CUPE Canadian Union of Public Employees

Comments on The Statement of Principles for Public-Private Partnerships Proposed by the Public Sector Accounting Board (PSAB)

From the Canadian Union of Public Employees (CUPE)

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General/Introduction

We welcome the Public Sector Accounting Board (PSAB) initiative to establish public sector accounting standards for public-private partnerships (P3s). For too long, P3s have been a black hole for accountability and transparency, with generally negligible but also highly inconsistent reporting by different jurisdictions. Meanwhile, use of P3s by Canadian jurisdictions has mushroomed, driven in part by the ability of governments to shift the liabilities off their immediate balance sheets and onto future years. Data analysis of all contracts has revealed that similar types of liabilities and obligations through the UK's Private Finance Initiative (PFI) reached over £300 billion.[1] This is a massive amount of previously hidden debt/liabilities, equivalent to about C$500 billion, or almost $20,000 per UK family.

However, in Canada we have no way of knowing the magnitude of similar P3 liabilities and long-term obligations. The public may have information on the reported, and often discounted, capital cost from other sources, but there's no consistency in reporting P3s in public financial statements. We also have no knowledge of the much larger obligations associated with P3s. It is essential that legislators, policy-makers and members of the public know more to gain better knowledge of our existing and future fiscal state, but also to better inform and influence our current public policy-making.

CUPE has particular interest in this area because we are Canada's largest union, representing over 650,000 workers across Canada, including many in sectors where P3s are in operation and are being proposed, including water and wastewater, hospitals, schools, transportation and transit, recreation facilities, energy and other sectors. We are of course concerned about the impacts on our members' jobs in the short-term, but we are particularly concerned about the impact of P3s on the cost, quality and availability of public services over the longer-term. Our members not only work to provide public services, but they also depend heavily on quality public services to maintain a decent standard of living, as do all Canadians. If the funding for these is cannibalized by P3 projects whose costs are largely hidden up front, then the vast majority of Canadians will be worse off over the longer term.

It is important that governments account for future P3 costs and obligations in their financial statements. But as IMF economists Funke, Irwin and Rial explain, unless costs and obligations are reflected in the most prominent indicators of the deficit and debt, the public accounting bias in favour of P3s will remain.

> *"Public-private partnerships (PPPs) can appeal to governments because they offer a new way of providing public services that is possibly more efficient than traditional public finance. But they can also appeal to governments because they allow new investments to be undertaken without any immediate increase in reported government spending or debt. This second motive for using PPPs rests largely on an illusion, because in the absence of efficiency gains (which are probably small relative to the total cost of the project), PPPs and publicly financed projects have a similar long-run effect on public finances. In some PPPs, the government defers payment, but ultimately must still pay the full cost of the project. In others, it concedes the right to collect user fees, and thus loses revenue it would have collected if the project had been financed traditionally."*
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> *"(Public accounting rules encourage) a government under pressure to reduce its deficit or debt in the short run to use a PPP even if, in the long run, the PPP costs more than public financing. This bias in favor of PPPs can also lead governments to assume financial commitments that later prove unaffordable. …*

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[1] Dennis Campbell, James Ball and Simon Rogers, "PFI will ultimately cost £300 billion", The Guardian, 5 July 2012. https://www.theguardian.com/politics/2012/jul/05/pfi-cost-300bn https://www.theguardian.com/news/datablog/2012/jul/05/pfi-contracts-list; Yousseff El-Gingihy, "If you think there's no money for NHS funding, you'd be right—PFI has sucked it dry", The Independent, 13 July 2016. http://www.independent.co.uk/voices/nhs-funding-pfi-contracts-hospitals-debts-what-is-it-rbs-a7134881.html

To reduce the bias in favor of PPPs, governments can improve the information that is available about the future fiscal costs and risks of PPPs. …. But governments often measure their debt and deficit in more than one way, and if there is no change in the most prominent ("headline") indicators of the debt and deficit, the bias will probably remain[2]."

As they emphasize, "Ensuring that all PPP projects are properly and consistently accounted for at every stage of the fiscal cycle reduces the incentive to pursue PPPs for the wrong reasons."[3]

The authors recommend options such as a budget framework that treats P3s in budgetary accounting terms in the same way as publicly financed projects, longer term commitment budgeting that explicitly accounts for future costs, a two-stage budgeting process in which all projects must first be approved in budget planning on the assumption they will be publicly financed, and/or ceilings on the amount that can be spent on PPP projects, as a number of countries have done. Canada has one of the most active and largest markets in the world for
P3 projects, but we also have one of the weakest legislative, accountability and transparency regimes for P3s in the world.

