Technical Director
International Public Sector Accounting Standards Board
International Federation of Accountants
277 Wellington Street West
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1 August 2008

Dear Sir/Madam

ACCA Comments on Consultation Paper – Accounting and Financial Reporting for Service Concession Arrangements

ACCA welcomes the opportunity to comment on this important Consultation Paper.

Generally

The attention of IPSASB to this complex area of accounting is extremely gratifying. As the Consultation notes "The existing or proposed guidance on reporting the underlying property in an SCA (or PPP arrangement)...has a different focus that can result in different reporting results even under the same set of circumstances...This report (2004 UKFRAB) notes a number of cases where underlying property of a PFI was not reported as a property, plant and equipment asset on the balance sheet of either the grantor or the operator". Clearly this is an unacceptable state of affairs from a public interest perspective.

However, while we broadly agree with the recommendations of the Consultation we would like to draw attention to some of the practical complexities of its implementation.

Firstly we do not consider that sufficient guidance has been given to the implied financing charge to be disclosed in the grantor's books. From the perspective of the operator this is a major consideration. When assembling the commercial package the operator typically follows the following steps:-

- Establish the forecast construction cost
- Establish the forecast life time operating costs
- Establish the expected return to the investor

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- Sculpture the debt to minimise cash flow exposure
- Agree the financing costs

Typically the operator will be highly leveraged, with virtually all of the funding being secured from senior and mezzanine sources. In the construction phase of the concession, where the operator is bearing construction risk, the cost of capital will be priced to reflect that risk. However, once the installation is constructed, and that risk is passed, major opportunities for refinancing gains become apparent. An example of the magnitude of the gains is included with this response.

We would therefore tend to agree with the Consultation when it suggests that the financing rate should be an estimate of the operator's cost of capital specific to the Service Concession Arrangement. Actually determining that cost of capital, however, is not a simple task.

This is but one aspect of the complexity of accounting for Service Concession Arrangements. We have found it of use to go back to first principles with a theoretical example and to follow the double entry bookkeeping entries. The attached spreadsheet shows our workings and may be of help in subsequent illustrative guidance from IFAC on this topic.

We would also draw your attention to the complexities of recognition of existing SCA's in the books of the grantor, and de-recognition in the books of the operator where this is appropriate. Certainly in the UK, where many SCA's have matured into their operational phase, a secondary market has developed with dedicated infrastructure funds buying and selling SCA's. This means that the traceability of the underlying property is not a simple matter, nor is it clear whether the private sector operator will willingly "give up" the underlying asset. There may also be unintended consequences on tax planning for the private sector operator.

Lastly, adoption of the Consultation Paper's requirements will undoubtedly have a material effect on long term fiscal sustainability reporting in some jurisdictions.

These are not trivial matters.

Specific Matters for Comment

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ACCA is broadly in agreement with the three Specific Matters for Comment while not forgetting the complex practical issues raised above.

Yours truly

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Healthcare Matters – a note on PFI refinancing in the UK Healthcare Sector

What is PFI refinancing?

At the heart of most UK hospital Private Finance Initiative (PFI) arrangements is an agreement whereby a private sector consortium is granted the right to design, build and manage the facilities of a hospital for a concession of typically 25 years. In return for the consortium's cost of building and operating the facility they will agree a fixed annual or *unitary charge*.

The unitary charge is to cover not only the cost of construction, operating and maintaining the facility, but also provide profits to the consortium and to repay the principal and interest on loan arrangements with the funding banks.

The private sector consortium will form itself into a *Special Purpose Vehicle* (SPV), usually a limited company. The funding sources are as follows:-

- Usually 90% of the funding will come from a bank or consortium of banks. This is known as *Senior Debt*
- Around 9% may be provided by a Third party equity investor as debt, for example a private equity house such as Barclays Capital. Any funding provided under this heading is referred to as *junior debt* or *mezzanine debt* or *risk capital*
- Third party equity investment via a shareholding stake may take up 0.51% of the debt structure
- Only 0.49% of the total funding usually comes from the SPV's shareholders

This high level of debt to low level of equity is referred to as a *highly leveraged* arrangement and obviously presents itself to the Senior Debt provider as one of high risk, both in terms of financial exposure at any point in the 25 year concession period, but also in terms of persistent risk over time. On the other hand the Senior Debt provider knows that they are financing an arrangement which has a revenue stream guaranteed over the next 25 years of concession.

Moreover the risk profile of the typical Healthcare PFI changes over time. At the outset, prior to construction of any facilities, construction risk – failure to deliver on time and to budget and quality - will be a major element of the risk appraisal. However once the facility is built and operational, the risk reduces significantly. In the maturing PFI market it was realised that this would be a good point to return to the Senior Debt providers to renegotiate better loan repayment terms to reflect the management and passing away of this risk. These renegotiations are known as *refinancing*. Gains arising were further enhanced by the maturing of the PFI market place and a better understanding of the risk profile, coupled with a reduction in long term interest rates from the late 1990's through to today.

