

**Technical Guidance
on the Application of the
Standards used in the
production of National
Accounts to PFI and Similar
Transactions**

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1. Introduction

In the letter entitled “Consolidated budgeting guidance for 2009-10 (IFRS updated)” issued on 28 April 2009, HM Treasury set out the proposed changes to the budgeting rules as a result of the move to International Financial Reporting Standards (“IFRS”). As set out in that letter, the accounting and budgetary treatments in relation to PFI and similar transactions¹ will diverge from 1 April 2009:

- departmental resource accounts will follow the guidance in IFRIC 12 as amended in the Financial Reporting Manual (“FRM”); and
- departmental budgets must follow National Accounting standards, these standards are laid out in Part IV of the Manual on Government Deficit and Debt (“MGDD”)² (that provides guidance on the application of the European System of Accounts 1995 (“ESA 95”)), and the technical guidance given in this paper.

The effect of this de-coupling is that where a service concession arrangement is controlled by the public sector within the meaning of IFRIC 12, but nonetheless passes sufficient risk transfer to the private sector under the MGDD tests, dual reporting will be required. HM Treasury committed to provide supplementary technical detail on the application of the guidance contained within the MGDD to PFI and similar transactions. That guidance is contained within this paper. Appendix A contains further detail on the background to the issues that are dealt with in this paper.

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1.1 Scope of this paper

This paper is applicable to all bodies classified to the public sector by the Office for National Statistics (“ONS”), i.e. central government departments, their agencies and non-departmental public bodies, NHS Trusts and entities owned or controlled by NHS Trusts, local authorities and entities controlled by local authorities and any entities classified as public corporations.

The paper provides technical guidance on the classification of assets that underlie PFI and similar transactions in the system of National Accounts. The guidance contained within this paper is based on Part IV, 4.2 of the MGDD, “*Long term contracts between government units and non-government partners (Public-private partnerships)*”. The MGDD is issued by the European statistical agency, Eurostat, and provides guidance on the application of ESA 95.

The detailed guidance in this paper is only directly applicable where transactions are characterised as being for the provision of “*services purchased by government on the basis of dedicated assets*”, as defined within the MGDD. For practical purposes, any contract that is determined as being a service concession arrangement, such that the procuring authority must consider IFRIC 12 for the purposes of their financial statements, must also be considered under this guidance.

It is expected that the guidance will be applied to the majority of PFI and similar transactions. When considering more complex PFI type transactions any analysis will require the application of judgement, and care should be taken when applying the principles contained within this paper.

¹ Further guidance on the types of transaction covered by this guidance is contained in Section 3.1

² http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-BE-04-004/EN/KS-BE-04-004-EN.PDF

Note that certain types of transactions, specifically user-pays arrangements, are outside the direct scope of this guidance. The paper does not provide guidance on the National Accounts balance sheet classification of assets that underlie transactions that have been assessed as being leases under IFRS (i.e. in cases where the assessment does not start with the IFRIC 12 considerations the provisions of this paper do not apply). Further, this paper does not provide guidance on assessing the sector classification of an entity as either public or private sector, nor does it provide guidance on the application of other areas covered within the MGDD, for example on the treatment of securitisation operations. Section 3.1 sets out further details on scope.

2. The system of National Accounts

This section of the paper contains a brief introduction to the National Accounts and the matters that need to be considered when assessing the treatment of PFI and similar transactions within the National Accounts.

2.1 Introduction to the National Accounts

The National Accounts are a system of accounts that are used to measure, in a comparable fashion, the economic activity of an area and the activity between the sectors of the economy that operate within that area. The National Accounts are produced under the standards set out in ESA 95, which is supplemented by supporting manuals and documents, of which the MGDD forms part.

ESA 95 provides a methodology by which assets, liabilities and transactions, as well as the entities engaged in the economy, are classified. ESA 95 seeks to classify entities, transactions and assets based on their underlying economic substance and not their legal form. Whilst there are many similarities with IFRS accounting concepts as they are to be applied in the public sector, there are also some significant differences to consider.

The ONS, a Non-Ministerial Government Department, is tasked with producing the National Accounts in the UK free from political intervention. Key outputs from the system include Gross Domestic Product (“GDP”) statistics, Balance of Payments (“BoP”) statistics and the Public Sector Finances (“PSF”) statistics (the subset of the National Accounts that records levels of activity within the public sector). A summary of how the ONS make decisions is contained within Appendix B.

2.2 National Accounts and fiscal policy

As a member of the EU, the UK has certain obligations to report the activity of the public sector as measured under ESA 95 for Excessive Deficit Procedure purposes. Specifically, the Maastricht Treaty requires that EU member states maintain their general government deficit (defined as the difference between receipts and expenditures) and general government gross debt (defined as the stock of outstanding liabilities) within certain limits relative to their GDP.

In addition to its obligations under EU Treaty, the UK sets its domestic fiscal policy (i.e. the way in which the levels of public expenditure, taxes, borrowing and debt are managed) with reference to measures based on the National Accounts framework. Specifically, UK fiscal policy targets certain balances and aggregates thereof that are derived from the National Accounts and published in the PSF.

Accordingly, when considering PFI and similar transactions, public sector entities need to be mindful of the impact of their transactions on the reported fiscal position, as measured with reference to the National Accounts under the provisions of ESA 95. Further, HM Treasury needs to ensure that the budgets allocated to and reported against by public sector entities reflect the impact of PFI and similar transactions on the National Accounts.

2.3 Accounting for PFI and similar transactions within the National Accounts

When considering PFI and similar transactions within the National Accounts, the key issue to consider is whose balance sheet the assets, and associated liabilities, should be reported on for the purpose of the National Accounts. In the National Accounts it is the economic ownership of the assets that is important, not the legal ownership, nor the results of the control tests applied in the financial statements of public sector entities compiled under the Financial Reporting Manual (“FRM”). For the purposes of National Accounts, economic ownership is evidenced by the access to the risk and rewards associated with the underlying

assets. Detailed guidance on the approach to be used for assessing the National Accounts treatment is contained within Section 3.2 of this paper.

