THE ACCOUNTING TREATMENT OF PUBLIC-PRIVATE PARTNERSHIPS IN THE EUROPEAN UNION – CRITICAL ANALYSIS

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Abstract

Throughout recent years Public-Private Partnerships (PPPs) have increasingly gained popularity as an alternative mode of public infrastructure provision within and beyond the European Union. In general, governments promote the initiation of PPP-type arrangements for two main reasons: Their potential to increase economic efficiency (Value for Money) compared to traditional public procurement, and their off-balance sheet nature. While Value for Money would constitute a valid argument in favor of PPPs, they are predominantly used for their fiscal and budgetary implications. This essay investigates the questions, whether and under what circumstances PPPs can result in improved efficiency, and whether the accounting treatment of PPPs issued by Eurostat (2004) provides an appropriate framework within the context of the European Union to ensure that PPPs are used for the right reasons. As the analysis will point out, there are several critical issues which are not appropriately accounted for by the Eurostat decision. Therefore, the main challenge of policy makers and accounting professionals is to find an adequate way to overcome the existing problems. In this regard, the essay also offers some recommendations for future policy making.

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Table of Contents

List of Tables

List of Figures

List of Abbreviations

EBRD	European Bank of Reconstruction and Development
EC	European Commission
EIB	European Investment Bank
EPEC	European PPP Expertise Centre
ESA 95 Manual	1995 European System of Accounts Manual
EC	European Commission
EMU	European Monetary Union
Eurostat	Statistical Office of the European Communities
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
JASPERS	Joint Assistance to Support Projects in the European Regions
OECD	Organization for Economic Cooperation and Development
PFI	Private Finance Initiative
PPP	Public-Private Partnership
PSC	Public Sector Comparator
SPV	Special Purpose Vehicle
VfM	Value for Money

Introduction

During the last two decades, governments have been increasingly looking for new ways to provide public infrastructure and services. One of the most frequently used alternatives at present is Public-Private Partnerships (henceforth PPPs), for which the theoretical and political basis has been provided by the public sector reform movement also known as "New Public Management" (NPM) that started in the 1980's (Yescombe, 2007:16).

PPPs in general refer to long-term arrangements between a public and a private sector partner, where the private partner delivers infrastructure assets and services that have been usually provided by the public sector (IMF, 2004:3). PPPs became very popular, for two main reasons, one of them being increased efficiency (Value for Money), the other one the involvement of private finance. While economic theory stresses the efficiency argument, experts of the practical field, claim differently. Their reasoning is closely linked to the aspect of private finance in PPP-type projects. According to their view, PPPs are often preferred by states, as they allow them to present public investments off the government's books. The off-balance sheet nature of PPPs results from the fact that these types of projects are treated as private sector investments, and their costs are treated as recurring annual operating expenses, instead of debt service (See Välila, 2005; Hall, 2008 and 2010; OECD, 2008).

Since the current accounting methods can be used in a way that PPP-type investments do not have to become visible on the governments' balance sheet, it is very likely that the budgetary restrictions imposed by the EU on the member states have a crucial impact on governments' decisions regarding the initiation of PPPs. This is all the more true in the current situation, where due to the financial crisis even the richest member states of the EU are struggling to fulfill the requirements regarding the acceptable level of public debt and

deficit. Notwithstanding the challenges of the financial market in 2009, an important impact of the crisis in much of Europe has been the renewed interest in PPP models due to their potential positive impact on the creation of renewed economic growth (EPEC, 2009:10). The main puzzle is therefore, how it may be effectively ensured in the present situation that PPPs are being further encouraged, yet in a way that their implementation will be based truly on efficiency arguments, instead of their fiscal and budgetary implications, i.e. their off-balance sheet nature.

The questions that this thesis aims to provide answers for is closely linked to the issue presented above. In this regard, two major issues are going to be analyzed. The first one is whether and under what circumstances PPPs may indeed result in increased efficiency (VfM) compared traditional procurement. Second, the essay will investigate whether the Eurostat decision provides an adequate framework to prevent EU member states from engaging in PPPs only due to their non-debt nature. Finally, based on the results of the analysis, the implications for future policy making are going to be discussed in detail.

To this end the thesis is structured as follows: Chapter 1 gives an insight into the recent developments of the European PPP-market, the existing EU rules, laws and policies encouraging PPPs, and the driving motives behind their use. The purpose of Chapter 2 is to provide some definitional clarity regarding the specific types of PPPs that this essay seeks to deal with given the EU context. Subsequently, Chapter 3 investigates the microeconomic aspects of PPPs. In Chapter 4 the analysis then turns to the macroeconomic side of PPPs, starting with the presentation of EU fiscal rules, which is followed by a detailed discussion of the Eurostat decision from February 2004 and the new chapter on PPPs in the ESA 95 Manual. Afterwards, Chapter 5 aims at investigating the major critiques related to the

Eurostat ruling, and provides some recommendations for future policy making. Finally, the last chapter concludes.

Chapter 1 – Public-Private Partnerships in the European Union

Within the European Union (EU), the PPP market has been steadily developed and several regulations, laws and policies have been passed in order to encourage their use (Hall, 2008). The aim of this chapter is to provide some insights into the recent developments of the European PPP-market, the existing laws, rules and policies, and the rationales behind the encouragement of PPP-type arrangements.

1.1 The European PPP-Market

The probably best developed PPP-program within the EU is the Private Finance Initiative used in the United Kingdom (UK). The PFI was announced in 1992 with the aim to bring private finance into the provision of public infrastructure (IMF, 2004:5). In 2008, 34 PFI or PPP-type projects have been signed in the UK, amounting to a total project value of £6,5 billion (IFSL, 2009). While compared to previous years this value is rather low, though it certainly does not mean that PFI projects have become less relevant, rather it may be written on the account of the current financial situation.

Outside of the UK, the PPP market has been steadily expanding in other EU member states as well. According to the cumulative value of PPP deals signed by the end of 2008, Spain, France, Italy and Ireland are among the leading countries following the United Kingdom. Yet, several PPP contracts have been concluded in the new Central and Eastern European member states as well, Poland and Hungary having the strongest PPP market within the region at present. In the EU context the main sector of application is transportation, however a growing number of projects can be observed in other areas of public infrastructure provision as well, most importantly in health, education and public housing (Blanc-Brude et

al., 2007:15). The following table intends to provide some insight into the developments of the European PPP market during the period of 2001 to 2008:[1]

Table 1.1 Value for signed PPP contracts within the EU

Value of signed contracts, € million

Country	2001-2004	2005	2006	2007	2008	Total	Number of signed deals between 2001-2008
Austria	49	…	850	…	…	899	6
Belgium	1300	480	…	300	680	1780	6
Bulgaria	…	366	288	366	…	654	6
Cyprus	…	500	…	…	…	500	1
Finland	…	700	…	…	…	700	1
France	…	1788	735	329	1241	4093	34
Germany	440	830	177	465	117	2029	40
Greece	…	798	1600	3885	1000	2398	8
Hungary	…	…	38	15	500	556	11
Ireland	720	121	623	1489	300	3253	19
Italy	890	2179	439	55	…	3563	20
Netherlands	1302	…	431	…	1020	1733	9
Portugal	278	…	32	140	…	450	7
Spain	1000	1154	1664	309	…	4127	38
Other countries	485	2	490	…	…	977	7
United Kingdom	21849	6237	14111	10698	8236	61131	536
Total (UK excluded)	7987	8918	7367	7353	4958	36583	215

Source: IFSL Research, 2009: 3

Having demonstrated the current developments in the European PPP-market, the next section aims at describing the rules, laws and policies that had a great influence on the increased use of PPPs within the region.

[1] In the case of this general description of the European PPP-market no distinction has been made between the different forms PPPs can take.

