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3. Working Group Meeting

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