ACCOUNTING TREATMENT

An off-balance sheet treatment from the position of the Authority is a fundamental requirement of the Treasury in supporting the Waste Management PFI Project. This requirement is based on the presumption that the project will be off the public sector balance sheet only when sufficient project risk has been transferred to the private sector.

No formal accounting opinion has been performed for this project to date. However, in assisting the Authority in developing its OBC, Ernst & Young has considered the issues that will impact on the final accounting opinion, which will be required from the Auditors as part of the Full Business Case.

This appendix is in regard to accounting and disclosure aspects of the project only, and does not cover other aspects such as legality or value for money. In accordance with Ernst & Young LLP's policy of applying Government guidance in accounting for PFI transactions, the revised Treasury Taskforce guidance "Private Finance Technical Note No 1 (Revised)" (the "Guidance") dated 24 June 1999 ("TN 1") on how to apply the Accounting Standards Board's Application Note F for Financial Reporting Standard 5 ("FRS 5") - "Reporting the Substance of Transactions" has been used to review the accounting treatment for this project.

The initial view at the OBC stage, after reviewing the qualitative indicators and the allocation of the key risks of the project under TN 1, is that the majority of significant risks will lie with the Contractor, indicating that the transaction is likely to be accounted for as off balance sheet from the view of Merseyside Waste Disposal Authority.

The final decision on the accounting treatment is the responsibility of the relevant Accounting Officer in conjunction with the Auditors. We therefore recommend that, in accordance with the TN, you discuss this accounting assessment with your Auditors as soon as possible.

It is important to note, however, that whilst the Accounting Standards Board has reviewed the Treasury Taskforce Guidance, and does not consider it to be inconsistent with FRS 5, it is possible that the use of other guidance, including the ASB Application Note, may result in a differing opinion to that given under the Guidance.

General overview of balance sheet treatment methodology

TN 1 has been used to provide an initial view on the accounting treatment for this project at pre-ITT stage.

The assessment of the balance sheet treatment is divided into two stages: separation of contract, and assessment of the risk allocation in respect of the property-related services.

It is important to note in the context of a balance sheet assessment that the assets in question are likely to form a relatively minor element of the project cost structure, and on recent projects have been seen to be less than 20% by NPV of the overall contract, which have essentially taken the form of service contracts. As such, we are of the view that a project of this nature is at the margins of those for which TN 1 was intended.

Basic principle

Under FRS 5 assets of an enterprise are defined as “rights or other access to future economic benefits controlled by an entity as a result of past transactions or events”. The general principle of FRS 5 is that “a party will have an asset of a property where that party has access to the benefits of the property and exposure to the risks inherent in those benefits”.

The terminology used in FRS 5 has been adopted here. The public sector body entering into the PFI contract is referred to as the “purchaser” while the private sector body is the “Contractor”. The property used for the purposes of the PFI contract, in this case the waste management assets, is referred to as the “property” with the term asset reserved for items recognised on the balance sheet.

In the case of this scheme the Authority is the “purchaser” under the contract. The property will not be deemed to be an asset of the Authority if the analysis under TN 1 demonstrates the balance of risks and rewards lie predominately with the Contractor. Under TN 1 it should be noted that it is solely the payment stream related to the property that will be reviewed for accounting treatment. Other non property-related services are non-relevant for this analysis.

Separation of contract

The first stage of the balance sheet analysis is to consider whether individual elements of the contract operate independently from each other so as to be able to identify whether there is a payment stream that relates solely to the property.

The 4Ps payment mechanism, which the Authority intends to utilise, is based on a unitary charge for the delivery of the whole service and it is anticipated that the draft performance regime will cut across all areas of the contract. Equally, it is anticipated that in all instances each component of the payment mechanism will contain both property and service elements. As such, the payment mechanism is not likely to be separable for the elements of property related services, such as recycling and energy recovery. Since it is typically considered that these service elements of the contract are relevant to the accounting analysis of the property, the Technical Note requires that the project be considered under FRS 5 criteria.

Assessment of property-related assets

Because payments for the core service will combine service and property elements under a single non-separable charge, the application of SSAP 21

"Accounting for leases and hire purchase contracts" is not relevant under these circumstances.

TN 1 identifies both qualitative and quantitative drivers for determining the accounting treatment. The initial qualitative and quantitative assessments are evaluated below. In the absence of fully developed contract documentation we consider that a detailed quantitative analysis is not possible at the OBC Stage. Rather one based on the relative importance of the key risks and their allocation is more appropriate.