Where, for the purposes of National Accounts, assets legally owned by a private sector partner underlie a PFI, or similar transaction and those assets are judged to be on the public sector balance sheet, the treatment in the National Accounts is consistent with the treatment of a finance lease as it is recorded in financial statements. That is the cost of the public sector of acquiring that asset increases Public Sector Net Investment ("PSNI") and Public Sector Net Borrowing ("PSNB"). The finance lease liability that financed the acquisition of the asset adds to Public Sector Net Debt ("PSND"). Subsequently, depreciation on the asset, the interest charge that is recognised on the liability and the payment to the contractor for the provision of services are a cost to the current balance. The amortisation of the liability leads to a reduction in cash and liabilities with no impact on PSNB (which is not affected by financial transactions) or PSND (where the two effects net out).

Where, for the purposes of National Accounts, assets legally owned by a private sector partner underlie a PFI, or similar, transaction and those assets are judged not to be on the public sector balance sheet for the purposes of National Accounts, the treatment in the National Accounts is consistent with the treatment of an operating lease as it is recorded in financial statements. In those cases the current budget records the value of the services consumed by government.

3. Making an assessment for the purposes of the National Accounts

This section of the paper sets out the following matters:

1. The types of transaction that are within the scope of the MGDD guidance;
2. The risk and reward tests used in order to make a balance sheet determination for the purposes of the National Accounts; and
3. The steps required to reach a balance sheet determination for the purposes of the National Accounts.

3.1 Scope of the MGDD guidance

Part IV, 4.2 of the MGDD, titled “*Long term contracts between government units and non-government partners (Public-private partnerships)*” discusses the National Accounts issues raised by a number of different partnering arrangements. However, Part IV, 4.2 of the MGDD is clear that the specific guidance that it contains on assessing the balance sheet treatment of assets and associated liabilities for the purposes of the National Accounts can only be applied to one particular type of partnering arrangement, which it defines as “*services purchased by government on the basis of dedicated assets*”.

The following is an extract from the MGDD (Part IV, 4.2, section 1.2.g):

“It [services purchased by government on the basis of dedicated assets] tends to occur in areas of activity where government has a strong involvement (transport, education, health, and security). Government concludes with one or several experienced commercial partners, directly or through a special legal entity set up for the specific purpose of a PPP, a contract for the delivery of services derived from a specific asset.

“This type of contract mentions specifically-designed assets which generally need a significant initial capital expenditure (which is precisely why government uses such arrangements in many instances), and the delivery of agreed services, requiring the use of these assets and according to given quality and volume standards that are specifically defined in the contract. It is in this sense that these contracts differ from leases. The contract may refer either to a new asset or to significant refurbishment, modernisation or upgrading of existing assets, including assets already owned and managed by government but provided that the expenditure for renovation, etc., will represent a predominant part of the new value of the asset after renovation.

“A key feature of these PPPs is that government is the main purchaser of the services, through regular payments, once the assets are supplied by the partner, whether the demand originates directly from government itself or from third party users (as for health and education services, and some types of transport infrastructures). There is no need to specify a given threshold on this point. Strictly speaking, it means just above 50% but in reality this percentage tends to be much higher, generally above 90%, because most contracts refer to “typed” economic models.

“The use of the assets is specifically defined in the contract and the partner is necessarily limited as to how the assets may be used. For example, the partner cannot dispose of them at will, and in some instances, has to give priority to government users over other possible users. Note that many contracts do not rule out payments by “third parties”, but these are likely to represent a minor (even negligible) part of the partner’s revenue and frequently refer to a secondary activity associated with the dedicated assets (for instance “private” use of some infrastructure on given period or fees collected for telephone cables laid along, or under, a motorway).”

In the context of the UK, the expectation is that the majority of standardised PFI transactions, i.e. those where the private sector supplies access to an underlying asset to a public sector entity in return for fixed or variable payments that are procured under contracts based on Standardisation of PFI Contracts version 4 (March 2007) ("SoPC 4"), would meet the definition set of *services purchased by government on the basis of dedicated assets*, as set out in the MGDD.

The guidance in this paper should not be used to assess either standard, asset only, lease transactions (including leases where minimal services are provided, i.e. serviced office accommodation) or transactions where the private sector receives a significant proportion of income from third party sources. The MGDD states that strictly speaking the threshold at which significant is reached is just over 50%, although typically the types of project that will be considered as being within the scope of this paper will receive in excess of 90% of their income from selling services directly to government.

As such, except for those transactions where the end-user or other third party pays directly to access the asset, it is expected that any transaction which for the purposes of the production of an entity's financial statements needs to be assessed under IFRIC 12, also needs to be considered under the guidance contained within this paper. Note that this may necessitate an analysis of transactions that previously may not have been considered to be PFI contracts.

3.2 The risks and rewards tests required in order to make a balance sheet determination for the purposes of the National Accounts

The MGDD states that the assets that underlie PFI and similar transactions can only be considered as being off the public sector balance sheet where there is strong evidence that the private sector is bearing most of the risk and reward attached to the asset in question. It was agreed that, for the purposes of simplicity, the determination should focus on the following three main categories of risk (termed the "MGDD primary risk factors" for the purposes of this paper):

- Construction risk;
- Demand risk; and
- Availability risk.

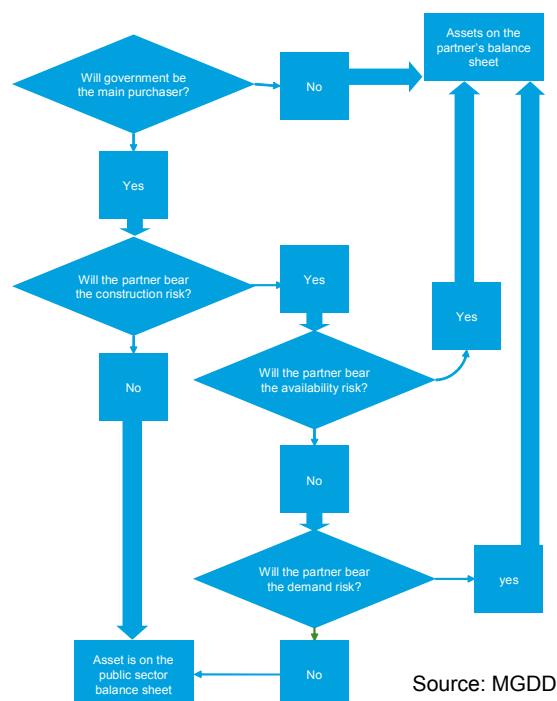
The following tests are then performed:

- If the public sector carries construction risk, the assets are viewed as being on the public sector balance sheet for the purposes of the National Accounts.
- Where the private sector holds construction risk, and one of either demand or availability risk, the assets are not considered to be on the public sector balance sheet for the purposes of National Accounts.

