

North London Waste Authority

Indicative accounting treatment for the purposes of
Resource and National Accounts

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Private and confidential

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Dear Tim

Indicative accounting treatment for the purposes of Resource and National Accounting

In accordance with the terms of our Framework Agreement with the North London Waste Authority ('the Authority') dated 27 April 2007 we have prepared a report that considers the indicative accounting treatment of the Waste Services and Fuel Use Waste PFI contracts (together, 'the Project').

Background

In *HM Treasury's Consolidated Budgeting Guidance for 2009-10 (IFRS updated)*, HM Treasury sets out proposed changes to the budgeting rules to make them consistent with International Financial Reporting Standards ('IFRS').

From 1 April 2009, the accounting and budgetary treatments in relation to PFI and similar transactions will diverge. Departmental resource accounts will follow the guidance in IFRIC 12 as amended in the IFRS-based Financial Reporting Manual ('iFReM'). Departmental budgets must follow National Accounting standards, as set out in the Manual on Government Deficit and Debt ('MGDD') that provides guidance on the application of the European System of Accounts 1995 ('ESA 95'), and the guidance set out in the Draft HM Treasury Technical Guidance dated 2 September 2009 ('HMT Technical Guidance') on the Application of the Standards used in the production of National Accounts to PFI and Similar Transactions.

In accordance with the *Local Government PFI Project Support Guide (2009-2010) – 1st Revision (September 2009)*:

"Authorities should take an early view on the likely treatment, and confirm in their OBC, that the project is a service concession within the meaning of IFRIC 12 such that the provisions of IFRIC 12 need to be considered. It is good practice for the authority to seek a view from its external auditor on whether the view is reasonable".

Providing that for financial accounting purposes the transaction has the general characteristics of a service concession, then the OBC also needs to include an initial view on the likely National Accounts balance sheet treatment used for departmental budgetary purposes."

Scope of work

In this report, we provide preliminary advice in respect of the accounting treatment of the Project, and specifically the Reference Project, for the purposes of Resource and National Accounting. This analysis has been undertaken on the basis of our understanding of the Project as at November 2009, based in turn on information contained in the OBC and the draft payment mechanisms developed to date. Any significant change to the final documentation may result in a change to the analysis and the result.

The analysis in this report is general in nature and only gives a summary of the relevant pronouncements. It does not take into account the specific policies and circumstances of any public body.

The final decision on the balance sheet treatment is the responsibility of the relevant Accounting Officer in conjunction with the Authority's auditors. We therefore recommend that, in accordance with the HMT Guidance, you discuss this assessment with your auditors as soon as possible. The appropriate treatment will ultimately need to be agreed with HM Treasury and the Office of National Statistics ('ONS'). We can give no representations that HM Treasury or the ONS would agree with the analysis presented.

The analysis presented in this note is based on relevant guidance and interpretations effective at the date of this note, and we are not responsible for advising of any changes in guidance or interpretations subsequent to the date of this note. We note that the HMT Technical Guidance is draft and therefore subject to possible change before a final version is issued. Accordingly, we note that should the final version contain different requirements, or should the nature of the Reference Project change, the analysis and conclusions reached may change.

Purpose of our report and restrictions on its use

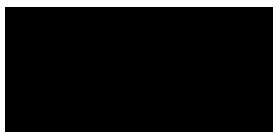
This report was prepared on your instructions solely for the purpose of the Authority and should not be relied upon for any other purpose. Because others may seek to use it for different purposes, this report should not be quoted, referred to or shown to any other parties unless so required by court order or a regulatory authority, without our prior consent in writing. In carrying out our work and preparing our paper, we have worked solely on the instructions of the Authority and for the Authority's purposes.

The paper has been prepared to assist you in considering the balance sheet treatment of the Project for the purposes of Departmental Resource Accounting and National Accounting. We note that we owe no responsibility or liability whatsoever to any party other than the Authority.

Our paper may not have considered issues relevant to any third parties. Any use such third parties may choose to make of our paper is entirely at their own risk and we shall have no responsibility whatsoever in relation to any such use. This paper should not be provided to any third parties without our prior approval and without them recognising in writing that we assume no responsibility or liability whatsoever to them in respect of the contents of our deliverables.

