



CENTRAL BALTIC
INTERREG IV A
PROGRAMME
2007-2013

MA Guidance Note on Revenue Generating Projects



EUROPEAN UNION
EUROPEAN REGIONAL DEVELOPMENT FUND
INVESTING IN YOUR FUTURE

Regional Council of
Southwest



Finland

Introduction

Article 55 of EU Regulation 1083/2006, defines a revenue generating project as:

- any operation involving an investment in infrastructure, the use of which is subject to charges borne directly by users or
- any operation involving the sale or rent of land or buildings, or
- any other provision of services against payment (i.e. where a project engages in activity where users are charged.)

In these instances, net profit (project income minus operating costs) must be deducted from the total project expenditure because ERDF subsidies cannot fund activities which can be financed in other ways. *Project Applicants are therefore required, where possible, to objectively estimate net profit in advance, as part of the application process.* Projected income and operating costs must therefore be stated in the annexes submitted with the Application form to the JTS so that any excess income can be deducted from the project on a claim by claim basis. The estimated future revenue affects the ERDF co-financing rate applied.

For any project regardless of its actual content with total budget above 1 000 000 Euros having estimated income/revenues during or after the project implementation it is mandatory to use a specific calculation model (Funding Gap rate –method) to set the right level of ERDF co-financing by the Central Baltic INTERREG IV A Programme 2007-2013. Projects with total budget up to and below 1 000 000 Euros do not have to apply the Funding Gap method.

Project partner from a specific participating Member State/Åland should first and foremost follow the national instructions and guidelines for revenue generation if available. However in case of absence of such a national instructions this MA Guidance may be directly applied.

Please see first the Programme Manual Chapter 5.9 Income (Budget line 9) before studying this MA Guidance Note.

Relevant concepts

Investment Financial Profitability

"Investment financial profitability" is the ability of the project to generate additional financial resources (i.e. profits) compared to those invested, *independently* of how the project is going to be financed. In other words, it is the ability of the project in itself to generate financial returns without considering the cash flows due to loans, private equity, or government contributions (e.g. grants). It is worth noting that one of the key indexes of the investment financial profitability is the financial net present value given by the difference between project discounted net revenues and project investment costs derived from a cash-flow analysis

The Funding Gap Method

The method used to determine the contribution from the Funds to revenue-generating projects is the so-called "funding-gap" method. The funding-gap is the difference between the current value of project investment costs and net revenue. Thus, the funding-gap expresses the part of the project investment costs which cannot be financed by the project itself and that therefore needs to be financed. This method is used for two main reasons: first, to ensure, on the one hand, that the project has enough resources to be implemented, and on the other hand, that it is not over-financed; secondly, to ensure a minimum level of project profitability to borrow money

Cash in-flows

Cash in-flows can be divided into:

- Revenues, that is, cash in-flows *directly paid by users* for the goods and/or services provided by the project, such as charges borne directly by users for the use of infrastructure, sale or rent of land or buildings, or payments for services;
- Other cash in-flows, that is, private and public contributions and/or financial gains than do not stem from tariffs, tolls, fees, rents or any other form of charge directly borne by the users.

Projects whose revenue is lower than operating costs

Where a project's revenue is less than its operating costs (i.e. negative net revenue), it cannot obviously contribute to financing the project investment costs indirectly by borrowing money or attracting capital from investors. Therefore, since the objective of the funding-gap method is to identify the part of the project investment cost which cannot be financed by the project itself, for projects with negative net revenue it is not necessary to apply the funding-gap method in order to identify the contribution from the Funds. Because operating costs are not covered by revenue, an analysis of the financial sustainability is required to verify that throughout the project's time horizon there is enough cash to cover the related expenditure.

Discount Rate

The discount rate takes into account the time value of money. The actual rate is the estimate of the percentage reduction in real time value of either expenditure or income in future years. For example, if someone gives you 25 Euros today, it is worth 25 Euros to you, but if they give you 25 Euros in two years time, it does not have the same value. Inflation and simply the lost opportunity of what you could have spent it on in the time, means that it is no longer worth the same amount. Similarly, if you do not have to pay for something until two year's time, it would cost you less in real terms or would have less impact on you than if you had to pay for it today. So, if something is worth 25 Euros to you today, but next year it would be worth 23.75 Euros, than the discount rate (the rate it has lost in value) would be 5% i.e. $23.75 / 25 = 95\%$.