In certain cases, the MGDD guidance envisages that the decision on which party is bearing most of the risk attached to the asset in question may be borderline, having considered the MGDD primary risk factors. For example, this may be the case where certain risks (or elements of each risk category) are shared between the parties. The MGDD states that where, having considered the MGDD primary risk factors, the decision is borderline then other risks, and in particular residual value risk (discussed in more detail in section 3.2.6), should also be considered.

Figure 1 contains a flowchart extracted from the MGDD guidance.

Figure 1. Flowchart extracted from MGDD



When considering the National Accounts balance sheet determination it is important to understand what is meant by the term risk, what elements of a transaction are to be tested and what factors should be considered under the definition of construction, availability and demand risk.

It is also necessary to consider what, if any, impact the presence of any public sector finance in the project may mean for the allocation of risks associated with the asset and how to make a judgement in borderline cases.

3.2.1 Definition of risk, and the elements of a project to which the tests should be applied

It is important to define the concept of risk and which elements of a project the tests are applied to.

For the purposes of the MGDD guidance and this paper, the concept of risk refers to the potential deviation from expectations in an assumed plan. Therefore, when considering the allocation of risks and rewards associated with the assets that underlie PFI and similar transactions, the question of whether a party should record the underlying asset is determined by looking at the extent to which each party would bear any variations in asset (the underlying property) related profits (or losses).

It is important to note that, in common with the UK GAAP assessment previously applied, the MGDD guidance is clear that any risks associated with services that are ancillary to the asset should not be considered. This means that services that can commercially be separated from the provision of the underlying asset should be excluded from the analysis. For example, service provision that is separately negotiable or which is market tested or benchmarked at regular intervals within the contract (see Box 1).

Statistical approaches can be used to model a range of expected values for the asset related profit and losses associated with the project, in order to determine which party bears the

majority of the risks and rewards associated with the assets, having reference to the MGDD primary risk factors.

Box 1. Indicators that a contract is separable (source FREM 6.2.41)

A contract may be separable in a variety of circumstances, including but not limited to the following:

- a) the contract identifies an element of a payment stream that varies according to the availability of the property itself and another element that varies according to usage or performance of certain services;
- b) different parts of the contract run for different periods or can be terminated separately. For example, an individual service element can be terminated without affecting the continuation of the rest of the contract; or
- c) different parts of the contract can be renegotiated separately. For example, a service element is market tested and some or all of the cost increases or reductions are passed on to the grantor in such a way that the part of the payment by the grantor that relates specifically to that service can be identified.

3.2.2 Definition of the MGDD primary risk factors

The MGDD defines the primary risk factors as follows (MGDD Part IV, 4.2, section 2a):

- *“Construction risk: covers events related to the initial state of the involved asset(s). In practice it is related to events such as late delivery, non-respect of specified standards, significant additional costs, technical deficiency, and external negative effects (including environmental risk) triggering compensating payments to third parties;*
- *“Availability risk: covers cases where, during the operation of the asset, the responsibility of the partner is called upon, because of insufficient management (“bad performance”), resulting in a volume of services lower than what was commercially agreed, or in services not meeting the quality standards specified in the contract;*
- *“Demand risk: covers the variability of demand (higher or lower than expected when the contract was signed) irrespective of the performance of the private partner. In other words, a shift of demand cannot be directly linked to an inadequate quality of the services provided by the partner. Instead, it should result from other factors, such as the business cycle, new market trends, a change in final users’ preferences, or technological obsolescence. This is part of a usual “economic risk” borne by private entities in a market economy.”*

The paper now considers the MGDD primary risk factors, and their constituent parts in more detail.

3.2.3 Construction Risk

Construction risk covers the risks associated with delivering the asset in working condition. It is expected that under SOPC 4 compliant contracts, construction risk would be held by the private sector; however it is important to consider carefully whether this is actually the case before any conclusion is drawn. The key aspects of construction risk include penalties for late delivery, exposure to cost overruns and changes in relevant prices, failure to meet specified standards, initial design risk and exposure to external factors such as environmental risks.

When considering construction risks it is only risk associated with the newly created assets that should be considered. Where newly created assets are developed on existing public sector land, whilst there may be potential to transfer risks associated with the ground conditions, it is more likely that the risks associated with the existing land will remain with the

public sector. As the analysis is only concerned with the newly created assets this would not be an indicator that the public sector bears construction risk.

Where an existing asset is upgraded by the private sector it may be that some latent defect risk is retained by the public sector. Whilst this may suggest a sharing of certain aspects of the construction risk, it would not necessarily lead to the conclusion that the public sector bears significantly all of the risk associated with construction. The MGDD states “*The construction risk applies only to the new capital expenditure under the responsibility of the partner, whatever the conditions in which the asset has been transferred*”.

In cases where the private sector partner is not responsible for latent defects, and these can be clearly separated from the majority of the capital spending, then it may be concluded that the private sector does not bear construction risk. However, in cases where the latent defect risk is significant compared to the total capital spending, then this could be indicative of either a sharing of construction risk, such that other factors should be considered in addition to the MGDD primary risk tests, or it could be indicative that the public sector bears construction risk, such that the asset should be considered as being on the public sector balance sheet.

In limited circumstances, the public sector could take risks in the a project that the private sector collectively is unable to bear. For example, where the public sector bears the risks associated with unexpected exogenous events beyond the coverage of commercially available insurance then, subject to an assessment of all relevant factors, this may not lead to an assessment that the public sector carries construction risk.

