

---

PUBLIC SECTOR  
ACCOUNTING BOARD



CONSEIL SUR  
LA COMPTABILITÉ  
DANS LE SECTEUR  
PUBLIC

## Exposure Draft

Public Sector Accounting Board

Proposed accounting standards

---

# Public Private Partnerships

February 2020

---

**CCPPP RESPONSE TO THE EXPOSURE DRAFT (PSAB 3160)**

---

## Table of Contents

Executive Summary .....	1
The Canadian Council for Public-Private Partnerships (CCPPP) .....	1
Overview of Exposure Draft .....	2
Principal Observations and Recommendations .....	5
Scope .....	5
Definitions .....	5
Recognition of Infrastructure Asset .....	5
Initial Measurement .....	9
Initial Measurement: Performance Obligations .....	11
Public Sector Capital Contributions .....	12
Discount Rate .....	13
Timing of recognition .....	13
Subsequent Measurement .....	13
Presentation and Disclosure .....	14
Transitional Arrangements .....	14
PURPOSE AND SCOPE .....	15
DEFINITIONS .....	18
RECOGNITION OF INFRASTRUCTURE ASSET .....	19
Control .....	20
Purpose and use .....	20
Access to future economic benefits .....	20
Residual interest .....	21
3.1 Breadth of Control Provisions .....	22
3.2 Purpose and Use .....	24
3.3 Future Economic Benefits and Risks .....	25
Access to future economic benefits .....	25
3.4 Price Control .....	26
3.5 Economic Benefits: Risk and Reward .....	27
3.6 Regulatory Control .....	29
3.7 Distinction between Financial Liability and Performance Obligation models .....	30
3.8 Mixed Use Assets .....	30

3.9 Significant Residual Interest .....	31
3.10 Comments on Example One illustrating control .....	32
Example 1 — New community recreation centre.....	32
INITIAL MEASUREMENT .....	36
4.1 Excessive reliance on historic cost to determine Fair Value. ....	37
4.1.1 Reliance on the winning bidder’s cost .....	37
4.1.2 Excessive reliance on a defined time period to differentiate capital from O&M costs .....	38
4.2 Insufficient and potentially misleading guidance in respect to the separation of capital and operating & maintenance components of a PPP transaction .....	39
4.3 The nature of different types of Financial Obligation should be reflected .....	40
Liability .....	40
4.3.1 Contingent liabilities.....	41
4.3.2 Grantor Financial Indebtedness.....	41
4.3.3 Contributed Surplus Move .....	41
4.3.4 Conditional Payments.....	41
4.4. Initial Recognition of User Pay (Performance Obligation) Transactions .....	42
4.5 Asset Recognition.....	43
Emerging Asset.....	44
4.6 Recognition of a performance obligation liability.....	44
4.7 Fair Value under User Pay Model.....	46
Assets acquired with the user-pay model .....	46
4.8 Misleading Use of the Term Performance Obligation .....	46
4.9 Different types of User Pay/ Revenue PPP Transactions .....	47
Full Demand Risk .....	47
Shadow Tolls.....	48
Shared Risk and Benefit transactions .....	48
Pricing controls.....	48
Concession Payments to/from Grantor.....	48
Revenue Shortfall Payments .....	48
4.10 Fair Value Estimation Challenges.....	48
4.11 Misrepresented Financial Statements.....	49
4.12 Criticisms of Example 2 .....	49
4.12.1 Example 2 — User Pay Model Toll highway.....	49