Public accounting standards also need to apply to other operational arrangements for delivering public services beyond these more strictly-defined P3s. For example, the growing interest in and use of social impact bonds and private financing for public infrastructure through the Canada Infrastructure Bank will create growing obligations and potential contingent liabilities that should be adequately reflected in public sector financial statements. Transparent and stringent accounting standards should apply to all public or private operations that provide public services and receive public funding, regardless of their particular operational structure.

Purpose and Scope

1. The definition of P3s as outlined in **Question 1**, suggests that this Statement of Principles (SoP) would apply only to those P3s that also have a Maintenance and Operations component, in addition to Design, Build and Finance. Design Build Finance (DBF) P3 projects with a long-term financing component should also be covered by this, otherwise accounting for them could fall through the cracks.

Recognition of Infrastructure *(Questions 2 and 3)*

2. **Question 1**: This statement of principles of course focuses on public-private partnerships as defined with an infrastructure, or tangible capital asset component. However, public sector accounting standards should also ensure that the liabilities associated with emerging forms of delivery of public services with private finance, such as social impact bonds and other payment-by-results schemes, are adequately reflected in public sector financial statements.
3. In relation to **Question 3** – clarifying the control guidance in ASSETS, PS 3210 – **Principle 1** provides a reasonable definition of many *existing* P3s. However, there may be considerable uncertainty over what is considered "significant residual interest." Would this cover project partnerships where the public sector entity has a less than 50% residual interest, as with the proposed Réseau électrique métropolitain? What about when multiple public sector entities have interests that constitute minority interests on their own, but a significant or majority interest together? Would right of first refusal and options to purchase at the end of a term be interpreted as potential or some degree of control? We think a broad approach should be taken to the question of the public sector's residual interest.

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[2] Funke, K., T. Irwin and I. Rial (2013), "Budgeting and Reporting for Public-Private Partnerships", *International Transport Forum Discussion Papers*, No. 2013/07, OECD Publishing, Paris. /www.itf-oecd.org/sites/default/files/docs/dp201307.pdf

[3] Ibid, page 16.

Even when the public sector has a minority or very small share in public infrastructure ownership, it will still ultimately bear a majority of the risk in instances of failure or abandonment by the private operator because there's an implicit guarantee the responsible level of government will ensure the public infrastructure continues to function. We also want to minimize the possibility that infrastructure projects adopt increased levels of private ownership in order to evade P3 reporting requirements. The relevant International Public Sector Accounting Standards (IPSAS 32) also apply to assets that are used in a service concession arrangement for its entire useful life ("a whole of life asset") if the other conditions (control of purpose and use and access and price) in Principle 1 are met[4]. Under IPSAS 32 the determination of whether a P3 asset and related liabilities are counted on the government's balance sheet is based on a risk and rewards approach, which has led to different and applications of this. However, because virtually all P3 projects are developed and operated through Special Purpose Vehicle (SPV) corporate structures, with limited liability and relatively minor equity stakes, the ultimate risks for ensuring the infrastructure and associated public services continue to operate always remains with the public entity.

Recognition of Liability *(Questions 4 – 6)*

4. **Question 4.** A liability should be entered when a public entity has an obligation to deliver cash, another financial asset, or other rights including non-financial considerations for building, acquisition, improvement or refurbishment of infrastructure. The obligations associated with other private finance schemes that don't involve a residual interest in infrastructure, such as social impact bonds, should also be reflected in public sector financial statements.

5. **Question 5.** Yes, we agree that a liability should be recognized for the unsatisfied portion of the performance obligation when the right to charge users or earn revenue is the consideration transferred for the building, acquisition, improvement, refurbishment maintenance or operation of infrastructure. Foregoing this future potential revenue is an opportunity cost for the public sector.