If you would like to clarify any aspect of this review or discuss other related matters then please do not hesitate to contact me.

Yours faithfully


Director

Ernst & Young LLP
United Kingdom

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1. Description of Project

We understand that:

- ▶ The Authority is at the Outline Business Case stage of its Waste PFI Project, and is submitting an application for PFI Credit support in December 2009 as part of its round 4 application to the Waste Infrastructure Delivery Programme ('WIDP').
- ▶ The Authority intends to let two Waste PFI contracts; the Waste Services contract will involve the provision of recycling, transfer and pre-treatment infrastructure and associated services; and the Fuel Use contract will accept and combust the fuel produced by the Waste Services contract.
- ▶ The Authority intends to make available sites to the Waste Services contractor for the provision of services, but requires bidders for the Fuel Use contract to provide suitable sites. Such sites will not necessarily be located in the Authority's administrative area, and such bidders may develop facilities to support existing industrial processes.
- ▶ In addition to the provision of new infrastructure, the Authority's intention is to transfer responsibility for an existing Energy from Waste ('EfW') facility to the Waste Services contractor to manage transition arrangements via the sale of London Waste Limited ("LWL"). We understand that such asset has limited remaining useful life and that the existing condition of the asset, residual value and decommissioning risk will lie with the Waste Services Contractor¹.
- ▶ Financial Close for each contract is anticipated in financial year 2012/13, and contract expiry is anticipated to be in 2042.
- ▶ The Authority's intention is that both contracts will follow Standardisation of PFI Contracts, and WIDP template guidance, adjusted to the minimum extent necessary to reflect project specific issues. The payment mechanism will follow the principles of the WIDP payment mechanism and transfer significant performance and availability risk to the private sector.
- ▶ The unitary charge paid by the Authority under each contract is anticipated to form the majority of the income received by the Contractor. However, it is anticipated that additional income will be generated (and used in the first instance to subsidise the value of the unitary charge) through the sale of electricity, surplus capacity, and potentially, heat.

¹ It is unclear at this stage whether the ultimate form of agreement will make the LWL assets separable from the remainder of the Waste Services contract for accounting treatment purposes. This will be a matter for judgement once contractual documentation is further developed. We understand that the Authority's current intention is to divest itself of LWL and as such to the extent that such assets are considered separable, the transaction is likely to be a straightforward disposal, outside of the scope of IFRIC12 and HM Treasury Draft Technical Guidance. Where assets are not considered separable from the Waste Services contract the guidance referred to in this paper would be expected apply to the Waste Services contract assets as a whole.

2. Treatment for the purposes of Resource Accounts

2.1 Introduction

In September 1998 the Accounting Standards Board ('ASB') produced an Application Note ('AN') for use in applying FRS 5 to PFI Transactions. Following this, the Treasury Taskforce on 24th June 1999 issued a revised Technical Note 'PFI Technical Note Number 1 (Revised)' (the Technical Note) to "provide additional practical guidance on the following areas of the AN to ensure the overarching principles of the AN are consistently applied".

The UK Government announced in March 2007 that government departments and other entities in the public sector will be required to prepare their financial statements using IFRS, adapted as necessary for the public sector. This requirement is currently expected to be effective for local authorities from 1 April 2009 for the financial year 2009/10.

IFRIC 12, issued in November 2006, provides guidance on the accounting by private sector operators for service concession arrangements that fall within the scope of IFRIC 12. However, IFRIC 12 states in paragraph 9 that it does not provide accounting guidance for public sector grantors.

HM Treasury has therefore been required to develop proposals for the accounting of such contracts by public sector bodies. It published proposals in December 2007 in the form of a discussion paper which was considered by HM Treasury's Financial Reporting Advisory Board ('FRAB') on 10 December 2007.