4.12.2 Criticism of Example 3 — Mixed consideration with life cycle costs: College residences..	50
Timing and Nature of Capitalized Costs .....	55
5.1 Definition of Capitalized Costs .....	55
5.2 Componentization .....	56
5.3 Timing of Recognition .....	57
Contingent Liability .....	57
5.4 Treatment of Government grant contributions during construction .....	57
5.5 Useful Life .....	58
5.6 Subsequent Measurement .....	59
5.6.1 Cost Overruns .....	60
5.6.2 Performance Deductions, Impairment and Revaluation .....	61
PS3150 Write-downs .....	61
5.7 Life Cycle Expenditures and Betterments .....	63
Betterments .....	63
5.8 Criticisms of Example 5: Multi-year example with financial compensation: City Bridge .....	64
Payment Bifurcation into Capital and Expense .....	74
6.1 Fair Value Estimation .....	75
6.2 Criticisms of Exposure Draft Example 4 .....	76
Alternative Example .....	76
Betterments .....	79
Betterments .....	79
SUBSEQUENT MEASUREMENT .....	81
Financial Obligation Model .....	82
Performance Obligation Model .....	82
SPV Management Costs .....	82
Definitions .....	82
O&M During Construction .....	83
Example 3: College Residence .....	83
DISCOUNT RATE .....	84
9.1 Appropriate Discount Rate .....	85
9.2 Definition of Contract Rate .....	85
9.3 Methods to ensure the Contract Rate is reasonable and to estimate it where it is not stated ....	87

9.4 Direct Borrowing Costs to Fund Government Contributions ..... 88

9.5 Consistency of Finance Charge ..... 89

9.6 Effective Interest Rate Method..... 90

9.7 CCPPP Alternative View..... 90

PRESENTATION AND DISCLOSURE ..... 92

TRANSITIONAL PROVISIONS..... 94

## Executive Summary

### The Canadian Council for Public-Private Partnerships (CCPPP)

CCPPP is pleased to provide a response to the Exposure Draft issued on November 1, 2019 by the Public Sector Accounting Board (PSAB) of Certified Public Accountants (CPA) that proposes new requirements for recognizing, measuring and classifying infrastructure procured through a public-private partnership.

Established in 1993, CCPPP is a national, not-for-profit, non-partisan, member-based organization with more than 350 members providing broad representation from across the public and private sectors. Its mission is to collaborate with all levels of government, Indigenous communities and the private sector to enable smart, innovative and sustainable approaches to developing and maintaining infrastructure that achieve the best outcomes for Canadians. The Council is a proponent of evidence-based public policy in support of P3s, facilitates the adoption of international best practices and educates stakeholders and the community on the economic and social benefits of public-private partnerships.

Canada is a world leader in PPPs. Our country has used the model to build, operate and maintain a variety of vital infrastructure, from hospitals to transit to water and wastewater treatment plants. In fact, there are currently 286 active P3 projects in Canada, with those already in operation or under construction valued at more than \$139.4 billion. The standards used in Canada are universally recognized as 'best in class' around the world.

PSAB's proposed new requirements are timely and important given the ongoing evolution of the Canadian P3 sector. That is why CCPPP supports PSAB's objective of developing a Canadian-specific PPP accounting standard. The Council sees great benefit in providing market participants, especially public sector accounting professionals, with clear accounting rules on PPPs given the diversified structures, legal agreements and financing arrangements that have emerged over the last 10 years and which are continuing to develop.

CCPPP previously published a report on [Public Sector Accounting for Public Private Partnership Transactions in Canada](#) in May 2008. The Council's response to the Exposure Draft draws upon this work. It has also engaged with its members, comprising key stakeholders in the development of PPP transactions in Canada about the proposed new requirements, including holding a session on the issue at our 27<sup>th</sup> Annual Conference on November 19, 2019. CCPPP's members have expressed concern at the potential unintended consequences of the accounting requirements as currently purposed.

CCPPP has structured its comments on the Exposure Draft to strike a fair and balanced approach between public private partnerships and other procurement models.

The Council's response to the Exposure Draft is focused on the 11 questions posed by PSAB. However, some of its responses go beyond the specific questions and cover other aspects of the Exposure Draft.

CCPPP has also attempted to structure its responses within the overall framework established by PSAB in the Exposure Draft and by international standard setters. The Council addresses specific gaps, inconsistencies and contradictions within the Exposure Draft in comparison with international standards.

PPPs have many unique characteristics, which is why the Council recommends a more comprehensive review of PPP accounting standards be undertaken by PSAB in conjunction with government and industry stakeholders. For this reason, CCPPP also provides thoughts for an “Alternative View” on how to more appropriately account for PPP transactions.