Net Present Value (NPV)

The value of the future income and expenditure streams **discounted** to today's values. If the net present value of the income is greater than the net present value of the expenditure it gives a positive net present value (NPV). This is the minimum that investor would require in order to be persuaded to invest. If the NPV was negative the investor would not invest. The calculation translates the future value of the investment costs less the future value of income into the net value of the overall investment, at the present day. When an investor makes an investment decision, they reduce the value of future income by a discount factor of the level of return (IRR) (interest) they would require in order to invest, so if we take 5%, today 100 Euros is worth 100 Euros, but next year it is only worth 95 Euros to me and the year after only 91 Euros. So if the level of income was the same each year, it would be worth less each year. The investor projects for this adjust income per year over the investment period. This would be totalled, together with the value of any assets remaining at the end of that period and subtracted from today's cost of investment.

Example:

- You expect to receive 100 Euros each year for the next 5 years generated by the net income (income less operating expenditure) from selling the use of a photocopier you have purchased, and the investment rate is 5%. At the end of 5 years, the current value of this is 433 Euros = $(95+91+86+82+79)$
- At the end of the period the photocopier will need to be replaced and will only have an

estimated value of 50 Euros which you can get from selling it second hand.

- In order for this investment to be worthwhile to you, your expenditure to buy the photocopier today cannot be greater than 433 Euros + 50 Euros = 483 Euros

State Aid

Article 87 of the Treaty of Rome. This restricts the level of support which the public sector can give to economic activities. It is illegal unless operating under a scheme notified and approved by the Commission, or under an approved block exemption. The definition of state aid is: A transfer of state resources to an private enterprise which gives a selective economic advantage to an private enterprise (any entity engaged in trading) which has the potential to distort competition.

Funding Gap methodology where net revenues can be estimated in advance for calculating the contribution from ERDF

Article 55 of Regulation (EC) No 1083/2006 states that revenue *reduces* the investment cost which can be considered as eligible expenditure. In other words revenue reduces proportionally the maximum eligible expenditure. In order to clarify what is meant by revenue, it is necessary to describe the funding-gap method calculation, along with its objectives and key steps. **It should be noted however that project partner from a specific participating Member State/Åland should first and foremost follow the national instructions and guidelines for revenue generation if available. However in case of absence of such a national instructions this MA Guidance may be applied.** Project developers have to consider which projects may be affected by this calculation. The activities should be segregated into:

- Projects which generate no revenue (which will not be affected)
- State Aid Projects (1083/2006, Art 55.6) must be approved under a notified State Aid scheme or block exemption (which will not be affected but must follow the rules of that scheme). Such projects will normally result in lower overall total public intervention rate (State aid rules are not applicable in the Central Baltic INTERREG IV A Programme as De Minimis rule is applied)
- Projects which may be affected by the Revenue Generating Project calculation

Complex projects may incorporate two or more of these factors. In such cases, the related costs and incomes must be segregated and treated separately.

There should be no projects where the net revenues will be negative as these projects will not be able to demonstrate that they obey the regulations on sustainability and durability of operations (1083/2006, Art 57). However, all revenue generating projects above 1 000 000 Euro budget limit should follow the Funding Gap methodology (see below) methodology. For the purposes of the calculation the following steps should be followed.

In case the project with the total budget of the project above 1 000 000 Euros has been considered potentially eligible in the Programme in pre-consultations with the JTS and there are clearly identifiable income to be generated during and/or after the implementation/completion of the project, the Funding Gap method needs to be applied. **Projects with total budget up to and below 1 000 000 Euros do not have to apply the Funding Gap method.**

First step after this is to establish the ineligible costs like the value of land over 10% of the total project costs, recoverable VAT, debt financing, retail and other rules are first removed from the eligible project to find the eligible expenditure. These will be used later in the equation.

Then the predicted costs and the predicted revenues of the project must be forecasted by amount and estimated timing of the amount. The revenues to be identified are the net operating revenues; therefore both the expected gross revenue and the expected operational costs must be identified and netted off against each other in the years in which they are predicted to take place. These costs and revenues (not affected by inflation) should be projected forward for the reference period of the project type. The Commission has issued guidelines on this which are shown in the table below:

| | |
|-----------------------|-------------|
| Energy | 15-25 years |
| Water and environment | 30 years |
| Railways | 30 years |
| Ports and airports | 25 years |
| Roads | 25-30 years |
| Industry | 10 years |
| Others | 15 years |

The project is not permitted to use arbitrary reference periods, but should follow the Commission guidelines.

