ESA 10: Classification of privately funded capital projects

Briefing paper

AUDIT SCOTLAND

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Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

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Introduction

1. The Office for National Statistics' decision in July 2015 to classify the Aberdeen Western Peripheral Route project as being under public sector control has potentially significant implications for the affordability of public sector capital investment in Scotland. This briefing paper was previously provided to the Scottish Parliament's Public Audit Committee as part of its consideration of the latest Scottish Government Major Capital Projects Progress Update in October 2015. It provides background to the issue, including how the Scottish Government is responding and the impact on the delivery of capital projects.

Eurostat and ESA 10

2. Eurostat (the European statistical body) requires European Union countries to compile specified statistical returns on the basis of the European System of Accounts (ESA). From September 2014 onward, statistics have been compiled in accordance with the 2010 ESA (which replaced the 1995 ESA). Although ESA 10 was first drafted in 2010, it was only finalised in August 2014 and came into effect a month later.

3. A key development of the 2010 ESA is the inclusion of a section on Public-Private Partnerships (PPP). This, and the accompanying Manual on Government Deficit and Debt (MGDD), provides guidance on how to assess the economic ownership of an asset created through a PPP contract. This is based on the balance of risks and rewards shared between the public sector grantor and the private sector operator. Another key development is the expanded guidance in the MGDD as to what should be considered public sector control of the operators of PPP contracts.

4. These statistical returns are used to prepare Statistical National Accounts which are used by HM Treasury to inform some aspects of guidance on UK fiscal budgets. Publicly classified capital projects require HM Treasury budget cover (Capital DEL) at the point of initial investment. For privately classified capital projects, HM Treasury Resource DEL budget is required to cover the spending over the lifetime of the contract.

ONS decision and AWPR

5. The Office for National Statistics (ONS) is responsible for assessing bodies and transactions against ESA rules to decide how they should be treated in the Statistical National Accounts. The ONS has published a Workplan (latest version is dated June 2015), setting out a list of 21 transactions or bodies it is planning to review for Statistical National Accounts classification

purposes. ONS is expected to complete most of these reviews during the course of 2015, a number of which are directly or indirectly pertinent to the devolved Scottish public sector:

- The £469 million Aberdeen Western Peripheral Route (AWPR) – as a new investment project.
- The £150 million Edinburgh Children's Hospital and £213 million Dumfries and Galloway Royal Infirmary built under the Scottish Government's Non-Profit Distributing (NPD) model for PPPs – as new units.
- Glasgow Prestwick Airport – as a result of its sale to the Scottish Government.
- Revenue Scotland – as a new body.
- Miscellaneous pension schemes, including the Local Government Pension Scheme – as a result of ESA 10 and new rules on pension administrators, pension managers, pension funds and multi-employer pension schemes.
- Universities – as a result of the significant increase in student fee maxima (relevant to Scotland from the perspective of RUK student fees).

6. For revenue-financed projects the ONS uses a two stage approach to assess whether classification of the project falls to the public or to the private sector:
    - Stage 1 is referred to as the Institutional Unit Test, used to assess the relative balance of control over the procured special purpose vehicles (SPV) normally established to deliver NPD projects.
    - Stage 2 is referred to as the Asset Test, used to assess the balance of risks and rewards (as an indicator of economic ownership) from the asset established through the NPD contract.

7. If the result of the Institutional Unit Test is that the balance of control rests with the public sector, then the ONS will normally also regard the asset as public sector for Statistical National Accounts purposes. If the balance of control over the SPV rests with the private sector, or is inconclusive, then ONS uses the Asset Test separately to determine the balance of risks and rewards from the asset.

8. The ONS published the results of its assessment of the AWPR project in July 2015. The ONS noted that the operation and delivery of the project is being managed by three special purpose vehicles.[1] It considered that, due to the contractual relationships and sharing of directors between the three units, the SPVs should be considered as one institutional unit for statistical purposes. The ONS concluded that "based on the Scottish Government's influence over the collective corporate policy of the SPVs, including effective vetoes over key aspects and accruals of surpluses to the Scottish Government, the AWPR SPVs are subject to public sector control". The ONS also found that, "due to the Scottish Government's share in the

[1] The three SPVs are Aberdeen Roads Holdings Ltd, Aberdeen Roads Ltd and Aberdeen Roads Finance Ltd. Connect Roads Infrastructure Investments (a wholly owned subsidiary of Balfour Beatty Infrastructure Investments Ltd, Carillion Private Finance (transport) Ltd and Galliford Try Investment Ltd) are equal shareholders in Aberdeen Roads Holdings Ltd. Aberdeen Roads Holdings Ltd is the sole shareholder in both Aberdeen Roads Ltd and Aberdeen Roads Finance Ltd.

economic rewards associated with the asset, it was judged to have economic ownership of the AWPR asset”.