6. **Question 6.** Valuing tangible public assets at cost or for a nominal amount in the case of crown land not only reflects a significant discrepancy with private sector accounting practices, but also provides a significant incentive for public entities to sell off public assets and privatize public infrastructure and services, often largely driven by these differences in accounting rules between public and private sectors. The relevant International Public Sector Accounting Standards specifies that service concessions be measured at their fair value and so it also makes sense that any infrastructure, property, plant or equipment also be measured at their fair value.[5]

   These inconsistencies in accounting treatments not only mean that public sector financial and fiscal statements often don't present an accurate picture of changes in the real financial situation of public entities, but more disturbingly often result in poor policy decisions undertaken for short-term political reasons that lead to negative longer-term financial consequences and cost the public more. Accounting standards should provide a comprehensive, transparent, and consistent representation of the financial situation in order to support good policy decisions. They shouldn't provide an incentive for substantive and often negative policy changes to be undertaken largely because of differences in these accounting standards.

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[4] International Public Sector Accounting Standards "IPSAS 32—SERVICE CONCESSION ARRANGEMENTS: GRANTOR", paragraph 9. http://www.ifac.org/system/files/publications/files/B8%20IPSAS_32.pdf

[5] See IPSAS 32, op cit, paragraph 11. IPSAS 17 provides the following definition: "Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." IPSAS 17—PROPERTY, PLANT AND EQUIPMENT, https://www.ifac.org/system/files/publications/files/ipsas-17-property-plant-2.pdf

Initial Measurement *(Questions 7 – 10)*

7. **Question 7.** As discussed above in relation to Question #6, the valuation of tangible capital assets at cost less depreciation in public sector accounts results in an imbalance with private sector accounting and unfortunately can create significant incentive for privatization of these assets and for the use of public-private partnerships, substantially driven by these differences in accounting standards. The UK has already moved substantially forward with valuation of property, plant and equipment including land and buildings at their current values in existing uses and at market values. This review is an important opportunity for the PSAB and Canadian jurisdictions to also move forward on this. If we don't start to move forward in these areas now, then we'll fall even further behind in these areas of accounting standards.

8. **Question 8.** As stated above, existing infrastructure should be measured at fair market value rather than historical or carrying costs, less impairments plus costs associated with improvement or refurbishments.

9. **Question 9.** There are very significant differences in the discount rates used by different jurisdictions, which reflect fundamentally different conceptual (and in some sense ideological or political) approaches. We think that the appropriate discount rate to use is the public entity's long-term cost of borrowing and that section .61 should be replaced with *"the discount rate should be based on appropriate public sector borrowing costs."* . Not only does this represent the public entitiy's actual cost of borrowing (and so the opportunity cost for these funds), but it is directly observable in the market. Using this as the discount rate then also requires proposed P3 projects to explicitly calculate and account for supposedly risk transfers. While these aren't generally made public as they should be, at least we can be assured that they are subject to review by auditors. Assuming that the private sector weighted average cost of capital for a particular project appropriately reflects risk transfers involves an enormous and unwarranted leap of faith about the efficiency of these markets[6]. However, if PSAB is not prepared to recommend that the appropriate public sector borrowing costs be used as the discount rate, public sector entities should also be required to report the nominal contractual cash flows and equivalents (in the case of non-financial considerations), as the UK and Portugal have done, and as is recommended by IMF experts[7].

   Market and project-based discount rates will vary from project to project and over time, which add another layer of calculation, potential confusion and opacity to financial statements. It is far more transparent, simple and consistent over time and between projects to report actual contractual cash flows and equivalents. These can be supplemented with a calculation of discounted and present values, but in those instances, the public entity should report on the discount rates applied, as proposed in Principle 7. This would serve to improve the representation of the actual transaction and provide greater clarity and transparency to the public and decision-makers.

Subsequent Measurement *(Questions 10 -11)*

10. **Question 10.** It appears to make sense to recognize the value of non-financial considerations, including the right to earn revenue, as revenue when the performance obligation is satisfied.