3.2.4 Availability risk

Availability risk covers the risks associated with making the asset available in the required condition to deliver the services associated with the asset over the life of the arrangement, including risks associated with lifecycle maintenance. Deductions for non-availability or poor performance must be automatic and significant in order to conclude that the private sector partner holds availability risk. A cap on the amount of deductions could suggest insufficient risk transfer to the private sector. In such cases, the significance of the potential deduction compared to the overall value of the contract should be considered.

Where the private sector partner is not penalised for events that arise due to circumstances outside of its control then this may suggest that insufficient availability risk has transferred to the private sector. However, limited, specific and clearly defined exogenous events that do not lead to performance deductions, such as “force majeure” or changes in government policy or legislation that is specific to the project, would not suggest that the majority of availability risk has not been transferred to the private sector. In these cases however, it is expected that the private sector partner would bear changes in non-project specific government policy or general legislative change.

3.2.5 Demand risk

This risk covers the volume of services that the final user demands of the private sector partner. The risk covers changes in the behaviour of the final user of the assets, due to such factors as general economic factors, new market trends, direct competition or technological obsolescence. Where demand risk is shared, the significance of the relative allocations should be considered.

In circumstances where a shift in demand results from a government action that relates specifically and directly to the asset in question, for example a significant policy change or development by the public sector, or under public sector mandate, of a competing asset, then the presence of a compensation payment from government would not imply the classification, or reclassification, of the assets to the public sector. However, if such clauses exist it is expected that the private sector would bear changes in non-project specific government policy or general legislative change.

Box 2. The potential impact of financing by government

Financing of a project by the public sector has the potential to influence the allocation of risk between the parties to the transaction.. The MGDD guidance, supplemented by discussion at Eurostat's Financial Accounts Working Party in the summers of 2008 and 2009, concludes that where the public sector finances the capital costs associated with the asset (e.g. through loans, grant, milestone or bullet payments), or underpins the finance in the project, this would be indicative of insufficient risk transfer to the private sector.

Financing by government – during construction

There are two distinct scenarios to consider. Firstly, cases where a public sector body that is not directly related to the procuring authority provides finance on commercial terms, and secondly cases where the procuring authority provides finance through milestone payments or prepayments during construction. The potential impact on the allocation of risks in the project (at the overall public sector level) is judged as being the same in either scenario. .

In the first case, where a part of the public sector that is not directly related to the procuring authority provides finance on commercial terms, either in order to reduce the cost of finance to the public sector overall or as a result of turbulence in debt and credit markets, then the procuring authority is required to consider the total percentage of the finance for the project that is provided. Where it exceeds 50% the assets should be considered to be on the public sector balance sheet for the purposes of National Accounts.

In the second case, where the public sector procuring authority makes milestone payments, (i.e. a payment on partial delivery of the assets or when the contractor reaches set points in construction), this would be indicative that the public sector bears some or all of the construction risk, or that the assets are simply being purchased as they are delivered. Accordingly, the assets should be recognised on the public sector balance sheet for the purposes of National Accounts.

Where the payments during construction represent prepayments for the construction of the asset, i.e. are made in advance of the milestone being reached, then the same analysis applies. In this scenario, the public sector is effectively financing the construction of the asset, which may suggest that either construction risk is with the public sector or that the assets are actually simply being purchased by the public sector (for example if the prepayments totals significantly all of the capital spending). .

Where a bullet payment, or payments in aggregate, exceeds 50% of the cost of the assets being delivered the assets should be considered to be on the public sector balance sheet for the purposes of National Accounts. There is separate value-for-money guidance that considers the total quantum of any such payments that should be considered.

Financing by government – post construction

Where a bullet payment that is directly related to the asset is made post the construction phase this may also be indicative that the public sector is purchasing part of, or the entire asset, if the amount is substantially all of the capital value. Alternatively, a bullet payment may be characterised as a prepayment of the services to be delivered over the life of the contract. In this case it may suggest that the private sector partner does not bear the subsequent demand or availability risks associated with the asset if the public sector are unable to claw-back the monies for poor performance, or if demand is below expectation (in the case where the partner bears demand risk). If the payment can be clawed back for poor performance (or reduced demand) then this would suggest that the bullet payment does not de-risk the project from the point of view of the private sector, although the overall quantum of the payment should be considered.

In any case, should the payment total over 50% of the total cost of the assets then the assets should be recognised on the public sector balance sheet.

Guarantees and other financial underpinning

In National Accounts, the general position is that guarantees to third parties, where a call on the guarantee is considered as being remote, are classified as contingent liabilities, and as such would not be treated as an actual government liability at that point. However, where the public sector guarantees the borrowings of the partner in a PFI or similar transaction this should be taken as evidence that the partner does not bear the risks and rewards of ownership of the asset and that the assets should be recorded on the public sector balance sheet.

Guarantees may exist in many forms. Special care should be given to the consideration of termination arrangements. Where, as a result of termination, the private sector debt provider has a de-facto guarantee, either as a result of compensation arrangements in the contract, the right to 'put' debt associated with the project to the public sector, or through another route, then this should be taken as evidence that the partner does not bear the risks and rewards of ownership of the asset such that the assets should be recorded on the public sector balance sheet.

Separate rules exist for securitisations. Where the private sector partner directly securitises government flows, or the government guarantees the flows that are securitised, then it may be that the debt should be re-routed into government and would affect the risk distribution in the project, such that the asset should be considered to be on the public sector balance sheet for the purposes of National Accounts..

3.2.6 Borderline cases – residual value risk

The MGDD guidance is clear that assets can only be considered off the balance sheet of the public sector where *“there is strong evidence that the private sector is bearing most of the risk attached to the asset in question”*. As set out in section 3.2, the assessment should be undertaken with reference to the MGDD primary risk factors and an assessment of the financing of the project.

However, in cases where the MGDD primary risk tests, or elements associated with those key risk tests, are shared it may be necessary to consider other aspects of the transaction.

The MGDD states that residual value risk may be considered in these circumstances but that it should not be considered as a primary risk test; rather it should be used to provide an additional indicator of the economic ownership of the assets that underlie the project. The MGDD states:

“If the assets remain the property of the partner at the end of the project, whatever their economic value at this time, then classification on the partner’s balance sheet would have an additional justification.”