On 10 June 2008, following consultation, HM Treasury published guidance on *Accounting for PPP arrangements, including PFI Contracts, under IFRS* ("HMT Guidance"). This is based on IFRIC 12 *Service Concession Agreements* and has been inserted into Chapter 6 of the IFRS based Financial Reporting Manual ("iFReM"). It applies for 2009-10 and subsequent years, and the Treasury Technical Note No. 1 *How to account for PFI transactions* will be withdrawn at the same time.

In summary, the iFReM proposes that where PPP/PFI arrangements fall within the scope of IFRIC 12, the public sector body should recognise the relevant infrastructure asset on its balance sheet. The guidance is required to be applied to the 2008-09 shadow IFRS-based accounts.

The Authority's Outline Business Case anticipates financial close in the year 2012/13, and the completion of the relevant assets in the financial years 2016/17 and 2017/18. Therefore, in accordance with Ernst & Young LLP's policy of applying Government guidance in accounting for PFI transactions, the HMT Guidance has been used to review the accounting treatment for this Project.

2.2 Relevant accounting standards and pronouncements

The accounting standards and pronouncements that, in our view, are most relevant for this section of the accounting review are:

- ▶ IFRIC Interpretation 4: Determining whether an Arrangement contains a Lease ('IFRIC 4');
- ▶ IFRIC Interpretation 12: Service Concessions Arrangements ('IFRIC 12');
- ▶ International Accounting Standard 17: Leases ('IAS 17');
- ▶ HM Treasury Guidance: Chapter 6 of the IFRS-based FReM 2009-10 ('iFReM') - Accounting for PPP arrangements, including PFI contracts, under IFRS ('HMT Guidance').

2.3 General overview of balance sheet treatment methodology

The HMT Guidance, which is based on IFRIC 12, has been used to provide an initial view on the accounting treatment for this Project at pre-ISDS stage.

The assessment of the balance sheet treatment is divided into two steps:

1. the scope of IFRIC 12 and definition of the infrastructure assets; and
2. the assessment of two conditions which both have to be met for an arrangement to fall within the scope of IFRIC 12:
 - a. One condition examines which party in the PFI contract controls or regulates the services provided.
 - b. The other examines which party controls any significant residual interest in the infrastructure at termination or expiry of the arrangement.

2.4 Basic principle

The HMT Guidance proposes that where PPP/PFI arrangements fall within the scope of IFRIC 12, the public sector grantor should record the relevant infrastructure asset on its balance sheet and recognise a corresponding financial liability.

The asset should be recorded at an amount based on the same methodology as for other assets of that type. The annual Unitary Payment should be separated between an amount for services and an amount for the property. The services element should be recognised in operating expenses to reflect the services received. The property element should be split between the repayment of the financial liability (capital repayment) and an interest charge. Therefore other than an allocation between property, interest and service elements there is little judgement in the accounting once a contract is regarded as being within the scope of IFRIC 12.

If the PFI scheme does not fall within the scope of IFRIC 12, then the Authority would need to consider whether the scheme contains a lease as defined in IFRIC 4.

The decision tree provided in the HMT Guidance to assist in determining the appropriate classification is set out at Appendix A.

2.5 Scope of IFRIC 12 and Definition of Infrastructure Asset

The scope section of the HMT Guidance states that IFRIC12 applies to:

- ▶ “Arrangements where the infrastructure is used for its entire useful life;
- ▶ Infrastructure that the operator constructs or acquires from a third party; and
- ▶ Infrastructure that the grantor provides to the operator for the purpose of the concession.”

It further states that:

“To be within the scope of IFRIC 12, the service concession arrangement must contractually oblige the private sector operator to provide the services related to the infrastructure to the public on behalf of the grantor (the public sector) (IFRIC 12.3). Contracts that do not involve the transfer or creation of an infrastructure asset for the purpose of the contract fall outside the scope of IFRIC 12, as do arrangements that do not involve the delivery of services to the public⁽¹⁾.”

The HMT Guidance does not provide a definition of infrastructure assets, and the iFReM text to only includes examples of infrastructure assets, including “non-current assets used for administrative purposes in delivering services to the public”.

