APPLICATION OF THE FUNDING GAP METHOD IN THE PROCESS OF FINANCING REGIONAL DEVELOPMENT IN ROMANIA

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1. Introduction and legal basis

The present paper aims at analyzing the framework and the methodology for applying the funding gap method in order to determine the level of structural funds co-financing in the process of financing regional development in Romania, through the Regional Operational Programme (ROP) co-financed from the European Fund for Regional Development (ERDF).

Both in the stage of submitting the application within the ROP and further on in the implementing/post-implementing phase, the Beneficiary and the Managing Authority/Intermediate Body must be aware and must consider which projects are revenue generating projects and need to be faced with a specific calculation algorithm for determining the level of co-financing the eligible expenditure of the project.

From the very beginning, it should be clear that there is a segregation between:

- Projects which generate no revenue (which **will not be affected**);
- Projects which will definitely be State Aid (1083/2006, Art 55.6) and 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;
- Projects which may **be affected by the Revenue Generating Project calculation.**

Article 55 of Regulation (EC) No 1083/2006 (hereafter "Article 55") lays down provisions for revenue-generating projects seeking co-funding by the Funds. Its provisions specify how revenue must be taken into account in the determination of eligible expenditure for a contribution from the Funds, deductions and refunds.

Council Regulation No 1341/2008 establishes that Art 55 (1) to (4) of Regulation No 1083/2006 only refers to projects co-financed by the ERDF or the Cohesion Fund, whose total value is more than 1 million euro.

Therefore, the calculation for revenue generating projects under RB CBCP **will not apply to:**

- state aid schemes notified as such;
- projects whose total value is less than 1 million euro.

2. Identification of the revenue

In the spirit of Article 55: “For the purposes of this Regulation, a revenue-generating project means 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**.”

Article 55 of Regulation (EC) No 1083/2006 provides that revenue *reduces* the investment cost which can be considered as eligible expenditure. So it is not taken into account to identify the maximum co-funding rates of assistance, but to reduce proportionally the maximum eligible expenditure.

The objective of considering revenue in financial analysis is to define that part of the investment costs which can be financed by the project itself (through tariffs, tolls, etc.) in order to identify the part of the investment costs, if any, which needs to be financed by the public contribution (e.g. direct grants).

Not all the inflows to the project can be considered as revenue. There are 2 categories of cash inflows to the project:

A. **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;

B. **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.

Examples of cash inflows derived from charges directly paid by users which are therefore considered as revenue to the project include:

- tolls charged to drivers to use roads;
- prices or rents paid by the users to use the buildings and payments by users for other services provided by the project;
- rents for exhibitions in cultural buildings.

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, 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.

Income generating projects can be classified and approached in a different way according the possibility or not to determine the income in advance.

According to this criterion there are two main **categories,** each of them being treated distinctively by Article 55.

The possibility to estimate the revenue	Fees or tariffs	Estimated demand
It is possible to estimate the revenue ex ante – Art.55(2)	They are clearly settled by policies or economic regulations	There are models and data available Opinions are formulated based on these models
It is **not** possible to estimate the revenue ex ante – Art.55(3)	No data is available in this respect	No data is available Experts” opinions are subjective

Each of the **2 categories** can be sub-divided into **2 cases**:

▮ **Category I** – projects for which it is objectively possible to estimate the revenue in advance and they are subject to Article 55(2):

□ Case A –after the implementing of the project it is observed that there are no significant differences between the envisaged revenues and the actual revenues;

□ Case B – after the implementing of the project it is observed that there are significant differences between the envisaged revenues and the actual revenues.

▮ **Category II** - projects for which it is not objectively possible to estimate the revenue in advance and they are subject to Article 55(3):

□ Case A – the actual functioning of the investment financed from the project starts at least 5 years before the official closing date of the operational programme;

□ Case B – the actual functioning of the investment financed from the project starts less than 5 years before the official closing date of the operational programme.

3. The funding gap method

The method used to determine the contribution from the Funds to revenue-generating projects is the "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.

According to the provisions of **Article 55(2): The Funding-gap Method,** *"Eligible expenditure on revenue-generating projects shall not exceed the current value of the investment cost less the current value of the net revenue from the investment over a specific reference period for:*

(a) investments in infrastructure; or

(b) other projects where it is possible to objectively estimate the revenues in advance.

In the calculation, the managing authority shall take account of the reference period appropriate to the category of investment concerned, the category of project, the profitability normally expected of the category of investment concerned, the application of the polluter-pays principle, and, if appropriate, considerations of equity linked to the relative prosperity of the Member State concerned."