It is in this context CCPPP also makes comments on the presentation and disclosure guidance. The Council finds the examples used to be out of step with the practical experience of Canadian PPPs and proposes amendments to these.

## **Overview of Exposure Draft**

CCPPP would like to see the new Canadian standard represent world leadership in public sector accounting in the same way that our PPP transactions represent world best practices. For this reason, the Council’s response cross references to the relevant provisions of the international standard IPSAS 32 and comments on where it considers these to be inadequate in the context of Canadian P3s.

The Council’s review of IPSAS 32 suggests there remain a number of challenging and potentially contradictory aspects of international guidance. IPSAS tends to address these issues in detail in application guidance and the basis for conclusions. CCPPP recommends PSAB expand its application guidance and basis for conclusions to provide greater clarity. Certain of these issues could be raised to the attention of IPSAS as a source of potential ambiguity in the future.

The Council expects its comments, which are objective in nature and create the right balance between financial and accounting considerations, will result in enhanced amendments to the Exposure Draft prior to finalization of the standard.

The evolution of accounting standards is similar to the evolution of PPP transactions and it is understandable that standards and procedures keep shifting and improving based on market feedback and experiences. In that spirit, CCPPP proposes a continuing dialogue between PPP stakeholders and PSAB in order to ensure the standards reflect continued evolution of the PPP model in Canada.

It is particularly important that the treatment of PPP assets and liabilities is accurate and appropriate as Canadian public sector accounting moves closer to the presentation of full public sector entity balance sheets over the next few years.

CCPPP is not arguing that PPP transactions should be “off-balance sheet” for public sector entities. However, the Council strongly believes recognition of assets and liabilities associated with PPP transactions should be based on the economic substance of the transaction and differentiate between PPPs that create different financial risk profiles for the public sector entity.

CCPPP is concerned that accounting treatment should be neutral with respect to procurement methods but should still reflect material differences in the substance of the public sector asset and liability and should avoid creating inappropriate incentives for the parties to the transaction. The Council is not attempting to promote one model over another but rather to ensure that the standards reflect fair representation of the financial exposure of tangible or intangible assets or actual or contingent liabilities.

The application of the PPP standards should ensure all transactions are recorded based on accounting standards and principles considered together. The current Exposure Draft focuses on the principles of matching, conservatism and materiality, but does not also consider adequately equally important accounting principles like going concern, cost principle and economic entity.

While there are a number of potential models available for PPPs, the majority of current Canadian PPPs have the following features:

- full transfer of design and construction risks to the private sector
- retention of risks that cannot be transferred fully or partially to the private sector on linear infrastructure. are budgeted but not recorded as they are uncertain and contingent
- For DBFOM, the risks of maintenance, operation and life cycle are transferred to the private sector. The only risk retained by the public sector may be change orders
- Life cycle costs are paid based on contractual obligations. Life cycle works are not commissioned nor is it possible to know if they constitute a betterment
- The capital cost at risk is intended to provide a warranty beyond the legal warranty period through a financial instrument (PPP contract)

The typical Canadian PPP will also have many different types of financing:

- 1) A grant or contribution from a higher level of government (reflecting a contributed surplus)
- 2) General government borrowings supported by the taxpayer
- 3) Self-supported government debt supported by user pay revenues
- 4) Non-recourse debt raised by a private sector partner with a government obligation to make payments for services delivered
- 5) Non-recourse debt raised by a private sector partner and supported by the right to collect user pay revenues
- 6) Private sector equity

When risks materialize the first loss is experienced by the parties that financed the project and the exposure of the public sector grantor in almost all cases is marginal.

The CCPPP approach starts from the perspective that most PPP transactions are a combination of an asset and a service (in some cases just service with underlying asset) with the choice of the relative combination of the two components largely left up to the private sector partner.



It is fundamental to the commercial and public interest use of PPPs that some degree of flexibility and responsibility for these choices is transferred to the private partner. The private sector when bidding the capital, service or life cycle components should not be taking into account whether the bifurcation of their costs would result in the best accounting representation from the public entity's perspective.