The guidance is also clear that an option for the public sector to purchase the asset at market value provides supporting evidence that the assets are not on the public sector balance sheet for the purposes of the National Accounts as the effect is that the residual value risk is with the private sector. The guidance states that where either of the following two criteria are met then recording the assets as public sector assets could be appropriate. Note however, that the criteria should only be considered if the private sector has not been demonstrated to hold the majority of the risks when the project has been assessed against the MGDD primary risk factors. The two criteria contained in the MGDD guidance are as follows:

- *“the predetermined price is obviously higher than the economic value of the assets; or*
- *“the price paid by government is lower than the economic value (or even nil) but government has already paid for the right to acquire the assets throughout the contract by making regular payments that reached a total amount very close to the full economic value of the assets.”*

When considering the second criteria, the test in IAS 17 (leases) may be considered, which seeks to compare the present value of the asset-only related cashflows to the fair value of the

asset at the beginning of the contract, using the discount rate inherent in the transaction (see the FREM for further guidance).

Note, the criteria should only be considered if the private sector has not been demonstrated to hold the majority of the risks as assessed against the MGDD primary risk factors.

3.3 The steps required to reach a determination for the purposes of the National Accounts

This section of the paper sets out the steps required in order to reach a National Accounts determination, and explains the linkage to the process undertaken for the production of the financial statements of individual public sector bodies. It is essential that this process is carried out in a rigorous and robust manner and that the analysis is clearly documented with supporting evidence. Figure 2 contains a flowchart that sets out the steps to be followed in reaching a conclusion on the National Accounts balance sheet determination.

Step 1. Is the project within scope?

As set out in section 3.1, the guidance contained within this paper is applicable to those private to public arrangements that (i) require the private sector to provide services to the public sector that require dedicated assets in order to deliver those services; and (ii) which are not directly majority funded by end-users of the assets that underlie the transaction through user charges. Therefore there are two sub-steps to consider.

Step 1(a). Is the project a contract for services that depends on the provision of dedicated assets?

For practical purposes, and as set out in section 3.1, where a procuring authority is required to consider the provisions of IFRIC 12 *Service Concession Arrangements* (as it is to be applied to the public sector grantor of a *service concession arrangement* as defined within the FREM and supplementary clarification guidance) it will be necessary to consider the guidance contained within this paper in order to make the balance sheet determination for the purposes of the National Accounts.

Step 1(b). Is the public sector procuring authority, the end-user or another third party the main purchaser of the services provided by the provision of the dedicated assets?

Having determined that the transaction is of a type that will be assessed under the provisions of IFRIC 12 for the purposes of the presentation of the financial statements (i.e. meets the definition of a service concession arrangement) and so for National Accounts purposes can be considered a contract for services based on the provision of dedicated assets, it is necessary to consider who is purchasing the services being provided.

Where the main purchaser of the services is the end-user of the asset (or another third party), for example the private motorist on a toll road, then the transaction is not directly within the scope of this guidance. In these cases public sector procuring authorities may need to consider similar issues but the project will be outside the direct scope of the guidance contained within this paper. Key issues in these cases are likely to include the sector classification of the entity engaged in the activity and the treatment of any guarantees or other financial underpinning provided by the public sector.

Where the public sector procuring authority is the main purchaser of the services provided by the private sector partner, i.e. it is not a user-pays arrangement, on the basis of the dedicated assets, the transaction continues to remain in scope.

Step 2. Having determined the transaction is within the scope of this guidance, is there strong evidence that the private sector is bearing most of the risk attached to the dedicated assets in question?

The MGDD primary risk factors should initially be assessed in a narrative fashion to establish which party to the transaction is responsible for each risk. Where the MGDD primary risk

factors provide a clear indication of the allocation of risks between the parties then there is no need to consider the transaction further and an appropriate judgement can be reached.

Where an individual risk is judged as being shared between the parties the relative significance of all aspects of the MGDD primary risk factors should be considered when deciding if, overall, it is still possible to rely on an analysis of the MGDD primary risk factors. Statistical techniques, including the use of Monte Carlo simulations, can be used to model a range of expected values for the asset related profit and losses associated with the project, in order to determine which party bears the majority of the risks and rewards associated with the assets, having reference to the MGDD primary risk factors.