Such refinancing gains are windfalls – they were never predicted in the initial business case, although they would have always been contemplated by the funders to such projects. If left undisturbed they can be returned directly to the SPV's shareholders as windfalls. This possibility, under the glare of publicity and political questioning, very quickly became intolerable. The result was a voluntary code for all PFI projects signed before post July 2002 whereby the local authority or NHS Trust would receive 30% of any refinancing gain with the balance going to the SPV; and 50% of any refinancing gain for all PFI projects signed after July 2002.

A PFI refinancing example – the Norfolk and Norwich PFI Hospital

(source: The Refinancing of the Norfolk and Norwich PFI Hospital : how the deal can be viewed in the light of the Refinancing, National Audit Office, 2005)

Expected Net Present Value (NPV) (2) of Returns to Octagon (SPV) Shareholders over contract period	**£millions**	**Internal rate of return (IRR) (3) to Octagon Shareholders**
At contract signing	**47.3m**	**18.9%**
Decrease between signing and up to refinancing	(11.9)m	
Value Prior to refinancing	**35.4m**	**15.9%**
Increase from refinancing	115.5m	
Sub total	150.9m	
Refinancing gain shared with Trust	(33.9)m	
Following refinancing – available for SPV shareholder	**£117.0m**	**60.4%**

Notes
1. The refinancing gains of £115.5millions arose on a project where the capital value of the hospital building was £229millions
2. Net Present Value (NPV) compares the value of a pound today to the value of that same pound in the future, taking inflation and returns into account
3. Internal Rate of Return (IRR) - the discount rate that makes the net present value equal to zero

Octagon – the SPV - achieved this outcome by increasing its borrowings from £200 million to £306 million. In securing the right to receive £34 millions of the gains the Trust accepted that any monies it would have to pay to terminate the contract early could increase by up to £257 millions following the refinancing, as its termination liabilities are related to the amount of Octagon's outstanding borrowings. The Trust also agreed to extend the PFI contract from 34 to 39 years, and to receive its share of the refinancing gains over the life of the contract, rather than as a one off payment.

Issues

Norfolk and Norwich became an issue, and the subject of a National Audit Office (NAO) investigation as a result of questions in the House of Commons by Norman Lamb, MP for North Norfolk, about the level of refinancing gains and their acceptability. This was followed by a critical report from the Select Committee on Public Accounts published in May 2006.

For all stakeholders, whether funders, shareholders or Trusts, it is important to keep refinancing as a live issue. Refinancing gains on new deals are largely academic as there is not much upside in current financing terms available in the funding markets. The voluntary arrangement to share refinancing gains equally between SPV and Trust is also an important step forward. However with UK Trusts under increasing public scrutiny about their general financial situation, and therefore eager to get their hands on any such windfall gains, transparency in commercial dealings will become more rather than less important in refinancing arrangements. Moreover as European funders and health authorities cast their critical eye over the UK's healthcare PFI experience it will be important to get the Norfolk and Norwich deal into perspective

Steve Priddy
June 2006

The Deal - from Private Sector (Operator) Perspective

		£m	
Construction	£	50.0	(assume a 2 year construction period £30 year 1; £20 ye
Operations	£	100.0	(assume 20 years post construction concession period)
Financing	£	30.0	(say)
Profit	£	10.0	
Tender Price	£	190.0	i.e. a unitary charge over 20 years of £9.5m p.a.

		£m	
Construction asset	at cost	50	
	at FV	50	

NB: FV used to measure the transferred asset where appropriate

Operating and financing costs and operator profit	140	
Making Up Unitary Charge	190	
over number of years		20 years

Operator	BS		P&L	
	Dr	Cr	Dr	Cr
Year 1				
1. Being the part cost of the construction of asset on construction				
Work in Progress	30.0			
Costs of construction (bank)		30.0		
Total	30.0	30.0		
Year 2				
1. Being the part cost of the construction of asset on construction				
Work in Progress	20.0			
Costs of construction (bank)		20.0		
2. Being the recognition of the financial asset				
Financial Asset	50.0			
Work in Progress		50.0		
Total	70.0	70.0		
Year 3 onwards				
1. The annual cash flows per annum				
Cash received	9.5			
Financial Asset		2.5		
Turnover				7.0
Operating costs			5.0	
Finance charge			1.5	
Annual Profit c/fwd			0.5	
Operating costs		6.5		
Retained Profit		0.5		
Total	9.5	9.5	7.0	7.0
Total revenues				190.0
Total costs			180.0	

Grantor	BS		P&L	
	Dr	Cr	Dr	Cr
Year 1				
No transactions				
Total				
Year 2				
2a. Being the recognition of the tangible fixed asset by grantor				
Liability for asset		50.0		
Capitalisation of fixed asset	50.0			
Total	50.0	50.0		
Year 3 onwards				
1a. Annual cash outflows				
Cash paid		9.5		
Liability for asset	2.5			
Service portion of cash payment			5.5	
Imputed Finance Charge			1.5	
2a. Amortisation of asset				
Amortisation of asset			2.5	
Amortisation of asset		2.5		
Fixed Asset	50.0			
Liability for asset		50.0		
P&L Charge	9.5			9.5
Total	62.0	62.0	9.5	9.5

NB: See para 120 of the consultation: The liability for what is effectively the service portion of the annual payment is thus accounted for as incurred