It is CCPPP's Alternative View that the bifurcation of PPP payments into an asset and an O&M component is harmful and not necessary. The entire transaction should be viewed as a service rendered at a combined unitary cost. Any asset recognition should be over the life of the asset where capable of estimation or at the end of the contract where residual value can be estimated.

It is of great concern to CCPPP that under the proposed Exposure Draft the accounting treatment for the following transactions would be the same (assuming the same construction cost):

- 1) A Design-Build, paid entirely by government through milestone construction payments and/ or substantial completion payments (DBF)
- 2) An availability payment based PPP concession with performance based payments made over 30 years (DBFOM)
- 3) A user pay transaction, where no payments are made directly by government but revenues are created by the right to levy a charge on users.

These three transactions have very different risk profiles and liabilities for the public sector and to record the same asset and liability for each seems prima facie wrong. It is important that accounting treatment is able to distinguish between these and provide for a fair representation of the financial exposure of the public entity.

CCPPP recommends an approach based on the economic substance of the transaction.

## Principal Observations and Recommendations

CCPPP's recommendations can be summarized as follows:

### Scope

CCPPP finds the scope to be clear for public-private partnerships. The Council considers the appropriate definition of a PPP as an arrangement under which the private sector partner:

- Builds or betters infrastructure, and
- finances the transaction past the point of substantial completion, and
- maintains or operates the infrastructure

However, CCPPP questions the purpose of having a distinct accounting standard in respect of public-private partnership transactions if the provisions of the standard result in the transaction being accounted for exactly as if it had been delivered directly by the public sector entity.

### Definitions

CCPPP agrees with the definitions provided in the Exposure Draft. However, the Council recommends a number of additional definitions it feels are important to the interpretation and application of the standard.

### Recognition of Infrastructure Asset

CCPPP does not find the control guidance provided in the Exposure Draft to be sufficient or appropriate as it relates to the recognition of infrastructure for the reasons set out below.

CCPPP agrees a liability should be recognized when the public sector entity has an *unconditional* (the Council's emphasis) obligation to deliver cash or another financial asset as consideration for the building, acquisition or betterment of infrastructure.

CCPPP disagrees with the statement that a performance obligation (also a liability) should be recognized for the unsatisfied portion of the performance obligation when consideration transferred for the building, acquisition or betterment of infrastructure is the right to charge users or earn revenue from another revenue generating asset.

CCPPP's concerns with respect to control guidance can be summarized as follows:

- 1) Control provisions are broad and would capture virtually all PPP transactions, including both financial liability (availability payment) and performance obligation (user pay transactions). This matters in particular because asset and liability measurement guidance is also essentially binary with limited flexibility for differing circumstances.

**CCPPP recommends** the control recognition and initial measurement provisions should operate in combination with each other such that the degree and nature of control exercised is a determinant of asset and liability recognition and measurement.

- 2) The definitions of Purpose and Use of infrastructure assets are imprecise and overlap with access to future economic benefits and risks.

**CCPPP recommends** that control over the purpose of an infrastructure asset should require rights to make payment deductions or obtain damages (including default) should an infrastructure asset not meet specifications or performance standards not be met.

**CCPPP further recommends** that access to economic benefits and risks of the infrastructure asset should be clearly distinguished from purpose and use. Otherwise the same criteria can be used to satisfy both of these control criteria, rendering the criteria excessively broad.

- 3) The proposed control guidance appears inconsistent with and more onerous than both IPSAS 32 and control guidance in other areas of the PSAB Handbook.
- 4) The Exposure Draft removes price control as a necessary element of control, further broadening the criteria. CCPPP regards control over price as being a necessary but not sufficient criterion for control.

**CCPPP recommends** that consistent with IPSAS 32 price control is a necessary condition for economic control.

**CCPPP recommends** that in order to be sufficient evidence of control the public sector grantor should also share in the risks of the price being set at a level which does not generate sufficient revenue through a liability to make shortfall payments or a right to share in the benefits through a revenue sharing arrangement.