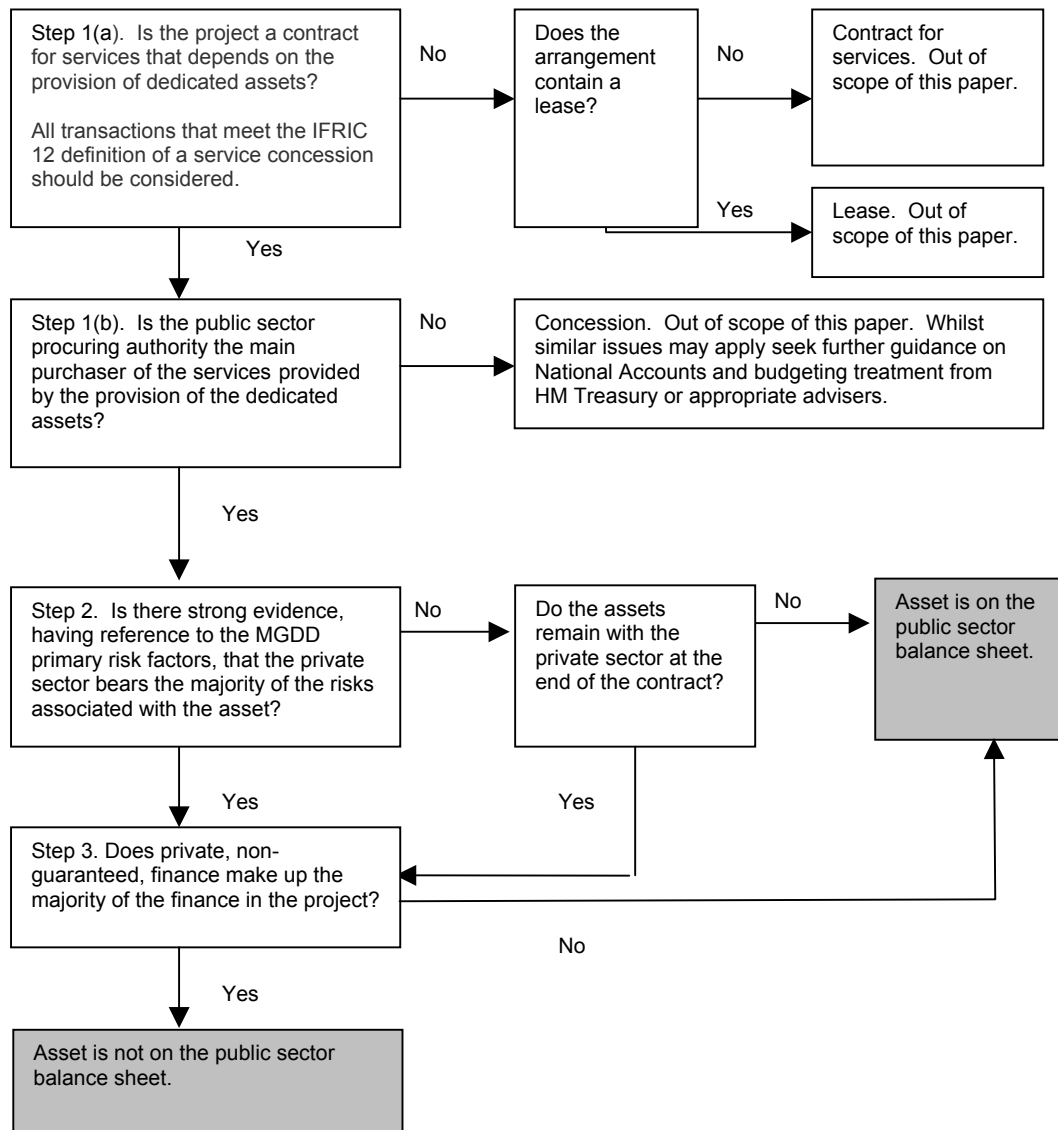
If, on the basis of the MGDD primary risk factors, it is not possible to conclude, then the presence of residual value risk should be considered.

Step 3. Are the financing arrangements consistent with the analysis?

Before concluding that a transaction is not to be accounted for on the public sector balance sheet, the financing arrangements must be examined. See boxes 2 and 3.

Once a determination has been reached, it is envisaged that it would only be necessary to review the decision if the transaction materially changes, potentially due to renegotiation of key terms of the contract or other external factors, such that the allocation of risks associated with the dedicated assets changes.

Figure 2. Process flowchart



Having concluded on the National Accounts balance sheet determination of the assets that underlie the transaction, it is necessary to consider whether the result of that assessment is such that dual reporting for the purposes of accounts and budgets is required, and this is covered in Section 4.

4. Implications for recording of the project

Having determined the balance sheet treatment for the purposes of National Accounts, consideration then needs to be given to the recording of the subsequent transactions over the life of the PFI or similar transaction. Two likely cases are distinguished:

- In those cases where the underlying assets are deemed to be on balance sheet in the financial statements under IFRIC 12 and there is insufficient risk transfer under the MGDD criteria to the private sector such that the underlying assets are considered to be on balance sheet for the purposes of National Accounts, then the treatment will be the same in both the financial statements and the National Accounts³. In these cases no special recording needs to be considered.
- Conversely, where the underlying assets are reported as being on balance sheet under IFRIC 12, but there is adequate risk transfer under the MGDD criteria such that the underlying assets are not treated as being on balance sheet for the purposes of National Accounts, then it will be necessary to maintain dual reporting. In these cases the impact on the National Accounts will be that of an operating lease, i.e. the recognition of the unitary charge as a current cost as it is incurred.

Figure 3 sets out these requirements:

	MGDD – on public sector balance sheet for the purposes of National Accounts	MGDD – off public sector balance sheet for the purposes of National Accounts
IFRIC 12 - on individual entity financial statements balance sheet	No special reporting required	Dual reporting required
IFRIC 12 - off individual entity financial statements balance sheet	Dual reporting required	No special reporting required

The records required for dual reporting will depend into which of the shaded quadrants in Figure 3 the transaction falls. Where the assets are assessed as not being on the balance sheet for the purposes of the National Accounts but on balance sheet for the purposes of the financial statements, appropriate records that deal with the assets in a way similar to other non-current assets must be maintained. The associated consequences of the transaction (depreciation, interest payable and service payments) should be separately identified. In addition, a record of the payments made to the private sector partner must be maintained for the purposes of the production of the National Accounts and departmental budgets, and reported to HM Treasury separately.

Where the assets are assessed as being on the balance sheet for the purposes of the National Accounts but off balance sheet for the purposes of the financial statements, appropriate records that deal with the assets in a way similar to other non-current assets must be maintained for the purposes of National Accounts and budgets in addition to the records held for the purposes of the production of individual entity financial statements. Further, the

³ Note that the MGDD guidance explicitly states that where the underlying asset will be recognised for National Accounts purposes then it is appropriate to recognise assets under construction during the construction phase. However, in line with general principles on the recognition of assets in the National Accounts (as set out in the MGDD also), public sector bodies will not be required to record assets under construction for the purposes of National Accounts where they can demonstrate that, in their financial statements, they are not deemed to be the economic owner of the assets until completion of the construction phase. This is on the grounds that spending should be recognised for National Accounts on an accruals basis.

associated consequences of the transaction (depreciation, interest payable and service payments) should be maintained for the purposes of the National Accounts and departmental budgets. Guidance on recording these is provided in PES 2009 (7).

4.1 Accounting for a reversionary interest in the National Accounts

Where the assets have been judged as being off the public sector balance sheet for the purposes of National Accounts, the MGDD guidance requires that public sector entities do not account for any build up of a reversionary interest, as was the case under UK GAAP. Rather, when the asset is transferred to government a capital grant is imputed from the private sector to the public sector and the proceeds of that capital grant are deemed to be used by the public sector to purchase the asset (so PSNI neutral).