1.2 Promotion of PPPs within the European Union

The European Commission (EC) has for many years pursued a policy of encouraging PPPs. Support by the EC has been shown in several instances, such as the promotion of the idea to use a PPP-type agreement in creating the Trans-European Networks (TEN) within the framework of the European Growth Initiative in 2003 (Eurostat, 2004b:3), or the Green Paper on PPPs that has been issued in 2004 with the aim "to facilitate the development of PPPs under conditions of effective competition and legal clarity" (Commission of the European Communities, 2004:5). Moreover, as public banks are guaranteed by the EU and its member states, the European Investment Bank (EIB) and the European Bank of Reconstruction and Development (EBRD) can obtain the best interest rates available which constitutes a significant advantage to the private sector companies who engage in financing PPPs (Hall, 2008:7). While these public banks are arguably major funders of PPPs throughout Europe, some problems still exist due to the incompatibility of EU funds with PPPs. In this regard, the EU has made several efforts to reconsider existing EU rules that have so far made it difficult for private companies to obtain funds (Hall, 2008:9). To this end, in 2003 and 2004 two guides have been published, yet a more important step has only been taken in 2006, where the EC, the EIB and the EBRD created a new institution to effectively deal with this problem. The Joint Assistance to Support Projects in the European Regions (JASPERS) is a publicly financed institution that offers free advice on constructing PPP projects, while also ensuring that these undertakings receive the highest support from public finance in the form of EU cohesion and structural funds (Hall, 2008:9). A further recent significant development in the PPP field is the launch of the European PPP Expertise Center (EPEC) by the European Commission and the European Investment Bank in September 2008. The objective of this collaboration is to strengthen the organizational capacity of the public sector to engage in PPP

transactions.[2] Certainly, the EU procurement laws have a significant influence on PPPs, especially with respect to the requirements of competitive tendering. Yet, these laws do not simply fit with PPP transactions, hence further harmonization is required (Hall, 2008:11). Finally, but with respect to the purpose of this essay most importantly, the ruling on the treatment of PPPs in national accounts issued by Eurostat and as its follower, the new chapter on PPPs introduced into the ESA 95 Manual are of considerable relevance, and are going to be discussed in detail in Chapter 4. Besides the several guides, laws, rules and policies the EU attaches great important to the introduction of national laws that are more favorable to PPPs. While progress is visible in this area as well, there are still some countries lacking a national legislation for PPPs (Hall, 2008:9).

The above described list of EU rules, laws and policies influencing PPPs is certainly not complete. Yet, it demonstrates the permanent efforts made by the EU to promote and facilitate PPP transactions. At this point it also has to be noted that the existing regulations and guidelines are in many aspects imperfect, and critiques have been raised in many instances (Hall, 2008). Therefore, the need for further actions is not negligible. However, as presented above, the EU is making considerable efforts to move into the right direction.

1.3 The Rationale Behind PPPs

The previous sections provided an insight into the developments of the European PPP-market and the EU rules, laws and policies aiming at the promotion and facilitation of PPPs. Yet, the most fundamental question is still unanswered: What are the main drivers behind the increased popularity and encouragement of PPPs?

[2] EPEC website: http://www.eib.org/epec/about/index.htm

It is a well-known fact that public infrastructure and service provision is prone to market failures. Accordingly, public intervention in these areas has been regarded as justified and even recommended (Välila, 2005:97 and Yescombe, 2007:1-2). Government involvement in this field can take several different forms, such as price and emission regulations, introduction of quality standards, taxation and subsidies. Yet, public production and ownership is probably the most widely applied form of state intervention (Välila, 2005:97). PPPs are in general viewed to be an alternative to this traditional way of public sector intervention, where both the public and the private sector partner is actively involved in the provision of a specific asset and the resulting services. Correction for market failures in this situation results from the alignment of both sectors' objectives (Välila, 2005:97).

Regarding the driving incentives of the public sector to initiate PPPs, there are two commonly cited views. According to the more positive view, PPPs offer real benefits in terms of increased Value for Money (henceforth VfM), i.e. a superior combination of productive and allocative efficiency at the project level, compared to traditional public procurement. Put differently, such partnerships combine the strengths of the public and private sector partners.. While the private sector produces at lower costs than the public sector does, the public sector safeguards that lower production costs do not compromise service quality (OECD, 2008 and Välila, 2005). This argument is also reflected in several EU guidelines, such as the Green Paper on PPPs (2004) or the European PPP Report 2009. In all these instances Commission emphasizes the VfM benefits PPPs can offer, yet none of the publications provides any justification for this assumption (Hall, 2010:10). Additionally, the existing empirical evidence on the benefits of PPPs in terms of increased efficiency is very mixed. To conclude, whether and under what circumstances PPPs can be more beneficial compared to traditional public procurement or other existing alternatives is unclear. Consequently, it is also highly

questionable if VfM is a is the real motive to initiate PPPs, or perhaps the answer is to be looked for elsewhere.

This leads to the examination of the other side of the coin. Namely, critics argue that PPPs are nothing else than a tool for governments to shift investment spending off their own books, creating the impression of lower debt and deficit to the public, and enabling themselves to spend more on other, politically more beneficial actions (Välila, 2005:95). According to a slightly less suspicious version of this argument, PPPs do not constitute an alternative, but rather a substitute for traditional public procurement allowing fiscally constrained governments to carry out large-scale public infrastructure projects that otherwise could not have been realized, or only with considerable delays (Välila, 2005:95). This also popular, but rather negative view of PPPs gained strong support by skeptics within the EU context. The explanation is that budgetary constraints imposed by the Maastricht Treaty limiting the acceptable level of debt and deficit may most likely create incentives for EU member states to use PPPs as a tool to refurbish national accounts (Hall, 2008:6-7). This argument can be further strengthened by the fact that the accounting treatment of PPPs is not at all clear, giving room for governments to abuse PPPs in order to mask the real level of deficit and debt. While the Eurostat's attempt to solve this issue was certainly an important first step, as this essay will show, the decision did not have the effects policy makers were hoping for. Finally, the current economic and financial circumstances do not act in favor of reducing the member states' incentives to (mis)use PPPs based on accounting considerations rather than to enhance efficiency in public infrastructure and service provision.

To conclude, while existing EU policies strongly emphasize the benefits of PPPs in terms of added VfM, there are good reasons to believe that the aim to increase efficiency is not the real motive behind the popularity of such partnerships.

Chapter 2 – Definition and Characterization of Public-Private Partnerships

The term "PPP" currently lacks a precise definition and is used to cover a wide variety of arrangements. In order to provide a clear framework for the analytical purposes of the underlying essay PPPs are going to be defined and characterized in a specific way, based on the decision on the treatment of PPPs in national accounts issued by Eurostat in February 2004. Henceforth, a PPP refers to "services purchased by the government on the basis of dedicated assets" [3], where the government signs a long-term[4] contract for the delivery of services derived from a specific asset with one or several non-governmental partners, directly or through a special legal entity[5] that has been set up specifically for the purpose of the PPP (Eurostat, 2004a:1 and 2004b:6). Furthermore, such PPPs involve a significant initial capital expenditure in order to provide a specifically designed asset and deliver the associated services according to the previously agreed upon quality and volume standards. The asset can be either completely new or an existing one previously owned by the government that needs significant modernization and upgrading (Eurostat, 2004b:6). Another key feature of these arrangements is that the government is the main purchaser of the services through regular payments to the partner once supply takes place irrespective from whether demand directly originates from the government or from other final users. It is also important to mention that in this case the term " general government" refers to the whole government sector. Public enterprises operating commercially through charging for services are considered to be outside

[3] Such arrangements are viewed as new forms of partnerships (designed as PPPs) which have particularly interesting implication both with respect to Excessive Deficit Procedure (EDP) and National Accounts (Eurostat, 2004b).

[4] At least three years by convention (Eurostat, 2004b:3)

[5] Special legal entity refers to a Special Purpose Vehicle (SPV), discussed in Chapter 3, Section 3.3.

of the government. Therefore, the non-governmental partner can be both a private or public enterprise (Eurostat, 2004b:6). Finally, this specific type of PPP usually corresponds to what is referred to as Build-Own-Operate-Transfer contract. Current examples of such contracts cover building and operation of roads, tunnels, bridges, schools, universities, networks, hospitals, health centers, cultural buildings and prisons (Eurostat, 2004b:5).

While the above characterization of a PPP-type arrangement is very precise and detailed, it has to be emphasized that it covers solely one among the several types of PPPs that are observable in practice. Hence, the following two tables intend to give a more comprehensive picture on the rich variety of existing definitions and types of PPPs:

Table 2.1 Characteristics of PPPs included in the definitions provided by various institutions

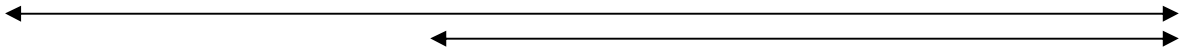
Institution / Aspects	EMU (2003)	Green Paper (EC, 2004)	IMF (2004)	OECD (2008)	Eurostat Decision (2004)
Risk Sharing	X	X	X	X	X
Bundling of Tasks	X	X (But: Not required, can be service provision only)	X	X (But: Service provision alone enough)	X
Private Financing	Not included	X (Public funds may be added)	X	Not explicitly stated	X (Only partial private finance required)
Long-Term perspective	Not included	X (But: No precise period defined)	Not included	Not included	X (at least three years)
Partner	Non-governmental*	Private	Private	Private	Non-governmental*
Public sector sets the quality standards	Not explicitly included	X	X	X	X
Public sector as main purchaser	X	Not included	X	Not included	X
Critiques	More precise definition, yet some elements still lacking	Very vague & imprecise def., PPPs could be anything	More precise, yet some elements still lacking	Rather vague definition	Precise definition, yet only applies to one certain category of PPPs**

* The term non-governmental refers to private entities and public entities involved in market operations only.