- 5) There is no recognition of the risk transfer features of PPPs, differences from conventional delivery or that choices between initial capital expenditures and O&M and life cycle costs may differ significantly under PPP delivery. In most cases, this means that PPPs will reflect a higher capitalization of asset and liabilities (which affects government budgeting) than conventional delivery. This will discourage the use of high quality PPP transactions. PPPs are all about the transfer of risk between the public sector and private sector partners. It is therefore disappointing that the Exposure Draft does not address any risk-based approach. IPSAS 32 Basis for Conclusions explicitly rejects a risk-based approach (BC13) *“IPASB also questioned whether sufficiently objective criteria could be established for addressing risks and rewards to enable consistent results to be determined. In addition weighting of various risks and rewards was seen to be problematic. The IPSASB concluded, therefore, that the risks and rewards approach is inappropriate.”*

**CCPPP recommends** that the different types of payment profile under a PPP can easily and objectively be categorized by the nature of their level of risk transfer. A “one principle fits all” approach is an oversimplification and creates misleading results. The Exposure Draft does not provide guidance as to the risk exposure of the public sector grantor, although control is stated as dependent upon exposure to risks.

**CCPPP recommends** that the public sector grantor controls access to the future economic benefits when it:

- a) can benefit from the economic resource through its capacity to provide goods and services, to provide future cash inflows or to reduce cash outflows;
- b) can deny or regulate access to those benefits by others; and
- c) is exposed to the risks associated with the economic resource.

CCPPP is of the view that there are a number of circumstances under which the public sector may be exposed to the economic risks and benefits of a user pay PPP transaction:

- a) Where the public sector entity guarantees a payment equal to the shortfall between forecast revenues and actual revenues or similarly guarantees a specified rate of return on investment to the private sector partner.
- b) Where the public sector entity participates in a share of revenues beyond a specified amount.
- c) Where the public sector guarantees a level of utilization of the infrastructure asset and restricts it from competition (denial or regulation of access to those benefits by others)

- 6) The distinction between PPP transactions, which are typically governed by a project specific contractual agreement, and other types of regulated infrastructure transactions, which may be governed by an industry wide regulatory model, is arbitrary. Many of the features of PPP transactions that would trigger recognition of control under the Exposure Draft are in the public good and regulatory in nature rather than exposing the public sector grantor to specific benefits or liabilities. The standard risks confusing regulatory controls in the public interest and control over economic interests. This leads to concerns with respect to inappropriate incentives where a public sector grantor may seek to avoid regulatory control mechanisms that are in the public interest in order to avoid recognition. This is of particular concern given the penal recognition of a performance obligation liability.

**CCPPP recommends** that controls of a regulatory nature are clearly distinguished from those that lead to economic control. The control provisions make no distinction between an availability payment and a user pay PPPs, Financial Liability (availability payment) projects and Performance Obligation projects in which the private sector collects user pay revenue streams have very clear and obvious differences in government's exposure to economic risks and benefits. User pay demand risk transactions will be consolidated on government balance sheets reflecting a liability equivalent to the forecast revenues. This will significantly discourage the use of user pay PPP transactions and does not reflect accounting principles of fair representation. The concept of the performance obligation liability has been artificially created for matching purposes and to address the concern that a future public sector residual value interest in a user pay asset may not be recognized or may be over inflated. This reflects the challenges of proportionate recognition of a residual interest which is very long dated.

**CCPPP recommends** the position that the performance obligation is on the private sector and the performance obligation liability is not a fair representation of the public sponsor's actual liability and

risk exposure. The assumption and justifications made in the Exposure Draft that the government stands ready to step in and repair damages is misleading and does not reflect the transaction economics and the parties' contractual obligations. Instead, consistent with our other recommendations, the public sector residual interest in a user pay asset should be recognized only at the point it is capable of reasonable estimation.

- 7) The Exposure Draft provides limited guidance on mixed use assets where the public sector grantor may exercise control over portions of the infrastructure asset but not the entire asset.