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6 Especially given that a few large firms dominate the market for P3s in Canadian jurisdictions. See Office of the Auditor General of Ontario, "Infrastructure Ontario—Alternative Financing and Procurement", Chapter 3.05 in 2014 Annual Report, December 2014. http://www.auditor.on.ca/en/content/annualreports/arreports/en14/305en14.pdf

7 Funke, et al, p. 19.

11. **Question 11.** Interests in public-private partnerships in Canada and other countries have often been resold for significant profits, often to investment funds based in tax. In the UK, equity sales have resulted in an annual 28.7% rate of return, more than double the expected rate of return stated in project business cases[8]. This suggests that the projects were significantly undervalued, most likely as a consequence of exaggeration and double-counting of risks transferred and/or elevated discount rates.[9]

Presentation and Disclosure *(Question 12)*

12. **Question 12.** We strongly support more detailed and comprehensive disclosure requirements both in general and in relation to public-private partnerships. Public entities should be required to disclose the information outlined in Principle 7 for each of the next five years (individually and in aggregate) and thereafter. As we also recommend in relation to discount rates (Question 7, Sections .59-61) the nominal cash flow amounts of these obligations should be also reported for greater transparency and accountability, as other jurisdictions have done. We also strongly support the requirement that operating and maintenance payments, as well as any other payments, or minimum revenue guarantees, also be required to be itemized. Providing this information would increase the transparency and accountability of infrastructure investments. It would also allow for greater comparability of P3 projects across jurisdictions. More specifically we recommend:

    - Adding the following sentence to the end of section .75: *Where the discount rate is elevated to include the risk specific to the infrastructure and liability, the value of that risk should be disclosed and added to the disclosed value of risk already added to cash flows.*
    - In Principle 7: making the following underlined additions: "In addition to the disclosure requirements of TANGIBLE CAPITAL ASSETS, Section PS 3150, a public sector entity should disclose the following information for each year:"

      (b): All contract documents including significant terms of the partnership affecting the amount, timing and certainty of expected cash flow…

    We note that the International Public Sector Accounting Standards include significant disclosure obligations and hope that Canadian public sector accounting at least meets these standards[10].

    32. All aspects of a service concession arrangement shall be considered in determining the appropriate disclosures in the notes. A grantor shall disclose the following information in respect of service concession arrangements in each reporting period:

    a) A description of the arrangement;
    b) Significant terms of the arrangement that may affect the amount, timing, and certainty of future cash flows (e.g., the period of the concession, re-pricing dates, and the basis upon which re-pricing or re-negotiation is determined);
    c) The nature and extent (e.g., quantity, time period, or amount, as appropriate) of:
        (i) Rights to use specified assets;
        (ii) Rights to expect the operator to provide specified services in relation to the service concession arrangement;
        (iii) Service concession assets recognized as assets during the reporting period, including existing assets of the grantor reclassified as service concession assets;

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[8] Dexter Whitfield, "PPP Profiteering and Offshoring: new Evidence" European Services Strategy Unit, October 2017. https://www.european-services-strategy.org.uk/wp-content/uploads/2017/10/PPP-profiteering-Offshoring-New-Evidence.pdf

[9] Office of the Auditor General of Ontario, op cit.

[10] IPSAS 32, paragraph 32-33.

(iv) Rights to receive specified assets at the end of the service concession arrangement;
(v) Renewal and termination options;
(vi) Other rights and obligations (e.g., major overhaul of service concession assets); and
(vii) Obligations to provide the operator with access to service concession assets or other revenue-generating assets; and

d) Changes in the arrangement occurring during the reporting period.

33. The disclosures required in accordance with paragraph 32 are provided individually for each material service concession arrangement or in aggregate for each class of service concession arrangements.

13. **Question 13.** *Are there any additional matters requiring consideration?*
While these accounting principles apply to financial decisions that have already been taken, we would also like to see them applied to the business case development upon which the decision is made whether to opt for a P3 or public procurement. Rather than just applying after the fact in financial reporting, these same standards should apply to the initial decision making. This would ensure decision-makers and the public receive relevant information in a timely manner to ensure greater accountability and transparency in the development of public infrastructure.

As Funke et al recommend,

> "To further enhance transparency, governments can disclose PPP contracts on their websites. The disclosures should include any amendment to original contracts, together with a summary of their main financial provisions. Certain material can be deleted on grounds of commercial confidentiality, but if the disclosure is to be useful the main financial provisions of the contract, including those in appendices and schedules, must be disclosed."[11]

If they are to be of any use, these must include the cash flow payments associated with the projects, any other terms which expose public entitities to risks, detailed determination of risks retained and estimated to be transferred, and should also include comparable information for any public sector comparator used in determining whether a public-private partnership would be used instead of traditional procurement.

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[11] Funke et al, p. 20.