Source: Created by the author on the basis of OECD, 2008:12; Hall, 2010:17-18; Eurostat, 2004b:5-6.

Table 2.2 Different forms of PPP-type arrangements and their allocation between the extremes of pure / traditional public procurement and full privatization

Public **Private**



Public-Private Partnerships

Contract type	Public sector procurement	Franchise	Design-Build-Operate-Transfer (DBFO)	Build-Transfer-Operate (BTO)	Build-Operate-Transfer (BOT)*	Build-Own-Operate (BOO)
Construction	Public	Public	Private	Private	Private	Private
Operation	Public	Private	Private	Private	Private	Private
Ownership	Public	Public	Public	Private during construction, then public	Private during construction, then public	Private
Who pays?	Public sector	Users	Public sector or users	Public sector or users	Public sector or users	Private sector, offtaker public sector, or users
Who is paid?	N/A	Private sector	Private sector	Private sector	Private sector	Private sector

*BOT is also known as Build-Own-Operate-Transfer (BOOT).

Source: Yescombe, 2007: 12

Having provided a general insight into the variety of PPP-type arrangements and a precise definition and characterization of those transaction that are going to be referred to as PPPs in this essay, in the following the three main aspects of PPPs are going to discussed in detail.

Chapter 3 – The Microeconomic Side of PPPs

As it has been pointed out previously, two main views exist regarding the motives for governments to initiate PPPs. These are increased VfM and/or the possibility to get investment expenditures off the government's books through the involvement of private finance.

3.1 Value for Money, Affordability and the Public Sector Comparator

The first main part of the analysis will now investigate whether and under which circumstances increased efficiency could be a credible argument for undertaking PPPs. This part could also be referred to as the microeconomic side of PPPs.

3.1.1 Value for Money

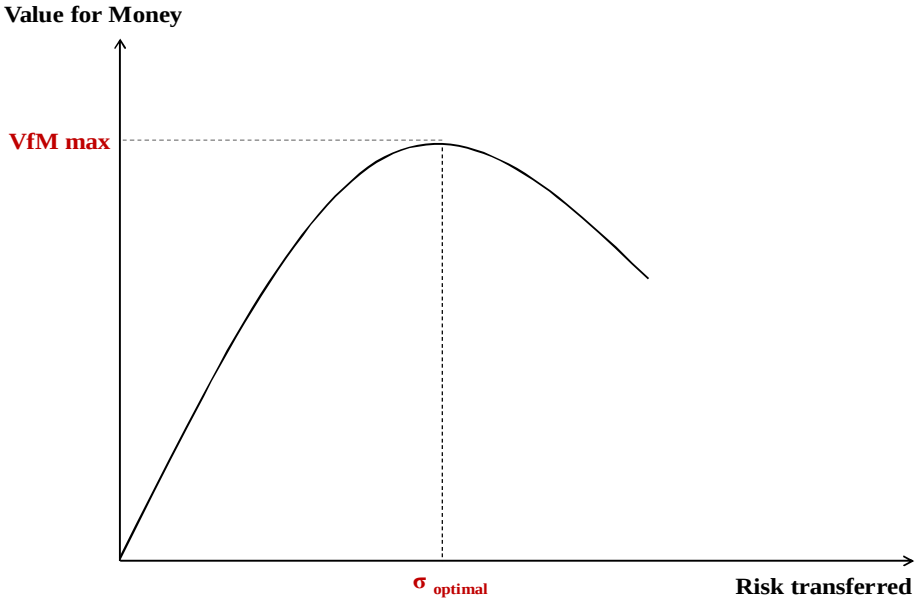
The economic justification for PPPs, as argued above, is that they may generate increased VfM, i.e. a combination of allocative and productive efficiency which is superior to the one created by traditional public procurement (Välila, 2005:100). To put it simply, this means that the required asset and the derived services can be produced at lower costs, while the quality of the public service delivered to the final users is not being compromised (Välila, 2005:100). There are three key sources of improved VfM in PPPs. These are risk sharing, private asset ownership and the bundling of tasks. Given the issues considered by this essay, only one of the three main sources of VfM is going to be discussed in detail, this being the aspect of risk transfer. Additionally, the discussion will include considerations regarding transaction costs, as well the existing methods for the evaluation whether a PPP is preferable to traditional public procurement.

3.1.1.1 Risk Transfer

The first, particularly important aspect related to the VfM argument is the transfer of risks from the public to the private sector. Adequate risk transfer is a prerequisite for successful partnerships, and failure of doing so considerably reduces the likelihood that a PPP will be more efficient compared to traditional public procurement. Moreover, risk transfer is also essentially linked to the fact that projects cannot be treated off the balance sheet for the public sector unless sufficient risk transfer to the private partner can be verified (Eurostat, 2004a and 2004b). Yet, for risks to be transferable it has to be fulfilled that the uncertain outcome can be quantified in terms of its magnitude, as well as timing and probability of occurrence. Transferability in turn allows for risks to be priced by the private partner and the project financiers, which is a precondition for risk transfer to be sensible in the first place (Välila, 2005:105).

Optimal risk sharing between the public and the private sector partner is particularly important as it creates incentives to improve risk management and assessment. Since better risk management and assessment can decrease project costs, risk transfer, if optimally done, may indeed create increased VfM. However, the preconditions for optimal risk sharing are that production costs are not reduced on the costs of service quality and that each type of risk is manageable and allocated to the party best able to manage it (Välila, 2005:105). According to the theory, the optimal amount of risk transferred to the private sector partner can be found at the point where VfM is maximized (OECD, 2008:33). This situation is illustrated in the following graph:

Figure 3.1 Optimal risk transfer and VfM



Source: OECD, 2008: 33.

Ensuring optimal risk transfer is however, a very complex issue, since there are countless risks at the different stages of a project which have to be taken into account and carefully assessed. The relevant literature on PPP offers several different approaches regarding the classification of risks. Risks in general can be divided into two main groups, namely exogenous and endogenous risks. Regarding exogenous risks, the private partner has no information advantage compared to the government, while endogenous risks involve those risks which can be influenced by the private or the public actor's actions (Sadka, 2006:11). The so called "Risk Matrix" is an important tool setting out the nature and effect of the risks that can occur (Yescombe, 2007:246). According to this classification, general and project-specific risks have to be distinguished. General risks include economic and political risks that usually cannot be directly influenced by the private partner. On the other hand, project-specific risks relate to the construction and operation phases in which the private partner is

directly involved, and thus it is able to at least partly influence these risks through its actions. This implies that many of the project-specific risks should be transferred to the private sector partner.

Table 3.1 Risk Matrix for PPPs

Risk Phase	Risk Category	Nature of Risk
General	**Economic Risk**	Political opposition to project Change in Law
	Political Risk	Interest rates Inflation
Construction Phase	**Site**	Site acquisition and ground condition Permits Environmental permits & risks Archeology and fossils Access, rights of way & easements Connections to the site Protesters Disposal of surplus land
	Construction	Construction subcontract Construction subcontractor Price adjustments Changes by the Public Authority Construction subcontractor's risks Revenue during construction
	Completion	Delay by construction subcontractor Other causes of delay Design Performance
Operation Phase	**Operation**	Usage / demand risk Network Revenue payment Availability and service Maintenance
	Termination	Project company default Termination by the Public Authority Force Majeure Residual value

Source: Yescombe, 2007: 246.

While the Risk Matrix presented above arguably provides a useful general guidance for and also a broad categorization of risks associated with PPP-type projects, for the purposes of the underlying essay four types of risks are considered to be of crucial relevance. The

description of the first three risk categories closely follows the risk criteria defined in the Eurostat decision[6] on the treatment of PPPs.