Section 6.2.10 of the iFReM states that the infrastructure asset usually displays one or more of the following characteristics:

- ▶ they are part of a system or network;
- ▶ they are specialised in nature and do not have alternative uses;
- ▶ they are immovable; and
- ▶ they may be subject to constraints on disposal.

2.5.1 Conclusion regarding Definition of the Infrastructure Asset

Based upon the terms of the current Reference Project and OBC, and the guidance detailed above, the new-build assets in both the Waste Services Contract and the Fuel Use contract are likely to fall within the definition of infrastructure assets.

2.6 Conditions for determination of whether a contract falls within the scope of IFRIC 12

The HMT Guidance states that where there is infrastructure, whether previously owned by the contractor or the grantor, or constructed or acquired from a third party for the purpose of the service arrangement and:

- a. the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price; and
- b. the grantor controls through beneficial entitlement or otherwise, any significant residual interest in the infrastructure at the end of the term of the arrangement (or there is no residual interest);

then the PPP arrangement or PFI contract is a service concession within the meaning of IFRIC 12 from the grantor’s viewpoint.

2.6.1 Condition a): Control of the nature of the service provided

IFRIC 12 (Application Guidance paragraph 3) notes that, in determining the applicability of the first condition, non-substantive features (such as price capping that would apply only in remote circumstances) should be ignored and the substance of the arrangement considered.

The grantor does not need to have complete control of the price: it is sufficient for the price to be regulated by the grantor, contract or regulator, for example by a capping mechanism.

At the OBC stage it is anticipated that the Waste Services contract will meet the first condition because the Authority will specify clearly in the output specification the nature of service to be delivered by the contractor, and through the fuel specification and payment mechanism will regulate the services to be provided and the price at which these are delivered on behalf of the public sector.

In respect of the Fuel Use contract, it is equally expected at the OBC stage that the contract with the operator will be regulated through an output specification, performance regime and payment mechanism with the Authority, and therefore this condition may be expected to apply equally to the Fuel Use contract.

2.6.2 Condition b): Control of any significant residual interest in the infrastructure asset at the end of the arrangement

IFRIC 12 Application Guidance 4 notes that the grantor's control over any significant residual interest should both restrict the operator's practical ability to sell or pledge the infrastructure and give the grantor a continuing right of use throughout the period of the arrangement. The residual interest in the infrastructure is the estimated current value of the infrastructure as if it were already of the age and in the condition expected at the end of the period of the arrangement.

We note that the control concept used in IFRIC 12 is not consistent with the meaning of control in other parts of IFRS. Control is generally defined throughout IFRS in terms of access to future economic benefits and the meaning of access to benefits is ignored in IFRIC 12. Control of benefits means exposure to risk which encompasses an upside element of potential gain and a downside element of exposure to loss. We would therefore suggest that the risks and rewards of ownership are part of the meaning of control under the IFRS Framework and other IFRSs. It is therefore clear that the control model used in IFRIC 12 is a different form based model to the control model used in other IFRSs. There are no clear examples or further detail in IFRIC 12 regarding the evaluation of control over significant residual value, and accordingly there are a number of areas debate as to the extent and scope of IFRIC 12 in this respect. However these revolve around the options available to the public sector body at the end of the PFI contract. In this context we provide an indicative view based on our interpretation of the current guidance.

iFRiM paragraph 6.2.29 states that where the infrastructure asset is used for its entire useful life, and there is little or no residual interest, the arrangement would fall within the scope of IFRIC 12, where the grantor controls or regulates the services as described in the first condition (see also IFRIC 12.6). Equally, the HMT Guidance states that significant residual interest will exist where the grantor is contractually required to purchase the infrastructure asset at the end of the term of the arrangement or where the contract specified that the residual interest will revert to the grantor.

At the OBC stage, it is anticipated that within both the Waste Services contract and the Fuel Use contract, the principal infrastructure assets (being the MBT and SRF combustion facilities, respectively) will have an operating life beyond the term of the PFI contracts, and therefore significant residual interest in these infrastructure assets is likely to exist. It may be considered that the remaining infrastructure (being HWRC, MRF and AD infrastructure) will be approaching the end of their respective useful lives at the end of the PFI contracts and as such will fall within IFRIC 12 on the basis of the above guidance.

