Public Accounting

Fiscal policy is a key tool at the hands of governments which can directly and significantly affect the viability of PPP projects.

Fiscal policy provides for fiscal guarantees and incentives as a way for government to support PPP project development: either through guarantees by providing future funds if traffic is lower than forecast and/or through incentives by offering tax reductions.

However, traditional public budgeting, based upon cash flows, does not account for the future outlays that can result from contingent liabilities. The true costs for the government resulting from contingent liabilities employed in infrastructure projects might be masked, thus distorting the true fiscal situation a country will be eventually facing.

The sudden activation of contingent liabilities due to an unexpected event may put government finances under severe strain, hindering development and even reversing economic gains from investment previously attracted to the country by means of contingent forms of support. If impending liabilities are neither known nor recorded, they cannot be effectively controlled.

Most countries are now setting up Risk Management Units (RMU) within their Ministries of Finance (MOF) to determine and manage the fiscal space available for future liabilities and to assess each PPP project that requires support to ensure the project conforms to both national PPP policy and guidelines for the provision of government support as well as their own internal guidelines. The RMUs should work closely with the PPP planning organizations/units and contracting agencies.

Lewis and Mody (1997) advocate an integrated risk management approach to be implemented by governments, comprising:

- compilation, identification and classification of risks confronted;
- measurement of risk exposure;
- incorporation of risk exposure figures in national accounts and budget;
- determination of the government's tolerance to risk and definition of criteria for the establishment of sufficient unexpected loss
- reserves;
- implementation of risk exposure supervisory and controlling systems.

Revision Of State Of The Art Contingent Liability Management,
Miguel Almeyda and Sergio Hinojosa. Washington DC, May 2001.

The Management of Contingent Liabilities: A Risk Management Framework for National Governments
Lewis, Christopher and Ashoka Mody. In Dealing with Public Risk in Private Infrastructure.
Eds. Irwin, Timothy et al. The World Bank. 1997.

Should PPP costs be accounted off budget?

In the case of public loans or bonds, governments pay back the loans over the life span of the project or some other period of time and therefore borrowing can be considered on budget since the state debt increases.

A PPP arrangement may be established, whereby a private partner or special purpose vehicle assumes debt related to the project, and is compensated by the government and/or directly by users over the project's life cycle, thereby allowing it to amortize this debt. In this case, the government makes payments not directly to the original lender, but rather to an intermediary company i.e. the project sponsor or concessionaire that assumes the debt. Many decision-makers in government see in PPP an opportunity to spend infrastructure costs off budget.

However, even if off-budget loans are not registered in any public sector accounting, in reality, they can and might represent in the future the same liability as if the government had taken up the loans itself. This is related to contingent liabilities in Module 3. If the project completely fails, whilst all the debt could come back to government, a more likely possibility is that there will be limited contingent liabilities that will pass back to government. The accounting rules in the USA as well as in the European Union are very restrictive in regard with the possibilities to consider PPP loans as off-budget.

In the US for instance, the Congressional Budget Office has established six points as criteria for recognizing PPP projects as not part of the public sector, as follows:

- The fixed asset serves a general purpose;
- The fixed asset also has a market in the private sector;
- During the term of the contract, the private partner has ownership title to the asset, which is not subsequently transferred to the government;
- 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.

In Europe, there is a set of common regulations and accounting standards that detail the way in which spending and tax collection should be accounted for. The main reason for theses rules is to be sure that the member States are respecting the Maastricht Criteria.

The Maastricht Criteria are defined in terms of national account data and impose that the European member states must respect the following rules for public budgets:

- The overall public debt shall remain under 60% of GDP.
- The annual new deficit shall remain under 3% of GDP.
- Member states shall achieve a mid-term balanced budget.

Usually, public investment in infrastructure projects, as on-budget project, is accounted for in the public accounts, and, where borrowing is involved, results in increased government deficit and debt. However, investment made by a publicly owned corporation can be considered off-budget as long as at least 50% of costs are covered by revenues.

In 2004, Eurostat (the statistical Office for the European Community) defined how PPPs should be treated in national accounting. Eurostat establishes that assets controlled by a PPP body can be considered to be off the public budget only if there is strong evidence that the partner is bearing most of the risk attached to the specific partnership. In particular, Eurostat recommends that the assets involved in a PPP should be classified as non-government assets if both of the following conditions are met:

- The private partner bears the construction risk, and
- The private partner bears at least one of either availability or demand/traffic risk

Therefore a deep analysis of the construction and traffic risk allocation needs to be conducted in order to prove that a PPP involving loans can be considered off-budget.

The point is to demonstrate that construction risk as well as traffic risk are borne 100% by the private partner and not partially. This is particularly difficult to estimate in regard with the traffic risk when some income guarantee or subsidies are given by the public sector when the traffic is less than expected.

This means that the extent to which demand risk is borne by the public or private partner depends on the threshold of the subsidy. If the threshold is very low – meaning that traffic volume must be relatively much lower (e.g. 50%) than expected in order to qualify for a subsidy – most demand risk is transferred to the private partner. But, if the threshold is high (e.g. 80% of the traffic volume), the demand risk is basically borne by the public entity.

Within a shadow toll model, the classification of on or off-budget depends on the applied banding structure, whereby traffic levels dictate the shadow tolls paid, and, in any event, the transfer of the demand risk may only be limited.

The confusion linked to on or off budget classification of PPP project has been particularly deep in the case of the Hungarian motorways (Module 6 -> Case Studies -> Hungary). In September 2005 Eurostat considered that the transfer of the exiting motorway as well as the construction contracts shall be considered as on-budget, when the government was considering removing it from the State budget. As a result of Eurostat's decision, the 2005 country's deficit increased by 1.5% of GDP.

The International Monetary Fund (IMF) has developed a different approach to PPP accounting rules. Considering that most PPPs involve transferring availability and construction risk to the private partner, IMF classifies these loans as off-budget.

PPPs are chosen to move public investment off budget and debt off balance sheet but the government still bears considerable risk, and faces potentially large fiscal costs. Proper accounting, monitoring and reporting is essential to prevent the misuse of PPPs in this way.

The ability to account those expenditures off budget should not influence the decision to tender a project under a PPP scheme.

Current Approaches to Accounting and Reporting

There is no general accounting and reporting standard for PPPs.

- Existing standards (ESA 95, GFSM 2001) cover some PPP transactions.
- In Australia and the United Kingdom, PPPs may be treated as a financial lease.

The Eurostat Decision mentioned above could result in PPPs being tailored to off-budget treatment but an alternative suggested approach notes that;

- The current approach does not do justice to the fact that PPPs are designed to share risks
- It would better to record PPP assets on private sector balance sheets, consistent with legal ownership

The fiscal costs and risks associated with PPPs should then be assessed, quantified, and disclosed.

Recently, it has been noted that the implementation of IFRS standards for accountability has consequences and could change the determination of whether PPP investments are on or off/balance.

This may result, at least in the UK, in most PPPs for road infrastructure soon going on-balance sheet. It is noted that this change devolves from changing the criteria for on or off balance sheet from which party bore the risk (currently) to which party controlled the asset (proposed).

This change may affect the attractiveness of PPPs because central and local government would have to provide budget cover for the full cost of each PPP asset at the point of bringing into use. The reason for so doing would be that control of the government budgets would be enhanced. This is being done to bring the Public Sector Borrowing Requirement under tighter control as this was a particular UK Treasury (MOF) concern (which is a universal concern but to a different extent depending on the country).