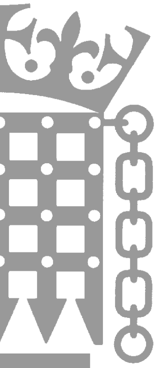

HOUSE OF LORDS

Select Committee on Economic Affairs

1st Report of Session 2009–10

Private Finance Projects and off-balance sheet debt

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Under PFI political judgement is being passed to market mechanisms and unelected officers. This is resulting in an increase in secrecy and anti-democratic procedures.

23. The decision on the type of PFI waste facility procured is being portrayed as a purely technical decision which can be taken by the private market mechanism. In fact officers are deciding on the "evaluation criteria" to be given to bidders on the basis of unprecedented political judgement (or guesswork.)

24. They must consider whether they think there might be carbon taxes in the future, whether the population will go up or down, whether the financial system will lead to more or less employment over the next 30 year period etc.

25. What they cannot do, according to the director of Coventry's PFI residual project, is stipulate a flexible and modular system capable of responding to change in waste flows and comparative costs of waste treatment. This we have been told will prevent the private bidders from participating.

26. Secrecy and lack of democratic accountability are key results of the PFI system which guards even the simplest requests for information as "commercially confidential". In contrast, under public procurement it was seen as a vital safeguard for the public to be given full and detailed access to council spending.

27. Those officers appointed to manage the PFI process have begun a new regime of secrecy. A FOI request for the amount spent on a new chimney for the present incinerator was fought for several months by officers who have so far been successful.

28. In previous years the annual right to view and copy all details of Coventry Council spending, under the Audit Commission Act, (dating back to the Poor Law Acts!) has been granted. This year they have been denied and it is not even possible to know the relative costs associated with different waste treatments being used by the council.

29. In Nottingham the PP has taken the council partner to the High Court to try to enforce a re-interpretation of this ancient right in favour of secrecy. If Veolia is successful all democratic accountability will be further obstructed.

30. The head of the PFI waste project has told the local media, Mr Daly said: "The public don't get to have a say [on the choice of technology]. That's not a public decision." (*Coventry Telegraph* 10 September 2009) This is greatly resented by residents.

Conclusion

31. hope to have drawn attention to ways in which PFI procurement interacts with financial, social and environmental factors.

32. I became aware of this House of Lords Inquiry, "Private Finance Projects and off-balance sheet debt Inquiry", only on the last day for submissions.

33. I would very much welcome the opportunity to contribute further, either in writing or person to this Inquiry.

Memorandum by Professor David Heald

Introduction

1. I am pleased to accept the Committee's invitation to give evidence and I will restrict that evidence to my own area of specialist expertise.[36] I have aligned the structure of the memorandum to the questions set out in the Committee's call for evidence (House of Lords Select Committee on Economic Affairs, 2009). A much fuller exposition of my views is available in an academic paper (Heald and Georgiou, 2009), a copy of which I have supplied to the Clerk.

[36] I am Professor of Accountancy at the University of Aberdeen Business School and specialist adviser on public expenditure and government accounting to the Treasury Committee of the House of Commons. From 1 August 2004 to 31 July 2009, I served a five-year term as a member of the Financial Reporting Advisory Board, on the nomination of the Head of the Government Economic Service as an independent economist. It is important to stress that the views expressed in this memorandum are my own and must not be attributed to any organisation.

Responses to Selected Questions

Question 6: *How should future payments by the Government under existing Private Finance contracts be recorded in public sector accounts? Is risk transfer an appropriate test? Should all such liabilities be included in the national debt? Should they be accounted for separately from government debt? How much does the public sector accounting treatment of capital and revenue aspects of projects matter?*

2. Self-evidently, this is not one question, but a batch of questions which I will address, though not in the order presented.

How much does the public sector accounting treatment of capital and revenue aspects of projects matter?