It is anticipated that the MBT infrastructure supporting the Waste Services contract will be built on Authority owned sites, and as such it is reasonable to assume at this stage that the assets will revert to the Authority at the end of the concession, though in common with a number of recent Waste PFI projects, the Authority may retain an option over this course of action. On this basis, and based on our interpretation of the current guidance, it is

reasonable to assume that the public sector grantor is likely to control the residual value interest in this infrastructure.

The control over the residual interest in the Fuel Use contract is arguably less clear. The expectation in the Outline Business Case is that the infrastructure will be built on a site not owned by the Authority, and will be connected to an industrial user of energy, whose demand for the output from the Fuel Use contract will extend beyond the term of the PFI contract. However, it is likely that the Authority will wish to secure a residual interest in the infrastructure (i) to secure the whole life benefits of the infrastructure it has commissioned and paid for over the term of the PFI contract and (ii) to match the arrangements with those of the Waste Services contract to ensure continuity of service. Whilst the terms of the contract in this respect remain to be negotiated as part of the competitive dialogue process, it is reasonable to assume at this stage, that the Authority is likely to seek to retain control over the residual interest in the infrastructure.

2.7 Conclusion

Based on the OBC documentation, the scope section of the HMT Guidance and IFRIC 12, it is likely that both the Waste Services contract and Fuel Use contract are likely to fall within the scope of IFRIC 12. Accordingly, the infrastructure asset under the contracts will be accounted for on an on-balance sheet basis, providing that the Authority seeks to control any residual interest in the principal infrastructure.

To the extent that either contract fails to meet the conditions set out above, that contract will fall outside the scope of IFRIC 12, and will need to be evaluated under IFRIC 4, *Determining whether an Arrangement contains a Lease*. If, based on the IFRIC 4 assessment, it is concluded that there is an implicit lease the grantor will then have to evaluate the terms of the lease in accordance with the guidance in IAS 17 *Leases* in order to determine whether the lease will be classified as a finance lease or an operating lease. If it is concluded that the arrangement does not contain a lease, the grantor will recognise any expenditure as it falls due under the arrangement.

Any significant change to the final documentation may result in a change to the analysis and the result.

Providing that the Waste Services contract and Fuel Use contract fall within the scope of IFRIC 12, the likely National Accounts balance sheet treatment for departmental budgetary purposes needs also to be considered as part of the OBC. This analysis is detailed in the following section.

3. Treatment for the purposes of National Accounts

3.1 Relevant pronouncements

The pronouncements that, in our view, are most relevant to the accounting review in this section are:

- ▶ Part IV of the Manual of Government Deficit and Debt ("MGDD")
- ▶ HM Treasury Draft Technical Guidance on the Application of the Standards used in the production of National Accounts to PFI and Similar Transactions dated 2 September 2009 ("HMT Technical Guidance")
- ▶ HM Treasury Application Note – PPP Projects in Current Market Conditions dated 28 August 2009 (the "Application Note")

3.2 Assessment of the arrangement in accordance with the HMT Technical Guidance and the MGDD

3.2.1 Scope of the HMT Technical Guidance and the MGDD

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, it is clear that the specific guidance it contains on assessing balance sheet treatment for the purposes of National Accounts can only be applied to one type of arrangement, which it defines as "services purchased by government on the basis of dedicated assets".

Section 3.1 of the HMT Technical Guidance states that transactions where the end user or other third party pays directly to access the asset and this is a significant portion of the Contractor's income then the arrangement is outside of the scope of the HMT Technical Guidance.

On this basis and in this case (in turn based on the description of the project, set out in section 1) we would suggest that the Project appears to fall within the scope of the MGDD and HMT Technical Guidance.