In order to correctly estimate the revenue, it is important to clarify 2 categories of items:
(a) fees or tariffs;
(b) number of users and/or the quantity of goods and services generated by the project.

The project funding gap is the difference between discounted investment costs and the discounted net revenue.

According to the first sentence of Article 55(2), eligible expenditure cannot exceed this difference.

When there is the possibility to objectively estimate the revenue in advance and the project falls under the scope of Article 55(2), and during the monitoring missions it is assessed that there are important differences between the estimated revenue and the actual revenue, the managing authority is advised to envisage mechanisms that allow the readjustment of grant calculation (the share of the eligible expenditure covered from the ERDF and the public national budget after the application of the funding gap method). Such mechanisms could consist of:

- reducing the maximul level of eligible expenditure for a certain project (when it is proved that the actual income is higher than the estimated one) and a pro rata allocation of the remaining ERDF and national contribution to other projects within the same operational programme;
- increasing the eligible value of the project (when the estimated revenue was not reached).

Neither of these mechanisms should be mistaken with the deduction and refunding mechanisms according to Article 55, paragraphs (3) and (4).

The following steps should be followed in order to calculate the contribution from ERDF for revenue generating projects under ROP.

Step 1 – Identify whether the project is revenue generating or not

Issue	Decision
The project is submitted under a notified state aid scheme	The calculation methodology for RGP will not be applied
The project total value is less than 1 million euro	The calculation methodology for RGP will not be applied
The project has cash inflows for the reference period by they are not directly paid by users (for example, there are allocations from the local municipality/council)	The calculation methodology for RGP will not be applied
The revenue of the projects is lower than their operating costs	The calculation methodology for RGP will not be applied
The only net inflow for the project is the residual value in the last year	The calculation methodology for RGP will not be applied
The total value of the project is higher than 1 million euro The projects records revenues, namely cash in-flows directly paid by users for the goods and/or services provided by the project Revenues are higher than the operating costs	The calculation methodology for RGP **will be applied**

Step 2 – Identify the net revenue to be included in the calculation

	Item	Source of data
(1)	Revenue	Revenue line from the financial analysis, part of the cost-benefit analysis.
(2)	Residual value (discounted)	The last year of the reference period – revenue line from the financial analysis
(3)	Operating costs	Operating costs line from the financial analysis, part of the cost-benefit analysis.
(4)	**Net revenue = Revenue – Operating Costs + Residual Value** **Present values are calculated with a rate of 5% within the financial analysis**	**Net income line from the financial analysis, part of the cost-benefit analysis.**

Step 3 – Calculating the funding gap

Funding gap = Present value of project investment – Net revenue

	Item	Source of data
(1)	Present value of project investment	Investment costs line from the financial analysis, part of the cost-benefit analysis.
(2)	Net revenue	Net income line from the financial analysis, part of the cost-benefit analysis. See also Step 2
(3)	**Funding gap**	**= Present value of project investment – Net revenue**

Step 4 – Calculation of the Discounted Eligible Expenditure

Discounted Eligible Expenditure = Funding gap * Ratio of eligible costs

	Item	Source of data
(1)	Funding gap	Present value of project investment – Net revenue See also Step 3
(2)	Ratio of eligible costs	= Discounted eligible cost / Discounted investment cost Eligible cost is taken from the project budget and sources of financing. Discounted investment cost is mentioned in the financial analysis.
(3)	**Discounted eligible expenditure**	**= Funding gap * Ratio of eligible costs**

Step 5 – Calculation of the contribution from ERDF and the contribution from the public national budgets

Discounted ERDF contribution = Discounted eligible expenditure * ERDF rate

	Item	Source of data
(1)	Discounted eligible expenditure	= Funding gap * Ratio of eligible costs See also Step 4
(2)	ERDF rate	It is the ERDF co-financing rate mentioned in the Guidelines
(3)	**Discounted ERDF contribution**	**= Discounted eligible expenditure * ERDF rate**

Discounted national public contribution = Discounted eligible expenditure * National contribution rate

	Item	Source of data
(1)	Discounted eligible expenditure	= Funding gap * Ratio of eligible costs See also Step 4
(2)	National contribution rate	It is the national co-financing rate mentioned in the Guidelines
(3)	**Discounted national public contribution**	**= Discounted eligible expenditure * National contribution rate**

4. Future research topics

In a future phase of this research, other issues will be dealt, related to projects for which it is not possible to estimate the revenue in advance or projects for which important differences occur between the estimated and the actual revenue. Thus, special research will be dedicated to deductions and refunding procedures applicable to revenue generating projects

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