Where departments are currently accounting for a reversionary interest through a reduction in the amount of unitary charge that is debited to the operating statement they should continue to do so, but no reversionary interest should be applied to projects signed after 1st April 2009 that are off balance sheet for National Accounts purposes only.

4.2 Accounting for a capital contribution in the National Accounts

Where the assets have been judged as being off the public sector balance sheet for the purposes of National Accounts, any capital contribution should be accounted for as a prepayment of future services to be delivered by the private sector. Departments should note that special rules contained within the Consolidated Budgeting Guidance apply to certain prepayments.

5. Other issues to consider

5.1 Sector classification

This paper does not give guidance on the sector classification of the partner. UK fiscal policy is based on the total public sector boundary, such that it includes not just general government, but public corporations too. The MGDD states that where the partner vehicle consists of one or several private partners that control the unit, then issues of sector classification do not arise. However, the key issue is control and it may be that due to special rights held by the public sector, the partner would be classified within the public sector. Care should be taken then when considering any special rights over the general corporate policy of the partner vehicle. Key areas to consider will include rights over dividends, use of assets (other than the asset subject to the contract) or pay and reward policies of the partner. Further guidance on sector classification can be found [HMT to add reference].

Where the public sector has rights over the corporate policies of the partner further guidance should be sought from HM Treasury.

Appendix A

Background

- Historically, the application of UK GAAP based accounting standards in the public sector has been seen to align with the approach set out in ESA 95, including for PFI and similar transactions. As a result, the ONS have used the UK GAAP based accounting determination reached under FRS 5 / TTF TN1, in assessing the assets that underlie a PFI deal for National Accounts determination and to record the subsequent impacts (except that the ONS calculate their own measure of depreciation / capital consumption).
- This practice pre-dates specific guidance from Eurostat on PFI and similar transactions, and was deemed appropriate on the grounds that ESA 95 takes a risks and rewards based approach to assessing who is owner of an asset or liability, as does the UK GAAP based approach utilised in public sector accounts until the end of 2008/09 (with the move to IFRS from 1 April 2009). In support of this approach ESA 95 Annex II concludes that when considering lease transactions the commercial accounting definitions provide an appropriate methodology for assessing whose balance sheet an asset should appear on.
- On 11 February 2004, Eurostat issued specific guidance to EU Member States (“MS”) on accounting for “public private partnership” transactions that involve “dedicated assets”, as a new Part IV (4.2) to the MGDD. The Eurostat guidance exclusively deals with the impact on government deficit and debt of certain types of projects which are deemed to be public private partnerships, which the guidance terms *services purchased by government on the basis of dedicated assets*.
- The guidance stated that the approach under GAAP (including UK GAAP) appears consistent with the substance of ESA 95 requirements and as such that national statisticians may rely on the GAAP based determination, although the guidance is clear that it is for national statisticians and not accountants to make this determination.
- Following the issuance of the Eurostat guidance, the ONS continued to use the accounting determination when making an assessment of the balance sheet classification of the assets that underlie PFI and similar transactions. This position was reached on the basis that the judgements of government and company accountants, and their independent auditors, are seen as being consistent with the Eurostat guidelines.
- Post the introduction of IFRS, the ONS can no longer use the accounting determination to assess the treatment of assets that underlie PFI and similar transactions for the purposes of the National Accounts. This is on the basis that, in contrast to the UK GAAP based approach, the control based approach required under IFRS is not deemed by the ONS to be consistent with the principles that underpin ESA 95 and the production of the National Accounts. This is on the grounds that the ESA 95 principles are based on a risks and rewards based methodology when considering which party to a PFI should account for the underlying assets and associated liabilities.
- The effect of this change is that the determination of the balance sheet classification of assets that underlie PFI and similar transactions within the financial statements of public sector entities can no longer be used when considering the impact of these types of transactions on the National Accounts and the reported fiscal position.
- The public expenditure budgeting system, as defined within the Consolidated Budgeting Guidance (“CBG”), has two stated aims. Firstly, to protect the reported fiscal position and secondly to place appropriate incentives on public sector managers. It follows that the budgeting system needs to reflect the effect that PFI

and similar transactions have on the National Accounts, which may be different to the financial accounts.

- As mentioned in the HM Treasury 24 April 2009 letter to Finance Directors [HMT to add reference], and as a result of historic reliance on the UK GAAP based determination, there is no requirement to reassess PFI and similar transactions signed prior to 1 April 2009. However, Public Sector Bodies signing PFI and similar transactions post 1 April 2009 will be required to undertake an ESA 95 based assessment both of initial recognition and subsequent transactions, alongside their IFRS assessment.
- Where there is a difference between the IFRS accounting treatment and the budgeting treatment, whether based on a UK GAAP assessment or the ESA 95 assessment, this creates the need for dual recording of projects.
- The different frameworks will interact as follows:

Framework	Leases		Service Concessions
Accounting	IAS 17	IFRIC 4	IFRIC 12 (as interpreted by the FReM)
Budgeting	IAS 17	IFRIC 4	ESA 95

The table shows that dual reporting (via the COINS database, see PES 2009 (7)) will only be required where transactions are considered to be service concessions that are controlled by the public sector within the meaning of IFRIC 12 but nonetheless pass sufficient risk to the private sector under the MGDD guidance, i.e. the ESA 95 assessment produces a different answer to the IFRIC 12 assessment with respect to the balance sheet treatment of the underlying asset.