The Commission specified discount rate of 5% for normal projects (4% for environment) should be used to discount both the expected costs and the expected net revenues. The residual value of the asset at the end of the reference period must be estimated and discounted at the discount rate applicable at the end of the reference period. Should it be impossible to estimate a residual value at the end of the reference period, the DG Regio Technical Branch has advised that perpetuity should be calculated. This is done by taking the net operating income in the last year of the reference period and dividing it by the appropriate discount rate. The total expenditure of the delivery phase of the scheme (i.e. including the ineligible costs) should be discounted using the same discount rates to produce a discounted total expenditure of the investment.

The total cumulative net revenue + the discounted value of the residual value of the asset at the end of the reference period should then be subtracted from the discounted total expenditure of the investment. This is the net present value of the eligible expenditure. The eligible expenditure should be divided by the net eligible expenditure to identify the Fund Gap Rate.

When determining the cumulative net revenue only the cash in-flows directly paid by users (e.g. rents, fees, tolls etc) have to be taken into account in determining the gap. Public and private contributions that do not stem from charges to the users of the service (eg. subsidies, grants or investments) are not taken into account.

Furthermore in instances where not all the investment costs are eligible for ERDF support, the net revenue must be allocated pro rata to the eligible and non-eligible parts of the investment cost. In order to determine the proportion of the net revenue that is to be taken into consideration, the discounted investment costs need to be compared with discounted eligible costs. The example to follow will give a simple indication of the overall calculation procedure.

The Funding-Gap Rate (R):

$$R = \text{Max EE/DIC}$$

where

- Max EE is the *maximum eligible expenditure* = DIC-DNR (Art. 55.2)
- DIC is the *discounted investment cost*
- DNR is the *discounted net revenue* = discounted revenues - discounted operating costs + discounted residual value

Example 1:¹

The assumed undiscounted eligible expenditure is 80 Euros and the assumed undiscounted total expenditure at the end of the project is 100 Euros in an environmental project lasting three years with 4% discount rate.

The discounted total expenditure (DIC) is 89 which is calculated as follows:

$$\text{DIC} = \frac{100}{(1,04)^3} = 88,89 \approx 89$$

In this example the assumed undiscounted revenue at the end of the project is 22,5 Euros with it's discounted Present Value 20 Euros calculated as follows the assumption being that there is a steady annual 7,2 Euro revenue stream generated during the following three years:

$$\text{Discounted Net Present Value of revenues} = \frac{22,5}{(1,04)^3} = 20,00$$

The total sum being 20 Euros as Net Present Value of the revenues.

When discounted the total expenditure is 89 Euros – 20 Euros discounted net revenue = 69 Euros
Discounted eligible expenditure

$$\text{Funding gap rate } R = \text{EE/DIC} = 69/89 = 78\%$$

This Funding gap should now be applied to the decision amount.

The so called decision amount is the real eligible expenditure (not discounted) multiplied by the Funding Gap rate

$$\text{So in this example } 80 \times 78\% = 62$$

¹ Only revenues defined as cash in-flows *directly paid by users* have to be taken into account in the determination of the funding-gap as defined in Article 55(2). Other cash in-flows must not to be included in the determination of the funding-gap although they may be considered in the analysis of the national capital profitability.

It is only this amount to which the Commission co-financing percentage should be applied. Therefore in the Programme for instance in Sweden the maximum ERDF co-financing rate would be 75%, the calculation will be:

$$62 \times 75\% = 46,5$$

Therefore, out of a total project cost of 100 Euros, only 46,5 Euros would be obtained from Structural Funds.

The costs between 100 Euros and 62 Euros are no longer eligible (either not eligible because they do not meet the Commission eligibility rules or because they are not eligible due to being net revenue) must be met by the beneficiary, in this case 38 Euros.

If it is not possible to establish future revenue streams, the Commission requires that the first five years, gross revenues (i.e. not less operating costs) after the completion of the operation to be deducted from what can be reclaimed from the Commission. **It should be noted that the new modified regulation apply to any project which generates revenue, not just capital projects and not just infrastructure projects. Any project which provides a service against payment is to be caught.**

Table below summarises the calculation procedure:

| | |
|--|-------------|
| Undiscounted total expenditure (undiscounted total eligible expenditure) | 100 (80) |
| Discounted total expenditure | 89 |
| Discounted Net Revenue | 20 |
| Discounted eligible expenditure | 89-20 |
| Funding gap rate R | 69/89=78% |
| Real eligible expenditure (decision amount) | 80*78%=62 |
| The actual ERDF amount obtained from the Programme | 62*75%=46,5 |

For these projects refund is needed if it becomes apparent that not all generated revenue has been deducted earlier.