Qualitative indicators

The three qualitative factors for evaluation are:

1. Termination for Contractor default;
2. Nature of Contractor's financing; and
3. Who determines the nature of the property?

Each of these factors is considered in turn below.

1. Termination for Contractor default

The draft contract documentation will closely follow the principles of the OGC/TTF guidance and will use the market value of the project as the basis for the termination sum in the event of Contractor default. This payment is reliant on a further private sector operator being willing to pay for the assets concerned; to the extent that no payment is received no payment will be made to the Contractor. Under these terms, the balance of risk rests with the Contractor and so will support an off-balance sheet opinion from the point of view of the Authority.

2. Nature of Contractor's financing

It is unclear what debt/equity funding will be used for the project by the bidders, and therefore this factor is uncertain.

3. Who determines the nature of the property?

The Contractor will be wholly responsible for all aspects of the design and will take responsibility for fulfilling the requirements of the contract. The Contractor will be required in the ITT to provide the services to the standard set out in the output specification. The key risks over the nature of the property including how it is to be operated and the cost implications and future lifecycle expenditure levels will be borne by the Contractor. This provides a preliminary indication that the property will be an asset of the Contractor.

Overall, there is strong contributory evidence from the qualitative factors at the OBC stage that the project structure will support an off balance sheet treatment. In order to provide further evidence the other factors below have been assessed and a view is provided below.

Other factors

Outlined below is a review of the risks associated with the project, which would be key when performing a quantitative analysis and the potential treatment this would indicate.

1. Demand risk

The Application Note states, “Where demand risk is significant, it will normally give the clearest evidence of who should record an asset of the property.” It is anticipated that the payment mechanism will seek a unitary payment for the delivery of all services contained in the draft contract specification. The demand for services is a function of both the volume and composition of contract waste.

a) Volume

It is anticipated that the ITT will require the Contractor to [divert] a given target percentage of waste regardless of volume. Failure to achieve the contractual target will result in a reduction in the unitary charge. It is likely that bidders will be required to specify maximum and minimum tonnage thresholds within which capacity will be provided without recourse to the contract change mechanism. Within these bands the Contractor will bear the balance of risk that increases in waste volume require further investment to achieve contractual targets or that a decrease in waste volumes results in over-investment in facilities. The application of the contract change mechanism beyond these maximum and minimum tonnage thresholds will transfer risk to the Authorityl.

Given the nature of the 4Ps payment mechanism and the likely variations of waste volumes over the contract period, and as the initial demand risk at this stage is likely to be borne by the Contractor over the most likely tonnage ranges, the majority of the demand risk is likely to be with the Contractor.

b) Composition

At this stage it is anticipated that the Contractor will be exposed to significant changes in waste composition to the extent that these influence the demand for services. An initial assessment of these demand risk elements places the balance of risk with the Contractor.

2. Third party revenue

Third party revenue risk is the risk that revenues arising from third party demand for the property will be greater or less than expected. It is expected that the draft ITT will request a guaranteed annual amount of third party revenue. The total value of guaranteed third party income is unknown at this stage, but it is envisaged that the realisation of the Contractor’s required project rate of return will be partly dependent on the generation of this guaranteed revenue, as that therefore the risk is with the Contractor.

If, however, the final level of third party revenue is insignificant this would be an indicator of a public sector asset.

3. Design risk

Design Risk is the risk that the design of the property is such that, even if it is constructed satisfactorily, it will not fully meet the requirements of the contract.

Under the ITT the Contractor will bear the risk that the design solution may result in different lifecycle, maintenance or operating cost profiles than expected. There is no link between the payment structure and changes to these costs. This gives a preliminary indication that the Contractor will bear the design risk in the project.

4. Deductions for under performance or non-availability

The Project includes a performance regime covering both the non-performance and non-availability of the property and associated services. However, the only deductions that are relevant for this analysis are those that are specific to the property. That is, any deductions that relate to failures that result in the property no longer being available for use (ie, non-availability deductions).

The terms of the deduction regime included within the ITT will transfer a significant degree of risk to the Contractor and therefore the Contractor will bear the risk of under-performance or non-availability of the property.

5. Potential changes in relevant costs

The proposed contract extends for 25 years and therefore the Contractor’s cost base will be subject to variations arising from changes in technology, and, for example, inflation of materials and labour rates. For the purposes of this initial analysis, the only relevant cost changes are those that relate specifically to the property. Therefore, changes in the cost of providing non-property related services are ignored although these will form the majority of the relevant costs.