Accordingly, the first category to be considered is **construction risk,** which refers to events such as late delivery, not respecting specified standards, potential additional construction costs, technical deficiencies, and external negative effects. The second relevant type is **availability risk,** where the responsibility of the partner is quite obvious. It relates to the issue where the private partner cannot deliver the contractually agreed upon volume or to meet safety or public certification standards relating to the provision of services to final users, as previously specified in the contract. Additionally, it also applies where the partner does not meet the required service quality standards due to an evident lack of performance. The last category explicitly considered by the Eurostat decision is the **demand risk**, covering variations in the level of demand – higher or lower than expected when the contract was signed – irrespective of the behavior of the private partner. This risk should only cover changes of demand that do not result from inadequate quality of the services provided by the partner or any action that changes the quantity or quality of services provided. Instead, it should arise from other factors, such as the business cycle, new market trends, direct competition or technological obsolescence. Demand risk deserves some further attention at this place. As the definition by Eurostat also indicates, demand risk can be influenced and managed only to a limited extent by either the public or the private sector partner. This leads to the highly debated question of which party is best suited to manage it. On the one hand, it can be argued that demand risk should be borne entirely by the public sector, as most factors affecting demand risk, such as general economic and sector-specific policies are under the control of the government. On the other hand, it can also be claimed that the private partner

[6] See Eurostat, 2004a and 2004b

should bear the demand risk, as it can only in this situation be ensured that the private agent will have the right incentives to act in the principal's interest, i.e. to promote efficiency. According to the literature, one possible way to deal with the issue of optimal allocation of demand risk is to agree on a certain mode of risk sharing between the partners (Välila, 2005:107). Finally, even though **residual value risk** as a category is not included in the Eurostat decision, it is considered to be of high relevance due to its implications regarding the accounting treatment of PPPs (IMF, 2004). Residual value risk in general occurs when the market price of the asset used in the PPP agreement turns out to be different from its originally expected value (ASB, 2008:10). Optimal risk transfer is arguable the most important source of VfM, not only because of its direct impacts on efficiency, but also with respect to the treatment of PPPs in national accounts, as the Eurostat ruling demonstrates this well. Yet, VfM can be increased through other channels as well, such as private asset ownership and bundling of tasks. These further sources of improved efficiency will be shortly discussed in the following subsection.

3.1.1.2 Transaction Costs

So far it has been analyzed which aspects have to be considered in order for PPPs to deliver VfM. Nevertheless, it has to be kept in mind that even if a PPP agreement seems to offer better VfM, it is not free of costs. Therefore, transaction costs have to be part of each analysis (Välila, 2005:109). Transaction costs involve direct costs associated with the tendering, contract negotiation, and monitoring. Moreover, due to the long-term nature of PPP agreements further economic costs can occur over the contract period, which can indirectly affect the net benefits of PPPs. There are several types of risks which may lead to the emergence of indirect economic costs, such as the risk of contract termination, expropriation, as well as subsequent contract renegotiations (Välila, 2005:109-111). While transaction costs

may in some cases indeed outweigh the potential benefits of PPPs in terms of increased VfM, it is important to note that this does not mean that traditional public procurement or any other alternative would not be confronted with the issue of transaction costs. Thus, in order to see the net effects of such direct and indirect costs, they do not only have to be incorporated within the analysis of a PPP-type project, but also in comparison with the alternatives.

3.1.2 Affordability

While VfM is probably the most important criteria for the viability of PPPs, the question of affordability is another important benchmark calling for attention. The consideration of this aspect is all the more important, as due to the off-balance sheet nature of PPPs their use has often led to misconceptions regarding the affordability of these projects. Affordability is not only related to PPPs, but to government expenditure items in general. A project is viewed as affordable, if government expenditure that is associated with a project, a PPP-type one or other, can be financed within the inter-temporal budget constraint of the public sector. Hence, if the expenditure implied by the PPP project can be allocated within current levels of government expenditure and revenue, and if it can be assumed that these levels are sustainable in the future, a PPP is considered to be affordable (OECD, 2008:22-26). Yet, affordability should not be confused with fiscal rules and legally imposed budgetary limits, such as the Maastricht criteria in the EU (OECD, 2008:28). The existence of such budgetary limits can create an incentive for governments to use PPPs in order to get the project off their books. Since large public infrastructure projects are generally associated with high initial capital expenditures that may contribute to breaking the limit of budget deficit, PPPs may seem to be a good alternative, due to the fact that the private partner is responsible for this initial capital spending, whereas the government only has to pay a regular fee to the private partner for the delivery of the service. This in turn might enable states to keep their

expenditures within the deficit limit. Hence, a project which could not have been implemented by using traditional public procurement becomes affordable in the framework of a PPP. In these cases however, sustainability of the project and increased VfM are not necessarily of great concern. It is rather the fact that the PPP solves the budget limitation issue which drives the government's decision (OECD, 2008:28).

3.1.3 Public Sector Comparator (PSC)

Having investigated the different aspects of VfM, the analysis can now turn to the question how the potential advantages of PPPs can be effectively measured and compared in practice to those offered by traditional public provision.

In general, whenever the construction of a new public infrastructure is economically justified and the implementation of the project is considered in the form of a PPP, the public authority should further evaluate whether the PPP alternative may offer enhanced VfM compared to traditional public procurement. A so-called Public Sector Comparator (PSC) is an instrument that can be used to answer this question. A PSC is simply an assumption about the Net Present Value (NPV) cost of the project in the case of conventional procurement which is then evaluated against the NPV cost of the same project carried out in the form of a PPP (Yescombe, 2007:63). Commonly, the NPV cost of conventional procurement results from an estimation based on historical costs of services that have traditionally been provided by the public sector. Additionally, it also accounts for defined output specifications and associated risks. The estimation includes the operation costs from most recent years as well, and is then adjusted on the basis of future particularities, such as changes in demand, political considerations and so on (OECD, 2008:49). The NPV cost of PPP on the other hand, may either be estimated or it may as well be known if bids have been already received for it. The

PPP is preferable, if its NPV cost is below the NPV cost associated with traditional public procurement (Yescombe, 2007:63-64).

The PSC is a very important tool enabling policy makers to assess the affordability of PPPs by ensuring full life-cycle costing from the beginning, test the viability of projects measured by VfM, manage discussions for PPP partners on risk sharing and output specification issue, and to stimulate bidding competition by building trust and transparency into the bidding process (OECD, 2008:49). Notwithstanding its benefits, a PSC also raises several issues. The most frequently used critique against the use of PSC is the fact that it is highly hypothetical, and the assumptions made for its construction are subjective. This means, that even slight changes in the assumptions can lead to a manipulation regarding the results of the evaluation. Moreover, the construction of a PSC is a costly and time consuming exercise (OECD, 2008:51). Further issues of concern are related to the general comparability of costs and the discount rate to be used, as well as the adjustments that have to be made for risk transfer and other differences between a PPP and conventional procurement (Yescombe, 2007:63). It is also important to mention that a PSC often does not consider indirect costs that can arise during a project. The inclusion of such costs would be crucially important in order to ensure a realistic evaluation (OECD, 2008:51).

Finally, it has to be noted that different countries may use different methods that are not necessarily based on a PSC due to the lack of harmonization at the EU level. The characteristics of the various methods currently used by different EU countries are presented in the table below.

Table 3.2 Characterization of methods used by different countries to assess VfM

Method / Features	Complete Cost-Benefit Analysis	PSC *prior* to bidding process	PSC *after* bidding process	Reliance on competitive bidding only
Complexity	High	Medium	Medium	Low
Advantages	N/A	Relatively adequate information on whether the PPP may lead to VfM. If the answer is no, the bidding process will not be initiated at all.	PSC compared to the actual PPP bids	Least complex method
Disadvantages	Complex information needed, highly subjective	Subjective, assumptions easy to manipulate, update needed after bidding process took place, no inclusion of indirect costs	Potential danger that after the bidding process it will turn out that the PPP is not favorable	Not well suited for PPPs, and might not reflect the real impact of a PPP compared to traditional procurement
Countries of Application	Germany	UK, Netherlands	None of the EU member states	France, CEE countries

Source: Created by the author on the basis of OECD, 2008:48-49.

To conclude this section, up until now the main sources of VfM, most importantly risk transfer, and the aspect of affordability have been analyzed. This was relevant in order to clarify the arguments in favor of and against the view that PPPs deliver increased efficiency. To complete the picture on the microeconomic side of PPPs the following issue to be investigated is the private finance aspect of PPPs.

3.2 Private Finance

Private finance is a further crucial benchmark of PPPs that can positively affect the efficiency of economic outcomes and simultaneously influence the fiscal considerations regarding PPP-type arrangements.

The specific type of PPPs investigated in this essay[7] is typically organized in the form of a Special Purpose Vehicle (SPV).[8] An SPV is a consortium of financial institutions and private companies responsible for all activities associated with borrowing. It enables the involved parties to combine and coordinate the use of their capital and expertise. Insofar as this is the purpose, an SPV can be beneficial (Yescombe, 2007:348). In these cases the private partner acts as the debtor, which provides him with high incentives to improve the implementation of the project, thus leading to increased productive efficiency (de Bettignies and Ross, 2004:147-148). Furthermore, in the case of private financing investors are directly compensated for the credit risk they assume, which improves project selection and allocative efficiency (Välila, 2005:112). However, an SPV can also be a tool through which the government controls the PPP, either via the direct involvement of public financial institutions, or an explicit government guarantee of borrowing. Where this is the case, there is a risk that an SPV may be used to shift debt off the government's balance sheet, as the government's involvement in the financing of the PPP appears limited while in effect it is financing the PPP (Cangiano et al. 2004:556-557).