3. The accounting treatment of PFI projects is of utmost importance for the following principal reasons:

- Fiscal transparency (Heald, 2003a) will be damaged if the accounting treatment adopted by the public sector client does not reflect the economic substance of the transaction. If weaknesses in accounting regulation and/or enforcement allow capital assets to be excluded inappropriately, there will be an understatement of government borrowing and net debt. These have implications for, inter alia, fiscal sustainability and intergenerational equity.
- In circumstances where accounting arbitrage takes place (ie the choice of which standards/guidance to follow is made on the basis of securing the desired "result"), there are severe threats to Value-for-Money (VFM):
  - projects may be structured in ways that are solely designed to qualify for particular accounting treatments, and
  - those preparing the project appraisals are incentivised to manipulate the appraisal (eg exaggerate the quantified extent of risk transfer), with likely knock-on effects to other aspects of appraisal quality (Heald, 2003b).

4. It is important to emphasise that there are two different systems of accounting that are relevant to PFI: government financial reporting (since 2001-02 on modified UK GAAP but from 2009-10 on modified IFRS); and national accounts (European System of Accounts (ESA) 1995 (Eurostat 1995), supplemented by Eurostat (2004) guidance). The implications of these separate systems are discussed below.

How should future payments by the Government under existing Private Finance contracts be recorded in public sector accounts? Is risk transfer an appropriate test?

5. These two questions fit together, but require an explanation of the background to the present position. In terms of government financial reporting, the issue of balance sheet treatment arises because of the switch to accruals accounting (called Resource Accounting and Budgeting in the United Kingdom) from 2001–02. If cash accounting had been maintained, there would have been no asset or debt scoring. From its first annual report in 1997, the Financial Reporting Advisory Board (FRAB) has repeatedly expressed its dissatisfaction with PFI accounting. Evidence grew of strong incentives towards Off-Off: ie the capital asset being neither on the balance sheet of the public sector client, nor on that of the private sector operator.

6. The former incentive was driven by the control system exercised by central government: it became common knowledge in local authorities and NHS Trusts that the PFI was the "only show in town". Neither public sector funding nor approval for On-balance sheet PFI would be forthcoming. Of particular importance became the availability of arbitrage between the Accounting Standards Board's FRS5A (ASB, 1998) and the Treasury's Technical Note 1 (Revised) (Treasury Taskforce, 1999), supposedly an interpretation of FRS5A but which in effect became a competitor standard (Hodges and Mellett, 2002). The arbitrage worked through allowing the consideration of a wider range of risks that might be transferred (FRS5A emphasised demand risk and residual value risk) and through TTN1R's encouragement of quantitative analysis. There has been considerable comment, including by the National Audit Office, on how the quantified value of risk transfer frequently made PFI superior to the Public Sector Comparator (PSC) by a small margin.

7. The incentive for the private operator came from effects on the level of distributable profits of Special Purpose Vehicles (SPV) and from taxation treatment that became associated with contract debtor accounting (Austin, 2009; Heald and Georgiou, 2009). The combined effect was that many PFIs were believed to be recorded as fixed assets on the balance sheet of neither client nor operator. Whereas there might well be

differences on marginal cases between the independently taken judgements of finance directors and their respective auditors, the overall pattern provoked scepticism.[37]

8. In February 2007 it appeared as if the Treasury would withdraw TTN1R and let FRS5A determine accounting treatment for the client. However, in the March 2007 Budget, the Chancellor of the Exchequer announced that central government would adopt IFRS from 2008–09 (later changed to 2009–10). Although IFRS contains no guidance for the public sector client, IFRIC 12 (IASB, 2006), an interpretation not a standard, prescribes the treatment for the operator. The Treasury and FRAB then developed the "mirror-image treatment" of IFRIC 12 for application by the public sector client. The International Public Sector Accounting Standards Board (IPSASB) has adopted broadly the same approach in a consultation paper (IPSASB, 2008), though an Exposure Draft has not yet been published.[38] Importantly, the criterion is control, not risks and rewards. In this context, what is meant by control focuses on control over access to, and pricing of, "infrastructure" (an expansively understood term) and on control over residual value (many PFIs will revert to the public sector client about half way through their notional economic life). The move away from risks and rewards to control appears to derive from the problems that have been encountered on private sector leasing standards, with the International Accounting Standards Board (IASB) moving towards a "right-of-use" approach. It is far from clear how much difference there would be between a properly implemented risks and rewards approach and a properly implemented control approach. However, the progression has been from a very problematic history with risks and rewards, and there seems to be an element of wanting a fresh start. What the Treasury has implemented for PFI under IFRS adoption aligns with both what IASB is proposing on leases for the private sector and what IPSASB intends to propose for the public sector client of service concessions.