3.2.2 Classification of assets

Once it is decided that the assets are in the scope of the MGDD and the HMT Technical Guidance, the key issue is the classification of the assets involved in the arrangement – either as government assets or as the Contractor's assets. The assets can be considered as non government assets only if there is strong evidence that the Contractor is bearing most of the risk attached to the specific partnership. In this context, the risk assessment should focus on the following three main categories of risk:

- a. Construction risk: covering events like late delivery, respect of specifications and additional costs
- b. Availability risk: covering volume and quality of output; and
- c. Demand risk: covering variability of demand

The assets should be classified as off balance sheet for government if both of the following conditions are met:

- a. the Contractor bears the construction risk; and
- b. the Contractor bears at least one of either availability or demand risk.

If these conditions are met the contract is treated as similar to the treatment of an operating lease in ESA 95; it would be classified as the purchase of services by government.

If the conditions are not met, the assets are to be classified as on balance sheet for the government.

In a borderline case, it is appropriate to consider other criteria, and notably what happens to the asset at the end of its life, as well as the existence of any guarantees to support the Contractor's borrowing.

3.2.3 Construction risk

Based on our understanding of the proposed arrangements for each of the Waste Services and Fuel Use contracts, it will be the Contractor and not the Authority will be exposed to construction risk.

We understand that the Authority will not be obliged to pay for the assets unless they are delivered in working order and in accordance with the agreed specifications. A requirement for the Authority to pay without taking into account the effective state of the assets that are delivered would be evidence that the Authority bears the majority of the construction risk and is acting as de facto the owner of the assets. This would also be true should the Authority be required to make payments to cover additional costs, whatever their justification. In order for the Authority to be regarded as not having the construction risk the important point is that the Authority should not be obliged to pay for any event resulting in a default in the management of the construction phase by the Contractor and it is our understanding that this is the case in respect of the WIDP draft Residual Waste Project Agreement, which we understand to be the basis for the Authority's Project Agreements for each contract.

Based on our understanding of the proposed arrangements detailed above, the Contractor and not the Authority will be exposed to construction risk in respect of the assets built under the Project Agreement.

3.2.4 Availability risk

The Authority is assumed not to bear availability risk if it is entitled to reduce significantly its periodic payments if certain performance criteria are not met. Under these conditions, the Authority's payment must depend upon the effective degree of availability ensured by the Contractor during any given period of time. The application of deductions where the Contractor is defaulting on its service obligations must be automatic and must also have a significant effect on the Contractor's revenue.

At the Outline Business Case stage, the contract payment and performance regime remains to be finalised. However, our understanding based on the draft payment mechanisms developed for each of the Waste Services and Fuel Use contracts is that the unitary charge under each contract will be subject to automatic unavailability and service performance deductions where services and assets are effectively unavailable either to accept waste or to treat it in the manner required by the contract specification. This would suggest the risk of availability risk rests with the Contractor.

3.2.5 Demand risk

The Authority is assumed to bear this risk where it is obliged to ensure a given level of payment to the operator independently of the effective level of demand. Our understanding of the proposed payments structures is that the mix of fixed payments and some variable payments in respect of usage of the assets over and above a set level indicates that demand risk is shared between the Authority and the Contractor.

3.2.6 Residual value risk

Where the primary tests discussed above 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 it should not be considered as a primary risk test. Rather it is an additional indicator of the economic ownership of the assets. Therefore although residual value risk is anticipated to rest with the Authority in respect of the Waste Services and Fuel Use contracts, this test is only relevant in circumstances where the primary risk test is considered to result in a borderline view.

3.3 Conclusion

On the basis that the Contractor and not the Authority is anticipated to be exposed to the construction and availability risk, the analysis under the MGDD would suggest that for National Accounts purposes the Project assets would be off balance sheet.

4. Implications for recording of the Project

4.1 HMT Technical Guidance

In the HMT Technical Guidance, two likely reporting scenarios are distinguished as follows:

“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 statement and the National Accounts. 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.”

The following table, taken from the HMT Technical Guidance, 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 sheets	No special reporting required	Dual reporting required
IFRIC 12 – off individual entity financial statements balance sheet	Dual reporting required	No special reporting required

4.2 Conclusion

Based on the analysis performed and the HMT Technical Guidance above, dual reporting will be required.

Appendix A

PFI Accounting Decision Tree