There are several other debates surrounding the impacts of private finance of PPPs. The most important one is related to the cost of capital. According to the general view, the cost of borrowing is lower in the public than the private sector, since governments have the ability to spread and separate risks between taxpayers and final service users, and they are less prone to default and bankruptcy risk. However, there are several arguments that can be raised to question this (de Bettignies and Ross, 2004:146-147). First, the private partner can also spread risk across financial markets (IMF, 2004:12). The second argument relates to default risk. While due to their power to tax, governments may arguably have a lower default risk in

[7] See Chapter 2.

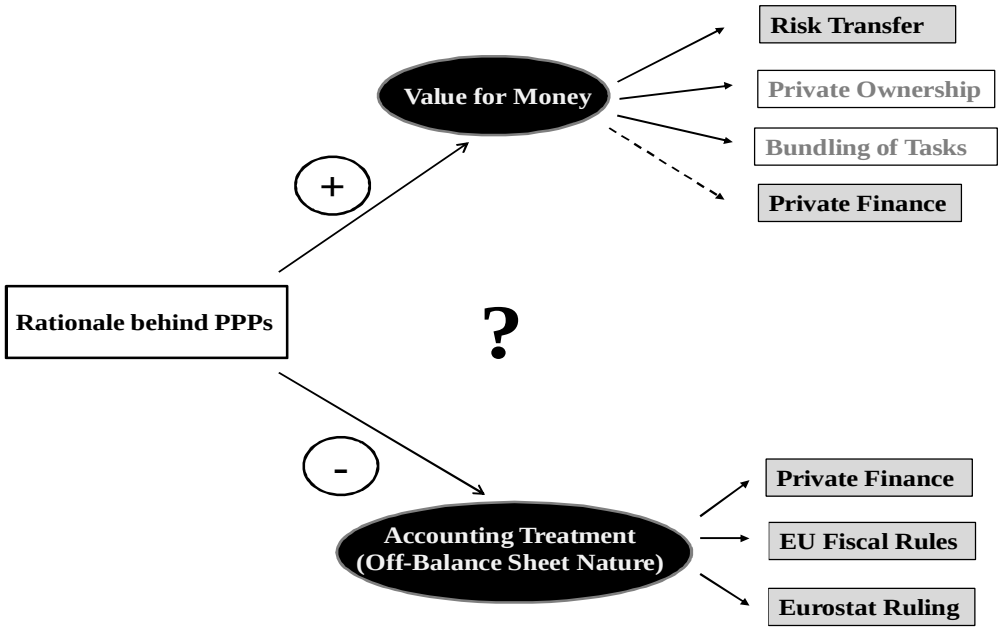
[8] According to the definition used in this essay.

contrast to the private sector, governments can also fail in this respect (IMF, 2004:12). For instance, sub-national governments often get into serious financial troubles (de Bettignies and Ross, 2004:147). Additionally, due to the financial crisis, bankruptcy and default became real risks for several national governments as well. Third, in projects in which the government is the buyer the private sector can usually borrow at very low rates, since the government's reliability as a buyer substitutes for reliability as a borrower (de Bettignies and Ross, 2004:147). Finally, the private partner as borrower is able to deduct interest payments and hence reduce its taxes to be paid. While the whole amount of these kinds of saving is not treated as real savings, a portion of it can still be viewed as a form of government subsidy to the private partner which is only available if the project is privately financed (de Bettignies and Ross, 2004:147). While the above theoretical arguments support the view that it is not perfectly clear whether costs of capital would always be higher for the private sector than the public sector, evidence shows a different picture. Studies carried out in the United Kingdom and the United States have demonstrated that public borrowing in reality is significantly cheaper than private borrowing in most cases (Hall, 2008:17 and Hall, 2010:9-10). This implies that PPPs in practice start with a handicap (Hall, 2008:17). Therefore, PPPs have to demonstrate that they generate significant efficiency gains which are high enough to offset the higher borrowing costs (Hall, 2010:9).

Regarding the microeconomic side of the analysis, it can be concluded that under certain conditions PPPs may indeed result in improved efficiency compared to traditional public procurement. Yet, the currently existing methods are inadequate and underdeveloped to evaluate each and every relevant aspect of a PPP. Therefore, whether and under what circumstances PPPs may be a truly superior alternative to conventional public procurement is

highly questionable. Beside the issue of how to evaluate the real benefits of PPPs effectively, the existing EU fiscal rules and the current accounting treatment of PPPs pose further dangers that efficiency considerations will not be priority when deciding about the initiation of PPPs, rather they are going to be based on mainly budgetary considerations. The next part will aim to provide an insight exactly on these issues. Yet, before continuing the analysis, it may be helpful to take a look at the following figure illustrating once again the main issue:

Figure 3.2 The possible driving motives behind the initiation of PPPs – Public sector perspective



Source: Figure created by the author

Chapter 4 – EU Fiscal Policy and the Accounting Treatment of Public-Private Partnerships

Turning to the link between fiscal policy and PPPs, as it has been previously mentioned, legally imposed fiscal limitations on budget debt and deficit can considerably influence the incentives of the government to initiate PPPs. This chapter will begin by describing the existing fiscal rules within the European Union. Subsequently it will turn to the discussion of the accounting treatment of PPPs[9] within the region.

Regarding the current treatment of PPPs in national accounts it has to be noted that in general most countries' government data are captured in three frameworks, namely the national accounts, the government finance statistics (GFS) and the country's own budget and accounting framework. National budgets are focused on the allocation of resources within a country, implying that differences between countries regarding this aspect can be high and international comparisons are not possible. On the other hand, national accounts and GFS use international standards and this way allow for international comparisons (OECD, 2008:58). Additionally, the current accounting treatment of PPPs in national accounts is based on the principle that any PPP can only be recorded in one institutional sector, i.e. either the public or the private sector (Välila, 2005:112). Having said that, the analysis will now turn to the existing EU fiscal rules.

[9] As defined in Chapter 2.

4.1 EU Fiscal Policy

The EU fiscal rules were introduced in 1996 as part of the Maastricht Treaty, and form part of the Stability and Growth Pact (Hall, 2008:7). According to the rules, joining the monetary union requires the states among others to be able to maintain a budget deficit of less than 3 per cent of the GDP and a public debt less than 60 per cent of GDP, or at least values declining toward this benchmark (Baldwin and Wyplosz, 2004:392). These ratios cover the deficit and debt of the general government that refers to "institutional units producing non-market services as their main activity" (Reference). This means that public enterprises which operate commercially through service charges are exluded (Hall, 2008:7). As a result, EU rules create an incentive for PPPs in government operations, such as health care and education services, since they shift government borrowing for capital investment to the private sector partner (Hall, 2008: 7). Furthermore, the EU rules make it equally attractive for governments to create PPPs with public enterprises, as that partner's borrowing and debts incurred are also outside of the government balance sheet (Hall, 2008:7).

As outlined above, EU fiscal rules indirectly favor the use of PPPs yet, the accounting treatment and the issue under which circumstances PPPs qualify for being left outside the governments' balance sheet have been unclear for a long time. In 2004, this issue has been, at least it was hoped for, solved by the decision taken by Eurostat and the subsequent extension of the ESA95 Manual by a further chapter on PPPs.

4.2 The Current Accounting Treatment of PPPs within the EU

4.2.1 Background

In order to achieve the objectives set by the Treaty, the European Union attaches great importance to the establishment of high-quality statistical instruments which provide a set of harmonized and reliable statistics on which to base decisions. In this respect, the European System of National and Regional Accounts (ESA) was a major development, among others offering an improved methodology, higher conceptual accuracy, and accounting rules which have to be applied in order to arrive at a consistent, reliable and comparative quantitative description of the economies of the member states (Kaufmann et al. 2006). Yet, up until 2004 there has been a lack of clarity on how to account for PPP-type transactions under the 1995 European System of Accounts (Eurostat, 2004b:2).

In order to solve this puzzle, in February 2004 Eurostat, the Statistical Office of the European Communities issued a decision concerning the accounting treatment of long-term contracts that have been undertaken by the government units in the framework of partnerships with non-government units (Eurostat, 2004).[10] Subsequently, in August 2004, as a result of the Eurostat ruling and further discussions on the accounting treatment of this specific as well as other types of PPPs, Eurostat has introduced a new chapter on PPP-type arrangements into the European System of Accounts (ESA95) Manual on government deficit and debt (Eurostat, 2004b).[11]

[10] The reason why in the Eurostat decision the PPP partner is described as a non-governmental unit rather than a private sector partner follows from the way in which public enterprises are treated in the EU fiscal rules (Hall, 2008:7).

[11] Chapter IV.2 of the Manual deals with the treatment of PPPs.