Annex 1 provides more detailed calculation example (which is not the same as this simple one here).

Based on Regulations and as mentioned above already, projects below and up to 1 000,000 Euros do not have to follow the revenue generating project funding gap equation procedure. However the revenues generated will have to be deducted in the Central Baltic INTERREG IV A Programme either during the implementation or during the 5 year period following the final ERDF payment made to the project.

Refunding – when it has not been possible to estimate the revenues in advance or the estimated future revenues have changed

Under these circumstances, net profit must be tracked for five years after the completion of the activity directly funded by ERDF. At the end of that period, the ERDF funding rate is applied to actual net revenues generated, and must be repaid by the project. The level of grant to be repaid is calculated on the basis of recalculated Net-Revenue and ERDF subsidy. The actual revenues generated following the period of investment and for up to 5 years following completion of a project will be monitored by the MA/JTS and CA. The net revenue is then deducted from the project's eligible expenditure. The maximum amount to be deducted will be based on the relevant co-financing rate applied for the project concerned

and shall not in total exceed the ERDF contribution received by the project in question. In the following example the net-revenues are recalculated after the completion of the project:

| | |
|---|---------------------------------|
| Discounted Net Revenue recalculated | 40 |
| Discounted eligible expenditure recalculated | $89-40=49$ |
| Funding gap rate R recalculated | $49/89=55\%$ |
| Real eligible expenditure (decision amount) recalculated | $80*55\%=44$ |
| The actual ERDF amount obtained from the Programme recalculated | $44*75\%=33$ |
| A change in the eligible expenditure due to the recalculated amount of eligible expenditure | $62-44=18$ |
| "Relevant" proportional share (10% ²) of Net Revenues calculated from the original eligible expenditure | $62*10\%=6,2$ |
| Has there been relevant additional revenues in the project? Yes, because the new revenue exceeds the 10% limit value 6,2 clearly leading to recoveries by the Certifying Authority | <u>$18 > 6,2$</u> |
| The amount to be recovered is the amount which results when the actual recalculated ERDF amount obtained from the Programme is deducted from the original granted ERDF amount. | $46,5-33 = \mathbf{13,5}$ |

² "Relevant" share of Net Revenue is an approximation used to determine the acceptable level of revenues calculated from the original eligible expenditure. The 10 % level has been considered to be appropriate share in the Central Baltic INTERREG IV A Programme by MA.

Annex 1: Calculation of the Contribution from the Programme: a numerical example

Consider that the discounted investment cost of a project is equal to €100 and discounted net revenue equal to €60 so that the maximum discounted eligible expenditure is equal to €40. Consider, in addition, that the purchase of land needed to realise the project is equal to €24. Since pursuant to Article 7(1)(b) of Regulation (EC) No 1080/2006 the cost of land cannot ordinarily exceed 10% of the eligible expenditure³, then only $(0.1 * 40 =)$ €4 can be accounted as eligible cost for land and thus €20 will not be eligible cost. Pursuant to Article 55(2), because non-eligible costs are 20% of the discounted investment cost, then we should allocate 20% of net revenue to non-eligible costs and 80% of the net revenue to the eligible cost. This is done by multiplying the funding-gap by that share of the discounted investment costs which is eligible, P , that is,

$$DEE = FG * P = (100 - 60) * 0.8 = 32$$

where DEE stands for discounted eligible expenditure, that is, the amount of investment cost which multiplied by the EU co-funding rate will identify the discounted contribution from the Funds, that is,

$$DG_{EU} = 32 * 0.75 = 24$$

from which it is possible to derive the contribution from the Programme in non-discounted values as presented below.

The pro rata allocation of revenue to eligible cost is carried out by multiplying the funding-gap times the ratio of the discounted eligible cost over discounted investment cost. The resulting amount, the discounted eligible expenditure, multiplied by the co-funding rate identifies the discounted contribution from the Funds from which the related undiscounted value can be derived. Given their importance, in the next box the three key steps to calculate the funding-gap are summarised.

The Three Key Steps to Calculate the contribution from the Funds

First Step: Funding-gap

$$\max DEE = DIC - DNR = FG$$

where :

- DEE is eligible expenditure;
- FG is the funding-gap;
- DIC is discounted investment cost;
- DNR is discounted net revenue.