9. I support the mirror-image of IFRIC 12 treatment, based on control, which has been implemented for central government financial reporting in 2009–10. It is widely expected that most PFI projects will henceforth be on the balance sheet of the public sector client and remain off the balance sheet of the private sector operator. The PFI asset is thus accounted for in the same way as if it belonged to the client. Contrary to what the question wording implies, future payments under PFI contracts are not accounted for. However, good disclosure practice requires information on these to be available, as is done in aggregate in Budget Report documentation.[39]

10. National accounts treatment depends not on UK GAAP/IFRS but on ESA 95 and additional Eurostat (2004) guidance. The criterion is risks and rewards, but the Eurostat (2004) guidance interprets this in a particular way. If both (a) construction risk, and (b) either availability risk or (c) demand risk is transferred, this is sufficient to allow Off-balance sheet treatment for the client. This is a lax version of risks and rewards, which most UK PFIs by number seem likely to pass.[40] Construction risk is transferred and the normal expectation would be that availability risk is much lower than demand risk.

11. The national accounts are not affected by the 2009–10 changeover of Estimates and Resource Accounts to IFRS, with PFI accounting moving to the control criterion of IFRIC 12. National accounts remaining on a risks and rewards basis creates a problem for ONS. Under UK GAAP, the financial accounting treatment, also on risks and rewards, was accepted by ONS, in part on the basis that it did not have sufficient resources to examine the huge number of UK schemes. Realisation of the flaws in financial accounting treatment was one factor behind the work reported in Chesson and Maitland-Smith (2006), which led to more finance leases being scored as debt. When pressured by Eurostat for not literally following the Eurostat guidance, ONS could always reply that its current practices include more assets on the public sector balance sheet (and therefore more public debt) than full implementation would report. The criteria (control for financial reporting, risks and rewards for national accounts) are now more visibly different than when the issue was variants of risks and rewards. Moreover, the weakening effect of Eurostat (2004), in relation to ESA 95, mirrors the weakening effect of TTNIR relative to FRS5A. It is not easy to establish the extent to which these effects were intentional, but they have certainly occurred.

[37] This scepticism was reinforced by marked variations across departmental groupings in the proportion of PFI assets by value on the client's balance sheet as at October 2007: Department for Children, Schools and Families (0% on); Ministry of Defence (39% On); Department of Health (2% on); Ministry of Justice (93% On); and Department for Transport (88% On) (Heald and Georgiou, 2009, Table 1). These differences appear to reflect differences in control environments and audit arrangements, rather than objective differences relevant to the criterion of risks and rewards.

[38] The United Kingdom has no obligation to follow IPSASB's standards. The operating philosophy, as in Australia and New Zealand, is to minimise adaptations and interpretations of private sector IFRS.

[39] For example, see Table 2.6 of Treasury (2009a, p 35).

[40] If the strict logic of Eurostat (2004) were to be followed and many PFIs treated as off the client's balance sheet in the national accounts, the issue would arise as to whether they are then included on private sector balance sheets, contrary to the financial reporting treatment. The national accounts are an articulated set of accounts, in which all cases of Off:Off and On:On are unacceptable.

Should all such liabilities be included in the national debt? Should they be accounted for separately from government debt?

12. The United Kingdom has international obligations, as well as EU commitments, to compile the UK national accounts and debt in accordance with international guidance, however defective that may be on particular issues. Accordingly, the numbers should be produced on required methodologies and in required formats. However, there is no reason why the Treasury cannot ensure that the more accurate and relevant figures are also provided for Parliament, citizens and the media. In my view, the IFRS treatment of PFI is strongly preferable to the Eurostat treatment and more relevant to debates about VFM, fiscal sustainability and intergenerational equity. Therefore, on grounds of fiscal transparency, figures should be reported prominently on both bases.