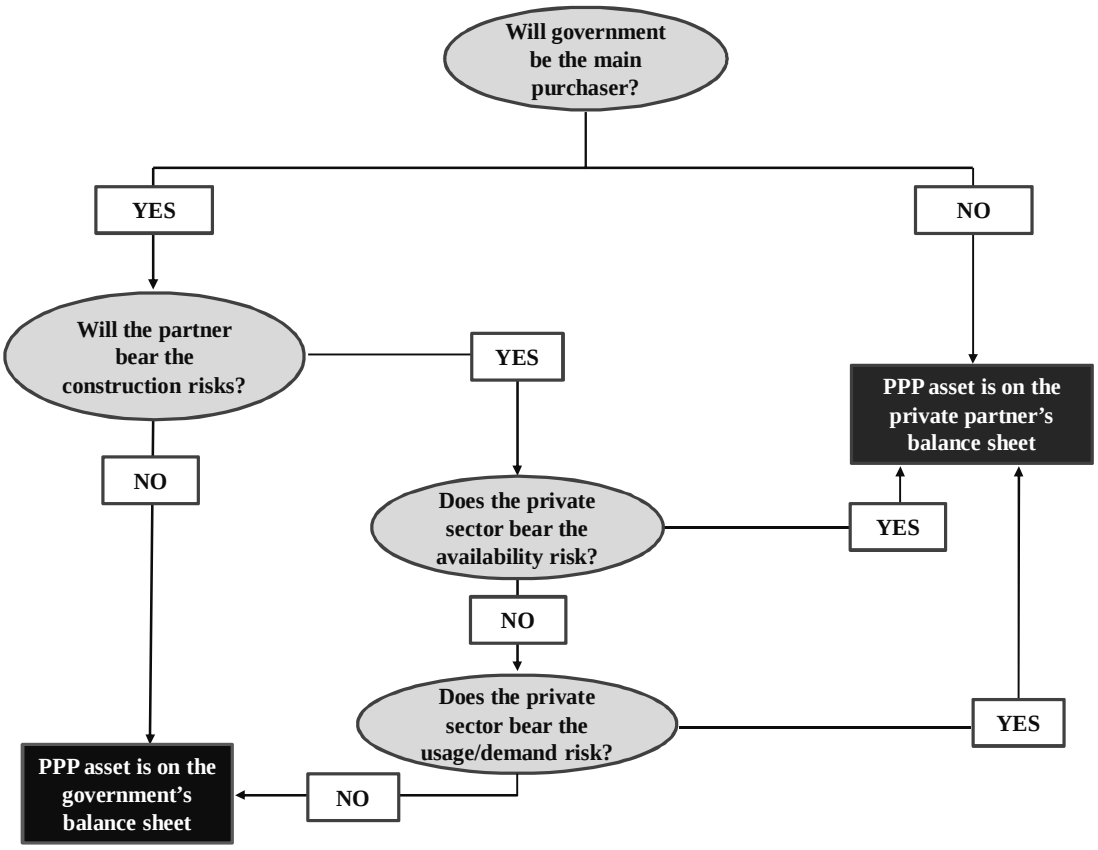
4.2.2 Eurostat Ruling on the Treatment of PPPs in National Accounts

The key issue with respect to PPPs is the classification of the assets involved. As a result of the methodological approach followed by Eurostat, the assets involved in a PPP can be considered as non-government assets, i.e. off balance sheet, only if there is strong evidence that the partner is bearing most of the risk attached to the specific partnership (Eurostat, 2004b: 2). According to the recommendations of European statistical experts, risk assessment focuses on three main categories of risk, namely construction risk, availability risk and demand risk (Eurostat, 2004b:2).[12]

Taking these three risk types into account, Eurostat recommends that assets involved in a PPP should be classified outside the government sector, if the private partner bears the risk of construction **and** *either* the availability *or* the demand risk at the same time (Eurostat, 2004:1).

[12] For further clarification of the three risk types see Chapter 3, Section 3.1.1

Figure 4.1 Eurostat decision tree



Source: Eurostat, 2004b:26.

If the above conditions are met, then the treatment of the contract is similar to the treatment of an operating lease in ESA95, meaning that it would be classified as the purchase of services by government, and does not have to be recorded on the government's balance sheet. If the conditions are not met, then the assets are to be classified on-balance sheet for the government. The treatment is here similar to the treatment of a financial lease in ESA95 requiring the recording of government capital expenditure and borrowing (Eurostat, 2004b:2).

4.2.3 Risk Assessment

With respect to the assessment of risk sharing between the involved parties, the key issue relates to those risks that are directly associated with the contract and the state of the asset involved, or depend on some management tasks which according to the contractual obligations have to be carried out by the non-governmental partner. This refers to the concept of economic ownership which is clearly different from legal ownership used in most accounting standards (Eurostat, 2004b:14). According to the Eurostat decision the risk analysis with respect to PPPs belongs to the responsibilities of the National Statistical Offices of the EU Member States and Acceding Countries (Eurostat, 2004a:3).

Regarding construction risks, governments having the obligation to start making regular payments to a partner without taking into account the effective state of the assets is regarded as evidence that governments bear the majority of the construction risks. The magnitude of the different risk components can be estimated by the amount that each partner would have to pay in the case of the occurrence of a specific deficiency. Furthermore, it is important to point out that the government should not be obliged to pay for any event resulting from the partner's actions. By contrast, the non-governmental partner should not have to pay for any unexpected events that are exogenously influenced, i.e. independent of the partner's actions. (Eurostat, 2004b:2 and 14). With respect to availability risk, it is generally assumed that the partner is able to influence most of this risk by its actions. According to the decision, availability risk is not treated as a risk borne by the government, if it has the right to reduce significantly its periodic payments in cases where the private partner does not supply the agreed upon quality or quantity. This may be reflected in low consumer satisfaction, low level of effective demand, or in non-availability of the service. Application of such penalties should be automatic, with a significant effect on the partner's profit, and must not be purely symbolic

in cases of default by the partner. This implies that marginal penalties and maximum limits set on the amount of payment reductions would both indicate that availability risk has not been transferred to the non-governmental partner in the adequate amount (Eurostat, 2004b:14). Finally, demand risk is assumed to be borne by the government in cases where it is obliged to ensure a given level of payment to the partner independently of the effective level of demand by final users. However, if the availability standards stated by the contract are fulfilled, then variations in demand are not due to the partner's actions. In such cases the asset can only be defined off the government's balance sheet, if it is the partner's own responsibility to manage such situations. Contractual clauses allowing the partner to use the asset for other purposes than originally have been agreed upon would be an indication that the partner is effectively bearing the demand risk. If demand variations are due to government actions, such as policy changes, then the absence of payment adjustments and even compensation payments would not lead to a reclassification of the asset as a governmental one. Finally, for exceptional external events the partner should be required to subscribe to an insurance policy *ex ante* (Eurostat, 2004b:14).

4.2.4 Supplementary Criteria

In complicated cases, where the assessments of risk sharing and contract design do not deliver clear results regarding the balance sheet treatment, it is possible to rely on further contractual characteristics (Eurostat, 2004b:10).

First, it is appropriate to consider what happens to the asset at the end of the contract, i.e. who is going to be the owner of the asset ex post and at what price. While this feature of ex post ownership does not directly refer to risk sharing aspects, indirectly there is a close link to be observed. If at the end of the contract the asset remains the property of the non-governmental partner, irrespective of its economic value at that time, then classification of the

asset on the partner's balance sheet is additionally justified. In other instances, where the government only has an option to buy the asset at the end of the contract for the current market value, the asset can also be recorded off the government's balance sheet. Yet, if the government has an obligation to acquire the assets at the end of the contract for a pre-determined price, the asset is likely to be recorded on balance sheet for the government. This is the case if the pre-determined price is obviously higher than the real economic value of the asset, or if the price is lower than the economic value, but the government has in the form of regular payments already paid for the right to acquire the asset throughout the contract that in total came close to the full economic value of the asset (Eurostat, 2004b:11-12).

The second aspect that can be considered in borderline cases is whether there are payments by the government to support the partner's borrowing. While in general an important aim of governments initiating long-term partnerships with non-governmental partners is to avoid large, immediate capital expenditures, it is not unusual that they participate in the financing of the project in other ways. If at the beginning of the project or during the construction the capital cost is mainly covered by the government, it indicates that the government bears the majority of risks, thus the asset should be reclassified to the government accounts.[13] The government may also offer a guarantee partially or fully covering the project-related borrowing of the partner, helping the partner to raise funds and improve credit rating. Such guarantees are viewed as contingent liabilities and are not recorded in the system, as 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. If the guarantee is effectively called, there might be a reclassification of the asset, especially if it considerable changes the share of risks borne by the parties. With respect to debt guarantees,

[13] The argument here is that financial risk is to be treated as part of the construction risk (Eurostat, 2004b:11).

classification of projects may often result in their treatment on the government balance sheet (Eurostat, 2004b:11-12).