Second Step: Discounted Eligible Expenditure:

$$DEE = FG * P$$

³ Except for exceptional and duly justified cases concerned with operations concerning environmental conservation in case of ERDF.

where: DEE is discounted eligible expenditure;
P is percentage consistent with the ratio of discounted eligible cost over discounted investment cost.

Third Step: Contribution from the Funds

$$DG_{EU} = DEE * CR_{EU}$$

where: CR_{EU} is the EU co-funding rate
 DG_{EU} stands for discounted contribution from the Funds

The numerical example given in section above presents the calculation of the contribution from the Funds in discounted values. In order to derive the contribution from the Funds in non-discounted values, each discounted eligible expenditure has to be multiplied by $(1+r)^t$ where r stands for interest rate (recommended value of rate is 5%), and t for the year in which the related eligible expenditure occurs. Using the same example given in section above and assuming that the project has a cash-flow profile as presented in Table 1.

Table 1

| Year | Inv. costs | Disc. Inv costs | Running costs | Disc runn. costs | Revenues | Disc. Revenues | Residual value | Net cash flow | Disc. Net Cash | Eligible costs | Disc elig. costs | DEE | UDEE |
|-------------------|------------|-----------------|---------------|------------------|------------|----------------|----------------|---------------|----------------|----------------|------------------|-----------|-----------|
| 2007 | 32 | 30,48 | | | | | | 32 | -30,48 | 23 | 21,90 | 7,98 | 8,37 |
| 2008 | 25 | 22,68 | | | | | | 25 | -22,68 | 23 | 20,86 | 7,98 | 8,79 |
| 2009 | 30 | 25,92 | | | | | | 30 | -25,92 | 22 | 19,00 | 7,98 | 9,23 |
| 2010 | 25 | 20,57 | | | | | | 25 | -20,57 | 22 | 18,10 | 7,98 | 9,69 |
| 2011 | | | 2 | 1,57 | 8,5 | 6,66 | | 6,5 | 5,09 | | | | |
| 2012 | | | 2 | 1,49 | 8,5 | 6,34 | | 6,5 | 4,85 | | | | |
| 2013 | | | 2 | 1,42 | 8,5 | 6,04 | | 6,5 | 4,62 | | | | |
| 2014 | | | 2 | 1,35 | 8,5 | 5,75 | | 6,5 | 4,40 | | | | |
| 2015 | | | 2 | 1,29 | 8,5 | 5,48 | | 6,5 | 4,19 | | | | |
| 2016 | | | 2 | 1,23 | 8,5 | 5,22 | | 6,5 | 3,99 | | | | |
| 2017 | | | 2 | 1,17 | 8,5 | 4,97 | | 6,5 | 3,80 | | | | |
| 2018 | | | 2 | 1,11 | 8,5 | 4,73 | | 6,5 | 3,62 | | | | |
| 2019 | | | 2 | 1,06 | 8,5 | 4,51 | | 6,5 | 3,45 | | | | |
| 2020 | | | 2 | 1,01 | 8,5 | 4,29 | | 6,5 | 3,28 | | | | |
| 2021 | | | 2 | 0,96 | 8,5 | 4,09 | | 6,5 | 3,13 | | | | |
| 2022 | | | 2 | 0,92 | 8,5 | 3,89 | | 6,5 | 2,98 | | | | |
| 2023 | | | 2 | 0,87 | 8,5 | 3,71 | | 6,5 | 2,84 | | | | |
| 2024 | | | 2 | 0,83 | 8,5 | 3,53 | | 6,5 | 2,70 | | | | |
| 2025 | | | 2 | 0,79 | 8,5 | 3,36 | | 6,5 | 2,57 | | | | |
| 2026 | | | 2 | 0,75 | 8,5 | 3,20 | 5 | 11,5 | 4,33 | | | | |
| Total | 112 | | 32 | | 136 | | 5 | | | 90 | | 32 | 36 |
| Discounted | | 100 | | 18 | | 76 | 2 | | -39,79 | | 80 | | |

Where DEE stands for discounted eligible expenditure, UDEE stands for non-discounted eligible expenditure.

Contribution from the Programme in non-discounted value:

$$UG_{EU} = UDEE * CR_{EU} = 32 * 0.75 = 24$$

where CR_{EU} is the EU co-funding rate;

UG_{EU} stands for non-discounted contribution from the Programme.

DIC = 100
DNR = 60 (76+2-18)
MaxDEE = 40 (100-60)
DEE = 30 (40*(80/100))
DG = 24 (32*75%)
UDEE = 36 (32*((1,05)⁴))