13. The Treasury should be commended for having been one of the international pioneers of the application of accruals accounting to government. Moreover, a decision was taken in 1995 to align budgeting with accounting, a process completed for 2003–04. The logic of these developments favoured the transition from UK GAAP (which will disappear) to IFRS and that is being implemented from 2009–10. This transition has also provided "cover"' beneath which the misleading accounting for PFI could be assigned to the past. Against this record of achievement, the Treasury (2009c) has depressingly decided that budgeting for PFI will from 2009–10 be done on a national accounts basis. This decision runs counter to the Treasury's (2009b) own Alignment Project, designed to give a clearer line of sight from Spending Reviews (budgets) to Estimates to Resource Accounts. The justification advanced for this decision is that the Treasury has no choice because of obligations to follow the national accounts for purposes of fiscal rules and other fiscal reporting.[41] This is threadbare, given that IFRS is more fiscally conservative on this matter than Eurostat (2004). Moreover, the Treasury has always insisted on being able to design and operate its public expenditure framework, without interference even from other UK departments. The most plausible explanation is that PFI (inside Estimates, Resource Accounts and Whole of Government Accounts, but largely outside national accounts and debt) is expected to compensate for the sharp planned reductions in public sector net investment that are presaged in the 2009 Budget Report (Treasury, 2009a). Given the impact of the global financial crisis on UK public finances, the small "gains" that might be achieved by this subterfuge are simply not worth the damage to trust and credibility.

Question 7: *Would public sector investment in the last decade have been lower without Private Finance? If so, by how much?*

14. Both parts of this question are unanswerable on anything other than a speculative basis. The Spending Review system, which started in 1998, has operated throughout this period.[42] The level of public spending, and the amount of PFI, has been determined by the Treasury. From the perspective of an individual local authority or NHS Trust, it might feel that there would have been less investment for them if they had not opted for PFI, but that conclusion cannot necessarily be taken to the aggregate level. Over the last decade there has been a remarkable rate of growth of public expenditure and—given the emphasis put on the self-imposed sustainable investment rule—the Treasury might have considered that Off-balance sheet PFI investment, not scoring within net debt or Maastricht debt, allowed there to be more "public" investment than otherwise.

Question 10: *Is there an optimal mix between conventional procurement and Private Finance for public sector investment? What is the long run role of private finance in the delivery of infrastructure both in the UK and globally?*

15. These are complex policy questions that are difficult to answer briefly. However, I would stress the following points:

— PFI is one method of public procurement: its existence may discipline conventional procurement just as the option of conventional procurement may discipline the PFI process.

— The choice between PFI and conventional procurement (PSC) should be done on an even-handed basis at project appraisal stage and samples of chosen projects should be subjected to thorough post-audit. The criterion should be VFM, undistorted by considerations of either the accounting or budgeting systems.

[41] The Treasury may rely on a letter sent on 5 October 2007 by the Office for National Statistics to the Treasury (Kellaway, 2007), but that would be to attribute the wrong significance to that letter. The letter referred to the compatibility of IFRIC 12 to national accounts classification, not to how the Treasury should run its budgeting system after the adoption of IFRS.

[42] In the mid and late 1990s, the amount of actual PFI was reduced by the effects of the universal testing rule, whereby all public sector projects had to be assessed for PFI-ability.

— The viability of PFI relative to conventional procurement depends upon generating efficiency gains in operation, in order to offset higher financing costs, and upon the SPV having sufficient retained resources to ensure that asset condition at reversion date meets the contractual expectations of the public sector client.

— In terms of both future UK and international reliance on PFI, much depends on the capacity of public authorities to act as intelligent and effective customers and on the underlying objective of policy being to ensure that VFM is not subordinated to presentational devices that damage fiscal transparency and increase fiscal risks. The laxness of the Eurostat (2004) rules, which has provoked concern at the International Monetary Fund, indicates that the difficulties encountered by the United Kingdom may be replicated internationally.

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