To conclude, while the Eurostat decision on PPPs clarified several issues regarding the treatment of PPPs in national accounts, the ruling is not free from criticism. These critical views and the recommended actions based on them are going to be discussed in the next sections.

Chapter 5 – Critical Evaluation and Recommendations

5.1 Specific Critiques ad Recommendations on the Eurostat Ruling

As mentioned above there is no doubt about the importance of the Eurostat decision regarding the treatment of PPPs. Nevertheless, it is also important to emphasize that the ruling is in many respect imperfect and thus prone to criticism. [14]

First, with respect to the general requirements of risk sharing, critiques have been raised both by international institutions, as well as in the field of academia. In general, it is claimed that the criteria in terms of risk sharing are rather loose. Even if construction risk and either availability or demand risk is completely transferred to the non-governmental partner, a large part of the risk still lies with the government as it bears the full amount of the remaining third risk type. As construction and availability risk is often borne by the private sector in traditional procurement projects, there is a danger that many projects will be classified as PPPs (OECD, 2008:64 and IMF, 2004:22) As the IMF and OECD argue, even more risk should be transferred to the private partner for optimal risk sharing and hence for any arrangement to classify as a PPP (OECD, 2008:64 and IMF, 2004:22).The IMF (2004) also highlights the issue of residual risk, i.e. who bears the asset value risk, which is currently not considered to be a primary criterion for PPPs by Eurostat. Residual value risk however, can constitute an important risk borne by the government and thus its ignorance can significantly affect the accounting treatment of PPPs. Therefore, it would be appropriate to explicitly include the aspect of residual risk in the main criteria, and to make the conditions under which

[14] See Hall (2008) and (2010) IMF (2004), OECD (2008),IMF (2004), and Välila (2005).

arrangements can qualify as PPPs, i.e. no record on the government balance sheet is required, overall stricter (OECD, 2008: and IMF, 2004:22).

As previously mentioned, each risk should be borne by the party best able to manage it, as this is the only way to ensure that improved VfM will be achieved. Yet, given that due to the budgetary restrictions some projects will not be carried out unless they can be classified as PPPs, governments within the EU may have a strong incentive to share risks in a way which will fulfill the Eurostat requirements even, if it leads to a situation where the partner is not the best suited to carry those risks. In such cases, project costs and the amount of long-term expenditure commitments for the government will increase distracting the partner from aiming to increase efficiency and reduce the costs of service provision (OECD, 2008:65). In order to avoid such practices the adequate assessment of the potential benefits of PPP-type project compared to traditional public procurement and the associated risks should be of high priority. Therefore, first and foremost the decision whether to undertake a project, and the choice between traditional public investment and a PPP, should be based on technically sound VfM comparisons (OECD, 2008:29-30). In this regard, the use of a PSC is highly recommended (OECD, 2008:85). Moreover, standardization and harmonization of the exact PSC method to be used across countries is a further important requirement, as the current use of various methods across countries is certainly inappropriate. Yet, the sole use of a PSC is not sufficient to ensure that the actual performance of the partner will yield the expected VfM. Thus, after the PPP contract has been concluded, the performance must be monitored throughout its life (OECD, 2008:54). Performance can be readily measured using a basket of performance indicators, such as efficiency measures defined in terms of inputs and outputs, effectiveness measures in terms of outcomes, service quality measures, financial performance measures, process and activity measures. Many countries already include such indicators in their contracts, yet further progress is still necessary (OECD, 2008:55). Finally, in contrast to

the Eurostat view, specific risk assessment is and remains a difficult exercise (Ter-Minassian, 2004:22). Further adding to this issue is the decision of the Eurostat, that it is the responsibility of the National Statistical Offices of the member nations to define and assess the risks of PPPs (Eurostat, 2004a:3). However, it is highly doubtful that national statistical offices would have the required know-how to skillfully evaluate the extent of risk transfer. Furthermore, the results of these analyses may often be intransparent, and unaccountable.[15] In order to overcome the above stated issues, efforts should be made to ensure that risk assessment is carried out in a professional and transparent way in each and every member state. Therefore, the accounting profession should seek to develop an approach that enables the adequate assessment and quantification of risks borne by the government, and to enforce disclosure of these risks. Countries should then develop their own capacity within and outside of National Statistical Offices to ensure international compliance.

Finally, even if all criteria defined by Eurostat seem to be fulfilled in order to qualify an arrangement as a PPP, there are several ways to dilute risk sharing. The most well-known instrument is to offer a government guarantee to the private sector. As it has been shown in the previous chapter, guarantees offered by the government in order to support the partners borrowing do not have to be recorded on the government balance sheet, unless the guarantee has been effectively called. This leads to uncertainties regarding what the government will eventually have to pay for the delivered services. While the provision of guarantees does not necessarily mean that not enough risk has been allocated to the private partner, it is questionable if such obligations will not lead to inefficiencies in risk sharing (OECD, 2008:65-66). Additionally, the provision of guarantees may expose the government to hidden and often higher costs than traditional public financing (IMF, 2004:24). To lessen these issues, government guarantees should be disclosed by publishing detailed information on

[15] Own opinion.

them, covering the public policy purpose of each guarantee, the total guarantee by sector and amount, the intended beneficiaries, and the likelihood that the guarantee will be called. Optimally, the expected value of guarantee payments should be estimated and reflected both in the annual budget as well as the medium-term fiscal outlook. However, acknowledging the measurement problems of the expected value of guarantee payments, it should not be treated as an expected liability which is added to the debt. Rather, the larger the expected liability associated with guarantees, the less favorably a particular debt path should be viewed. The formal incorporation of this liability into debt sustainability analysis however, awaits development of an adequate approach. In addition to full disclosure, countries should take steps to control the financial risks associated with guarantees through means of careful screening of requests for guarantees, limits on individual and overall exposure, and charging risk-related fees (IMF, 2004:28). Last but not least, it is important to note, that guarantees constitute long-term commitments for governments and thus have a strong impact on national accounts. This fact emphasizes the need for clear, harmonized and internationally accepted accounting and reporting standards which however, currently do not exist (OECD, 2008:58). Moreover, even with regards to the existent rules for other types of transactions, as the table below demonstrates, most EU member states do not comply with such rules.

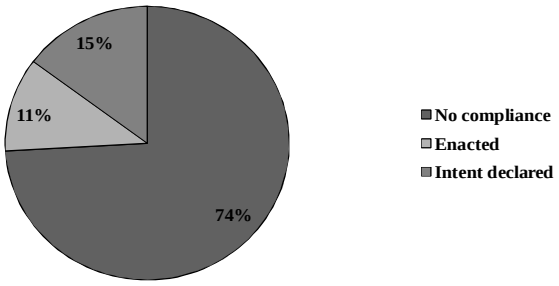
Table 5.1 Compliance with IFRS rules by EU member states (2008)

Country	IFRS 2008
Austria	X
Belgium	X
Bulgaria	XXX
Cyprus	XXX
Czech Republic	X
Denmark	X
Estonia	X
Finland	X
France	X
Germany	X
Greece	X
Hungary	X
Ireland	X
Italy	X
Latvia	X
Lithuania	X
Luxembourg	X
Malta	XXX
Netherlands	XX
Poland	X
Portugal	X
Romania	X
Slovakia	XX
Slovenia	X
Spain	X
Sweden	X
United Kingdom	XX

Interpretation of the table:

X – No Compliance
XX – Intent Declared
XXX – Enacted

Compliance with IFRS rules by EU member states in % (2008)



Source: Created by the author on the basis of the information provided by eStandards Forum (Country Profiles, 2008)[16]

While steps have been taken toward the establishment of an internationally accepted standard, the exact features of such a standard are still unclear and their enforcement seems rather problematic. Therefore, it is all the more challenging to close the loopholes that currently enable governments to use PPPs as a tool to bypass expenditure controls, and present them off the public budget (OECD, 2008:58).

[16] eStandards Forum, Website: http://www.estandardsforum.org/browse

5.2 Other Aspects of Concern

The above listed points reflect the most frequently raised critiques with respect to the Eurostat ruling, and the potential ways to avoid or at least minimize the likelihood that problems occur. Yet, there are several other aspects related to PPPs that require particular caution and attention from all stakeholders, if it is to be ensured that the government's main motive behind PPPs is the right one, namely increased efficiency instead of the aim to make public accounts look better.