Appendix B

Responsibility for making a National Accounts determination

- The guidance in this paper provides advice to public sector bodies who will make the determination in the first instance, having taken appropriate advice as necessary. Ultimately, any decision on the classification of transactions, assets, liabilities and entities within the system of National Accounts is for the independent ONS.
- The ONS makes classification decisions via a committee termed the National Accounts Classification Committee (“NACC”). NACC consists of a cross-section of officials from within the various constituent parts of the ONS (National Accounts, labour market statistics, etc). Decisions are signed off at an appropriate level within the ONS. Information about NACC is available on the ONS website⁴. A key reference document is the Protocol on Statistical Integration and Classification (“ONS Protocol”)⁵.
- Depending on the complexity of a case, a decision may require the sign off of the National Statistician. The ONS is an independent Non-Ministerial Department and ONS independence is seen as a key part of the Treasury’s framework for managing the public finances. Recent legislation (the Statistics and Registration Services Act 2007) has been aimed at strengthening the ONS’ independence, with the creation of the Statistics Authority to oversee the production of statistics across government.
- In order to protect the independence of the ONS, departments are asked not to seek classification decisions directly from the ONS. The standard process by which government seeks classification decisions from the ONS is set out in the ONS Protocol. Additional guidance is provided by the Treasury’s Classification Branch in the Classification Pack⁶.
- The ONS Protocol is clear that departments should, in the first instance, refer to published guidance and then if the case is not clear-cut, liaise with the Classification Branch in HM Treasury, who provide guidance and make decisions in more straightforward cases. Where a case is complex, or has the potential to be high profile or contentious, HM Treasury will ask the ONS to interpret the guidance and make a decision on the sector classification. In exceptional cases the ONS may contact Eurostat, the statistical authority of the EU, in order to seek guidance.
- The ONS Protocol is clear that the ONS is the final arbiter of decisions related to the National Accounts in the UK and that it can examine cases at any time it sees fit to do so (Annex A of the ONS protocol paragraph 10).

⁴ http://www.statistics.gov.uk/about/Methodology_by_theme/national_accounts_classifications.asp

⁵ http://www.statistics.gov.uk/about/national_statistics/cop/downloads/NSCodeofPractice2.pdf

⁶ http://www.hm-treasury.gov.uk/d/classification_pack.pdf

Appendix C

Example transactions

UK example

This is an illustrative example to aid understanding of the issues set out in this paper.

Key facts

- Sector: Healthcare provision
- Contract period: 30 years from asset commissioning
- Build phase: 2 years
- Capital cost of asset: £200 million
- Bullet payment post construction: £20 million
- Build is on an existing public site. The private sector is responsible for costs incurred as part of the new build but not costs associated with remedial works on the site, which may be required to facilitate the new build assets
- Expected useful economic life of asset: 50 years
- Assets passed to public sector at the end of 30 years, with an expected residual value of £50 million
- Private sector responsible for all maintenance, lifecycle and 'soft' services such as security, cleaning and catering
- Soft services are benchmarked every 5 years
- Contract based on SoPC4
- A separate assessment under the FReM has concluded that the assets should be recorded on the balance sheet in the financial statements on the grounds of the control based criteria contained within IFRIC 12.

The project meets the definition of a service concession for the purposes of the production of the financial statements under the FReM, and the government is the purchaser of the services being delivered. As such, it is within scope of the guidance contained within this paper on the grounds that the private sector partner is delivering services to government on the basis of dedicated assets, and the MGDD tests must be applied.

When applying the MGDD primary risk tests, the assessment concentrates on the asset related risks only. As the soft services are separable from the contract, they are not considered to be relevant to the analysis and so are excluded.

When considering construction risk, the private sector bears construction risk on the newly created assets. The fact that the public sector retains risks associated with the ground conditions is not relevant to the analysis, as the analysis focuses only on the newly created assets.

It is then necessary to consider whether the private sector bears one of demand or availability risk. In this case, the public sector is required to pay for the services so long as they are made available. As such, the public sector bears demand risk because it will be required to purchase the capacity, regardless of whether it actually requires that capacity.

When considering availability risk, the underperformance and non-availability regime set out in SoPC4 is such that availability risk lies with the private sector. This is evidenced by the fact

that if the asset is not available then the public sector will not be obliged to pay anything to the private sector.

Before concluding on the balance sheet determination for the purposes of the National Accounts, it is necessary to consider the bullet payment. In this case the bullet payment is a fixed amount that is paid post construction regardless of the actual construction cost outturn. Therefore it does not de-risk the construction phase for the private sector partner. Further, as the amount of the bullet payment is 10% of the construction costs it does not suggest that the public sector is paying for a significant amount of the asset up front and is well below the 50% threshold which, if breached, would require the assets to be accounted for as being on balance sheet for the purpose of national accounts.

When considering whether the bullet payment has the effect of de-risking the availability risk that is held by the private sector, whilst this is the case at the margin, it is not significant in the overall analysis as the private sector still bears significantly all of the availability risk. Accordingly, for the purposes of National Accounts the payment is treated as a prepayment of future service costs (see section 4.4.1). Under the current Consolidated Budgeting Guidance, the £20 million prepayment would be treated as net lending within the capital budget as it is over £20 million is long-term within the meaning of the guidance contained within the Consolidated Budgeting Guidance.

It is appropriate to conclude that the newly created assets are not on the public sector balance sheet for the purposes of the National Accounts. This contrasts to the separately performed assessment under the FR&M based guidance, which concluded that the assets should be accounted for on the balance sheet of the individual entity financial statements prepared under the FR&M.

Consequently, throughout the life of the transaction, for the purposes of National Accounts, the following should be recorded:

- Current expenditure equivalent to the sum of:
 - the cash paid under the unitary payment; plus
 - an imputed addition to the unitary payment, which represents the provision of services provided to the public sector that are financed by the amortisation of the prepayment already made by the public sector; less
 - an interest receipt, calculated as the unwinding of the discount on the prepayment.
- At the point the asset transfers to the public sector, the capital account shows:
 - imputed Gross Fixed Capital Formation (“GFCF”) representing the acquisition of the asset as a cost to PSNI, and
 - the receipt of an imputed capital grant that benefits PSNI.

For the purposes of departmental budgets, the recording follows the national accounts treatment, as follows:

- Resource DEL (near cash) shows:
 - the cash paid under the unitary payment; plus
 - an imputed addition to the unitary payment, which represents the provision of services provided to the public sector that are financed by the amortisation of the prepayment already made by the public sector; less
 - an interest receipt, calculated as the unwinding of the discount on the prepayment.
- Capital DEL shows:

- imputed GFCF representing the acquisition of the asset as a cost to Capital DEL; and
- the receipt of the imputed capital grant as a benefit to Capital DEL.

In addition, in the example above the prepayment meets the definition of large and long-term and so should be treated in the capital budget in the manner set out in the Consolidated Budgeting guidance.