CCPPP broadly agrees with the provisions of IPSAS 32 AG 12-13 and AASB 1059 BC25 -27 in this regard and **CCPPP recommends** that the Exposure Draft adopts similar guidance.

- 8) The control condition in respect of "significant residual interest" could lead to inappropriate incentives to lengthen concession terms beyond commercially optimum time frames and requires greater definition and interpretation guidance.

**CCPPP recommends** that "significant residual interest" is defined as the estimated current value of the asset as if it were already of the age and in the condition expected at the end of the service concession arrangement" (consistent with IPSAS 32 AG9), that this current value must be reasonably capable of estimation at the beginning of the concession and that the residual value should be material in the context of the overall transaction. In general CCPPP, believes that residual risk and benefit, especially in respect of User Pay transactions is not capable of reasonable estimation at the inception of a long-term contractual arrangement and accordingly should be reflected as a contingent liability until the point at which it can be reasonably estimated.

- 9) It would be beneficial to include an example of a PPP transaction that would not meet the control provisions. The example provided is not realistic and exposes the challenges in the control provisions identified above.

**CCPPP recommends** detailed changes to the control example and recommends the addition of an example where control criteria are not met.

Under CCPPP's control recognition recommendations the vast majority of Availability Payment (Financial Obligation) transactions would satisfy the control conditions whereas the majority of User Pay (Performance Obligation) transactions would not meet the control requirements because there is uncertainty (or absence) of future payments, there is inherent risk transfer and lack of ability to reasonably estimate residual value.

CCPPP's Alternative View is more nuanced and less binary with the degree of control being reflected in the nature of the asset and liability recognized. Under IFRIC 12 (4), service concession assets in the private sector deemed to be under the control of the public sector entity are still recorded on the entity balance sheet as a financial asset without raising concerns with respect to double counting.

One option may be to recognize a PPP as a financial instrument and offset the asset and the obligation in a swap-like transaction where the government is regarded as paying a premium to hedge the asset residual risk. The premium cannot be limited to the financing differential between the private and the public sector but rather the entire capital portion is a premium to cover the risk of

delivering the required service performance levels and the O&M costs associated with these plus the risk of the asset residual value that remains unconfirmed until expiry or a few years preceding expiry.

In this respect, the cost of finance (debt credit spreads and equity premiums charged by lenders and investors) in PPP is not a function of the cost to finance the asset itself but to mainly hedge against construction, operation and maintenance poor performance and default. The higher the scope of maintenance and operation (including revenue risk), regardless of the asset value, the higher will be the private sector rate.

Public sector accounting should not, therefore, attempt to artificially pre-suppose these choices by attempting to identify an asset value and corresponding financing cost where there may be an inability to quantify such a cost.

**CCPPP recommends** an approach that is consistent across both availability style and user pay PPP transactions. In both cases the economic substance of the transaction should be recognized through recognition of the stream of payments between the public sector and private concessionaire.

## Initial Measurement

The Council divides its comments on Initial Measurement between Financial Obligation (Availability Payment) transactions and Performance Obligation (User Pay) transactions.

CCPPP agrees in principle with the statement that the cost of the infrastructure should be measured initially at the infrastructure asset's fair value; however the Council believes the provisions of the standard and the application guidance in respect of how fair value should be estimated require additional work.

CCPPP's comments with respect to Financial Obligation transactions can be summarized as:

- 1) The Exposure Draft places excessive reliance on historic cost as the basis for Fair Value
  - Ignores the likelihood of embedded O&M costs in bid prices
  - Establishes capital costs by means of an artificial point in time (Substantial Completion) rather than based on the substance of the costs

**CCPPP recommends** that the Exposure Draft wording is amended to: "Relative Fair Value of the asset and O&M components of the transaction can be estimated from the public sector comparator (or similar estimates of what the government may choose to build) and from the bids submitted as part of a competitive tender process."

The Exposure Draft provides insufficient and potentially misleading guidance in respect to the separation of capital and operating & maintenance components of a PPP transaction.