To the extent that the Contractor retains these risks against a set payment profile, an off-balance sheet treatment would be implied. Whilst not finalised at this stage, it is anticipated that the indexation formulae included within the payment mechanism will allow for an element of the total unitary payment to be inflated at CPI. Because the unitary charge indexation will not be directly linked to variations in the Contractor’s actual costs, it is anticipated that the risk of potential changes in relevant costs, other than inflation, will be borne by the Contractor. Inflation risk will be with the purchaser.

6. Obsolescence/technological change

Given the nature of the project (waste handling and processing), the risk of obsolescence or changes in technology is significant for this project. Where this does not arise through a change in law, it is anticipated that the risk will be borne by the Contractor as the waste management system designed to meet the output specification is built around the technology solution.

Changes in environmental laws or regulations or rules governing PFI projects, all make it possible that future costs will need to be incurred relating to the property or property related services. Given the proposed 25-year life of the project, it is likely that such changes will occur at some point over the term of the contract. Under OGC / TTF guidance the balance of costs of complying

with changes in law will be borne by the Authority and therefore the Authority bears the element of this risk.

Overall, an indicative view on the risk associated with obsolescence / technological change is considered to be shared between the Contractor and the Authority.

7. Residual value

Residual value risk is the risk that the actual residual value of the property at the end of the contract will be different to that expected. Under the ASB Application Note, residual value is market value at the end of the contract.

Under the Treasury approach the definition of residual value depends on whether the property is specialised (residual value is depreciated replacement cost with potential variations for risk) or non-specialised (estimated open market value at the end of the lease ie, present value of what can be obtained by selling or leasing the asset at a market value at the end of the primary lease term). We have taken the initial view that the project property will be specialised, as there is no competing market demand from other organisations wishing to use this type of property in the locality.

It is anticipated that the draft project agreement will make provision for the Authority to notify the Contractor whether they wish the Contractor to transfer all or any of its rights, title and interests in and to the pre-agreed list of assets to the Authority or whether to re-tender the provision of the service. It is anticipated that where the assets are transferred to the Authority for a fixed or nominal sum, that the Authority will assume residual value risk over the transferred assets. However, the experience other schemes suggests that the draft project agreement is likely to make provision for a survey to be carried out on the project assets. To the extent that the survey concludes that the assets have not been adequately maintained, deductions from the unitary payment over the final 18 months of the contract may be made by the Authority. Therefore, under a regime such as this it is anticipated that residual value risk will be, in essence, shared between the Authority and Private sector.

8. Environmental Risk

The environmental risk for this project will relate mainly to the occupation and use of land and waste management facilities, whether the land and facilities belong to the Authority or are supplied by the contractor as part of his solution. In accordance with the 4Ps guidance, the risk from adverse environmental impacts from ground conditions will reside with the Contractor from commencement of services, dependant on the suitability and acceptance of the appropriate surveys.

For sites offered by the Authority for the project, it will retain the risk of dealing with any existing environmental issues. However, the Contractor will be required to accept that the environmental issues have been adequately dealt with as to not affect the contract and handback the sites to the Authority at the end of the contract in no worse condition; all additional risk associated with

complying with new environmental regulations will be covered by the specific change in law provisions in the project agreement.

For other environmental issues, the Contractor will be required to maintain the necessary leases, licences and consents to undertake the services in the contract, effectively ensuring that these risks are borne by the Contractor.

Conclusion

A summary of the relevant criteria affecting the accounting analysis for the Authority is as follows:

Key risks for accounting analysis

Key Risk	*Authority*	*Shared*	*Contractor*	*Risk Level*
Demand		✓		Low / medium
Third party revenues			✓	Medium
Design			✓	Medium
Under-performance or non-availability			✓	Medium
Changes in relevant costs (other than general inflation)			✓	High
Obsolescence/legislative change		✓		High
Residual value		✓		Medium / Low
Environmental		✓		Medium

The initial view, after reviewing the qualitative indicators and the allocation of the key risks of the project based on the OBC documentation, is that the majority of significant risks are projected to lie with the Contractor, indicating the potential to achieve an off balance-sheet view from the point of view of the Authority.

Any significant change to the final documentation may result in a change to the analysis and the result. It may also be the case that a full quantitative analysis based on the final numbers would result in a different outcome.