First, the Eurostat ruling allows publicly owned enterprises to be partners in PPPs without having to record their assets[17] on the governments balance sheet, if the entity is a market entity. They also have to follow the same rules regarding guarantees and subsidies as privately owned companies, which certainly leaves a lot of room for using PPPs (Yescombe, 2007:69). Furthermore, the rule to classify PPP assets only on the balance sheet of one institutional sector is also problematic as it does not reflect the extent to which risk has been actually transferred to the partner (OECD, 2008:58). This fact further skews the public sector's incentives to establish partnerships, increasing the risk that their use is driven by political and accounting considerations rather than by economic efficiency considerations (Välila, 2005:116). This also implies that fiscal rules are further preventing enough public investment from being made. Therefore, one possible but rather radical suggestion would be to review and change the rules themselves. Evading the rules by using PPPs, when they may be a more costly and risky, and even a less effective option than public provision, does not solve the problem, but makes it even worse (Hall, 2010:9). As the likelihood of such radical amendments being issued is rather low, great importance should be attached to budgetary transparency especially with regards to such complex transactions as PPPs. According to the

[17] The meaning of the term „asset" is not specified, which could be a further critique of the Eurostat decision.

"OECD Best Practices for Budget Transparency" (OECD, 2002) the budget should be comprehensive, encompassing all government revenue and expenditure, and long-term reports and sustainability analysis are also of key importance. Finally, accounting rules and policies should be described clearly, and discrepancies with generally accepted accounting practices should be disclosed (OECD; 2008:60).[18]

The second point relates to the fact that PPPs considered in this essay are typically organized in the form of an SPV. An SPV, as already mentioned in Section 3.3, can also be a tool through which the government controls the PPP and in such cases there is a risk that the SPV may be used to shift debt off the government's balance sheet. The ESA95 Manual also discusses the issue, and recommends that SPVs controlled by the government should be closely checked, in order to decide whether it can be considered as an independent institutional unit carrying out true market operations (Eurostat, 2004b:14). Yet, the Manual does not provide clarity on how such assessment could be carried out effectively. Therefore best and clearest way to deal with such cases would be to determine the extent to which SPVs are under state control by using control instruments, such as the ownership of majority of voting rights, government borrowing and the extent of state regulations. After controlling, all those SPVs should be consolidated with the public authority which are substantially controlled by the latter and their operations should also be recorded and reflected in the fiscal accounts (Cangiano et al. 2004:556-557 and IMF, 2009).

Finally, policy makers should aim at providing an adequate regulatory, legal and institutional environment for the successful implementation of PPPs, and continuous political support and commitment should be strengthened.

[18] A particular issue with regards to budgeting is the fact that most EU member states still use cash instead of accrual accounting. Yet, many international attempts to clarify the accounting treatment of PPPs are based on accrual accounting (See for example Kaufmann et al. 2006).

Having discussed the most important critiques and related proposed changes with regards to the current accounting treatment of PPPs within the EU, the following last table aims at listing and summarizing the above mentioned aspects and arguments one more time:

Table 5.2 Detailed summary of Critiques and Recommendations

Aspect	Critique	Recommendation
Risk Types – Eurostat Criteria	Not ensured that sufficient risk is transferred to the private partner	Criteria should become stricter, residual risk should be included in the primary criteria
Value for Money and Public Sector Comparator	Optimal risk sharing not ensured by the existing ruling; PSC not harmonized among countries; Manipulations possible; Indirect costs not accounted for	Use of PSC should be ensured in all member states, harmonization of the method needed, inclusion of indirect cost is highly recommended as well
Risk Assessment	Difficult exercise, lack of expertise and capacity in National Statistical Offices	Use of standardized performance indicators by all, performance monitoring
Performance Measurement	PSC is not enough to effectively measure performance	Use of standardized performance indicators by all, performance monitoring
Guarantees	No budget recording requirement, lack of disclosure	Full disclosure, introduction and enforcement of IFRS
Treatment of the asset	Asset can only be recorded on the balance sheet of one institutional sector →Bias for or against PPPs	Incentive neutral fiscal rules reflecting the true burden on public accounts should be aimed for
Treatment of the partner	Publicly owned entities with market operations are treated as private entities → Room for manipulation of deficit and debt levels	Close monitorin, preferably consolidation with the government
Special Purpose Vehicle	Often controlled by government, but still off-balance sheet treatment of PPP	Close monitoring by using control indicators, consolidation of the government with the SPV if extensive state control obvious, recording transactions on-balance sheet
Fiscal and Budgetary Transparency	No transparency, lack of international accounting and reporting standards (IFRS) regarding PPPs, no compliance with existing IFRS	Comprehensive budgeting, full disclosure, harmonization and clarification of rules and laws
Institutional Framework	PPP Units lack in some countries, institutional environment inadequate	Establish PPP Units, extend their responsibilities to monitoring
Regulatory and Legislative framework	No appropriate harmonization, lack of adequate national legislation	Harmonize laws and rules → Procurement Laws in particular and national legislation on PPPs
Role of IFIs	Advisory role not enough	Monitoring compliance by member states
Political Support and Commitment	Lack of political support and commitment to the establishment of adequate accounting rules → Politicians and decision makers aim to keep investments off the books	Establish and strengthen political support and commitment to the implementation of *efficient* PPPs (VfM should be priority)

Source: Table created by the author on the basis of IMF, 2004; Välila, 2005; OECD, 2008; IMF, 2009; Hall, 2010

Concluding Remarks

Public-Private Partnerships, as an alternative form of public infrastructure and service provision have gained high popularity throughout the European Union. The main potential benefit of such arrangements is their improved efficiency in terms of VfM compared to traditional public procurement. Therefore, according to the normative view, the main driving motive of the public sector to initiate PPPs should be based on efficiency considerations, meaning that the PPP alternative should only be used if its superiority is credibly evaluated. Yet, as evidence shows, PPPs are frequently based on other, fiscal and budgetary considerations.

The purpose of this essay was to analyze the micro- and macroeconomic sides of PPPs. As it has been shown, under specific circumstances PPPs can indeed deliver increased economic efficiency compared to traditional procurement. However, due to the lack of adequate assessment methods, as well as the existing fiscal rules limiting governments' room for maneuver with respect to investments in public infrastructure provision, it seems that efficiency considerations may not be the primary motive of governments to initiate PPPs. This argument can be further strengthened, as the Eurostat decision (2004), aiming at overcoming the issue of "misusing" PPPs, turned out to be inadequate to achieve its stated objectives.

To conclude, the Eurostat decision certainly demonstrates the commitment of the EU to make the clarify treatment of PPPs in national accounts. Yet, the current system is in many aspects inadequate. Therefore, on its own the Eurostat ruling does not provide an appropriate framework to close the existing loopholes regarding the use of PPPs. In order to overcome the issue of PPPs being used based on their budgetary implications, rather than efficiency, further actions are needed. Changing the criteria provided by the Eurostat ruling is one option. Yet,

this alone may most likely not be sufficient. Rather, more comprehensive measures should be taken, which do not only concentrate on the clarification and tightening of the existing ruling, but also enhance the role of efficiency considerations, transparency and accountability and the overall enabling environment for PPPs. Finally, credible political support and commitment is a precondition for the implementation of future changes, both with respect to the accounting treatment of PPPs and the driving motives of their initiation. Lacking commitment would in turn compromise the fundamental aim each and every government should follow, namely pursuing the public interest.

Annex 1

Table A.1 Summary of EU rules, laws and policies

Laws, Rules, Policies / Publishing Institution	Year of publication / initiation	Type	Description
EC	2009	Guide	Mobilizing Private and Public Investment for Recovery and Long-Term Structural Change: Developing Public-Private Partnerships
EC	2008	Guide	Guidance on Setting Up Institutional PPPs (IPPPs)
EC	2004	Guide	Green Paper on Public-Private Partnerships and Community Law on Public Contracts and Concessions
EC	2003	Policy	Initiation of PPPs for the construction of the Trans-European Networks (TENs) within the framework European Growth Initiative
EC and EIB	Sept 2008	Policy	Launch of the European PPP Expertise Centre (EPEC)
EC, EBRD	Since 2005	Policy, recomm.	Promotion of the introduction of national laws favorable to PPPs
EC, EIB, EBRD	2006	Policy	JASPERS: Joint Assistance to Support Projects in the European Regions
EC, EIB, EBRD	Since 2003	Policy	Financial support → Co-finance, Direct EU public spending for TENs, and EU public spending through EU Cohesion Fund, Structural Funds or ISPA
EC	2004	Law	EU Procurement Laws (Note: Procureent Laws do not simply fit with PPPs. Three types: concessions; competitive tendering requirements for non-concessions; institutional PPPs (IPPPs)
EC and Eurostat	Aug 2004	ESA 95 Manual (Ch.IV.2)	Long-Term Contracts Between Government and Non-Government Partners (Public-Private Partnerships)
Eurostat	Feb 2004	Ruling	New Decision on Deficit and Debt: Treatment of Public-Private Partnerships

Source: Created by the author [19]

[19] Table A.1 has been created by the author of this thesis based on Ch.1. Section 1.2 (Hall, 2008; EC, 2004; EC, 2009; Website of the European Commission)

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