Budgetary implications

9. In order to manage key fiscal policy objectives, HM Treasury applies Statistical National Accounts classifications in its approach to public expenditure control. This means in practice that ONS decisions on classification impact on how transactions are treated within treasury budgets.

10. The Scottish Parliament authorises the Scottish Budget annually. The budget authorised by Parliament is based on the accounting measurement of transactions, providing a link between the annual accounts and budget. This means that the Scottish Government has to manage its spending against both HM Treasury controls (linked to statistical classification) and Parliamentary budget limits. The Scottish Government consolidated accounts include a reconciliation between the two budgets.

11. The ONS decision to classify the AWPR as a public project means that there will be a charge, in budgetary terms, against the Scottish Government’s Capital DEL budget. This will not result in a cash outflow but it will result in a reduction of the amount of money available for spending on other capital projects. The total charge would reflect the construction cost of the AWPR, spread over the construction period.

12. The Scottish Government has agreed contingency arrangements with HM Treasury in respect of the AWPR project. A total of £450 million of contingency was identified in 2014/15, split £150 million of Scottish Government Resource DEL arising from underspends carried forward to 2015/16 and £300 million from HM Treasury. The additional £300 million of HM Treasury cover would not be available for other uses. The 2015/16 Scottish Budget currently assumes that £150 million carried forward will be available to spend.

Attempts to mitigate

13. Discussions between the Scottish Government and ONS are still ongoing. The Scottish Government is currently working with the Scottish Futures Trust (SFT) to develop mitigation measures intended to ensure other NPD contracts are classed as private sector, to prevent charges on the Capital DEL budget. It also hopes that the ONS will review its AWPR decision if aspects of the contract are changed. This is still work in progress and it is not yet clear how successful these mitigation measures will be.

14. The hub programme is a Scotland-wide initiative for delivering new community facilities through public private partnerships. Participating public bodies, such as health boards, councils, police, and fire and rescue services, have teamed up with a private sector partner to form a joint venture company known as a hubCo in five territorial areas. Each hubCo is expected to take a strategic approach to supporting the delivery of local community services, although public bodies are not required to procure their capital projects through the local hubCo.

15. Under non-hubCo procured NPD projects, such as AWPR, normal practice is for SFT to appoint an independent Public Interest Director to the SPV's board. The principal roles of the Public Interest Director are:

- Monitoring the SPV's compliance with core NPD principles and good governance practices.
- Bringing an independent and broad view to the SPV's board.
- Bringing the SPV board's attention to opportunities for refinancing.
- Bringing the SPV board's attention to opportunities for realising cost efficiencies and other improvements in the SPV's performance.[2]

16. A further feature of these NPD projects is that the procuring authority has a "golden share" in the SPV, which carries rights to veto certain decisions of the SPV. This is a key factor in the ONS's decision-making as to whether the SPV is classed as being subject to public or private sector control. The Scottish Government and SFT are currently looking at potential changes to the organisation and role of SPVs set up to manage the AWPR, Edinburgh Children's Hospital and Dumfries and Galloway Royal Infirmary projects to lessen the degree of public sector control.

17. Notwithstanding the public classification of the SPV, the ONS also considered the Asset Test and judged the public sector's share in the rewards of the project to be too great in order for the assets to be classified to the SPV.

18. Due to the complexities involved in interpreting the ESA10 rules and MGDD guidance in the specific context of the AWPR project, the ONS has agreed to refer a number of points to Eurostat for further consideration. Until Eurostat has had a chance to respond to the points raised, the Scottish Government and SFT will not be able to submit proposals for revisions to the AWPR contract to the ONS.

19. For hubCo procured revenue financed projects, normal practice is to establish SPVs which are wholly owned by the hubCo (known as sub-hubCos). HubCos are 60 per cent owned by the private sector development partner, 30 per cent owned by the public sector participants and 10 per cent owned by the SFT and this is mirrored in the balance of control of its sub-hubCos. To reduce public sector control over these SPVs, the SFT now proposes to replace them with Design, Build, Finance and Maintain Companies (DBFM Co), which sit outside the hubCo corporate structure. The new DBFM Co reduces public sector interest in the SPV from 40 per cent to 20 per cent. Ownership of a DBFM will consist of:

- 60 per cent owned by the private sector development partner in the hub territory.
- 20 per cent owned by a newly-formed private sector charity.
- 10 per cent owned by the public sector procuring participant.
- 10 per cent owned by SFT.

[2] NPD Model Explanatory Note, Scottish Futures Trust, March 2015

20. The SFT also proposes that a majority of the DBFM Co directors will be appointed by the private sector development partner, thus ensuring the board will be under private sector control. Scottish Ministers have now approved the new DBFM delivery structure, which is intended to be applied to all hub projects signed since the introduction of ESA 10. Projects where the financial close was reached before September 2014 are unaffected. The SFT has now submitted its proposals to the ONS, which is expected to respond in November 2015.

Impact on capital projects

21. The ONS review of AWPR is having no impact on the cost or delivery of other NPD projects currently in construction. However, the uncertainty caused by the ONS review has resulted in delays in reaching financial close in a number of revenue financed projects which are being delivered through the hubCo route. The Forfar Academy and Anderson High School projects have been progressed to financial close this financial year on the basis that they will be transferred into the new DBFM structure once it is implemented. Other affected hubCo projects originally scheduled to reach financial close in the first half of 2015 include:

- Newbattle High School (Midlothian Council)
- Elgin High School (Moray Council)
- Baldragon Academy (Dundee Council)
- Kelso High School (Scottish Borders Council)
- NHS Lothian Partnership Centre Bundle (North West Edinburgh, Blackburn and Firhill Partnerships)
- Inverclyde Health Centre (NHS Greater Glasgow and Clyde).

22. A number of other hubCo projects scheduled to reach financial close in the second half of 2015 could also be affected by delays:

- Pharmaceutical Specials service (NHS Tayside) - July 2015
- Stirling Care Village (NHS Forth Valley) - July 2015
- Inverclyde Care Home (NHS Greater Glasgow & Clyde) - July 2015
- Dalbeattie Learning Campus (Dumfries & Galloway Council) - September 2015
- Kilmarnock/James Hamilton Schools (East Ayrshire Council) - September 2015
- Ayr Academy (South Ayrshire Council) - September 2015
- Campbeltown Grammar School (Argyll & Bute Council) – October 2015
- Oban High School (Argyll & Bute Council) – October 2015.[3]

23. The Scottish Government has not publicly put a cost on the delays to projects caused by the ONS review of AWPR, although it says that several of them are also affected by delays for other project-specific reasons. While SFT considers that most contractors understand the

[3] Hub Projects Pipeline, Scottish Futures Trust, June 2015

complexities involved with the situation, concerns have been expressed at the cost of plant and labour tied up in projects which could otherwise now be in the construction phase.

24. Many public sector bodies also spend some of their capital budgets on the upfront costs of hubCo revenue financed projects e.g. on site clearance work. Under the proposed new arrangements this will still be possible. However, to reduce the public sector's risk exposure on future projects, the intention is that public sector capital contributions will not be made towards funding the principal DBFM contract costs. Instead, these will be financed by the private sector and subject to annual unitary charges.

25. This is likely to result in additional costs to the public sector because the cost of borrowing to the private sector is likely to be higher than what public bodies could obtain through the Public Works Loan Board (PWLB). Assuming that the cost of this work is financed by borrowing, and private sector interest rates are one per cent more than PWLB rates, then £50 million capital spend across all of the affected projects might result in additional public sector revenue charges of around £0.5-0.75 million per annum over the 25-30 year period that unitary charges are payable.

Conclusion

26. The accounting treatment of NPD projects does not change upon classification. Such projects are treated in public sector accounts as 'on-balance sheet' capital investment and will continue to do so regardless of the ONS classification.

27. The Scottish Government recognises the risk and is taking action to mitigate this. It is currently in discussion with HM Treasury on contingency arrangements and how these will be applied in practice. The Scottish Government will need to balance the financial and governance implications of its mitigating actions. In particular, in the event that the AWPR and other NPD projects are classified as public sector, then the Scottish Government, with less capital DEL budget to spend, will face a choice of progressing fewer capital projects, or funding more through its new borrowing powers.

28. It is likely to be some time before full resolution of the situation is reached. Audit Scotland will continue to monitor developments and report as appropriate.