**CCPPP recommends** that the proposed standard on the separation of capital and operating & maintenance components of a PPP transaction include the wording:

"Payments under a service concession agreement should only be considered separable where one of the following conditions is met:

- a) There is part of the payment stream that varies according to the availability of the service concession asset itself and another part which varies according to the usage or performance of certain services with no cross deductions between the two payment streams, or:
  - b) Different components of the service concession arrangement run for different periods or can be terminated separately. For example, a material individual service component can be terminated without affecting the continuation of the rest of the agreement, or:
  - c) Different components of the service concession arrangement can be negotiated separately. For example, a service component is market tested and some or all (a material portion) of the cost increases or reductions are passed on to the grantor in such a way that the part of the payment by the grantor that relates specifically to that service can be identified
  - d) The grantor has an unconditional obligation to make a predetermined series of payments to the operator, consistent with IPSAS 32 AG37-38.”
- 2) The Exposure Draft is insufficiently clear that a PPP asset should be amortized over its useful life rather than the term of the PPP concession.

**CCPPP recommends** that the standard should explicitly require an analysis of the expected useful life and residual value under the PPP transaction and that the amortization period should reflect this analysis.

- 3) Financial Obligations are recognized and presented in the same way regardless of their nature and conditionality. IPSAS 32 suggests that only unconditional obligations should be recognized as a Financial Obligation.

**CCPPP recommends** that the asset which exists at substantial completion should only be recorded as an asset in the grantor’s financial statements to the extent that the grantor has made unconditional obligations to pay for it or a portion of it. It is too early at this stage to know whether the asset has achieved its forecast fair value or whether it suffers from impairment. The Council notes that the grantor explicitly does not accept completion of the asset at service commencement. Recognition of the full value of the asset would not be prudent.

**CCPPP also recommends** that the grantor’s liabilities should clearly distinguish between:

- 1) Financial indebtedness
- 2) Unconditional payments
- 3) Payments conditional on performance

CCPPP’s Alternative View is that many of the potential public sector liabilities created under PPP transactions are contingent in nature and it is accordingly inappropriate to recognize an asset value and corresponding liability at inception which may not be capable of reasonable estimation. This is compounded by weaknesses in the Exposure Draft guidance with respect to subsequent measurement. In most Canadian PPPs, including availability payment based transactions, the obligation to pay future payments is not an unconditional financial obligation. It is entirely performance

related and subject to deductions. It should therefore represent payment for a service proportionately undelivered and accordingly should be expensed. Only where a portion of the future payments are effectively guaranteed (for example through an explicit separation of capital payment and protection against deductions or through capped deductions) should the future payments be recognized as a financial obligation and capitalized. Where the government does choose to make financial commitments that are certain in nature and reflect an asset value rather than the provision of a service which is proportionately unperformed throughout the concession term, then these should be recognized as the proportionate acquisition of an underlying asset.

## Initial Measurement: Performance Obligations

CCPPP has very significant concerns with the application of the Performance Obligation to user pay transactions. The Council's observations can be summarized as:

- 1) Recognition of an asset at inception of a transaction under which the financial and economic risks and benefits have been transferred to a third-party private sector partner for an extended period of time is inappropriate and not prudent.

**CCPPP recommends** that asset recognition should only occur when a reasonable estimation can be made of the residual value interest. In most cases, asset value should be recognized proportionately as the term of the PPP concession progresses.

- 2) Recognition of a corresponding "performance obligation" liability to offset this asset recognition is also inappropriate.

**CCPPP recommends** that a "performance obligation" should only be recognized where the public sector entity has a meaningful and measurable liability (for example an obligation to make up shortfalls in forecast revenues or make some other adjustment to price or concession term to guarantee the private sector partner a return).

- 3) Some potential public sector obligations, including relief events due to construction risks materializing or PPP default that may ultimately require government to step in, are remote events that are unquantifiable and therefore clearly fall under the definition of contingent liability. For example, a BBB user-pay infrastructure project is assigned a probability of default of 8% over 35 years based on both S&P and Moody's Project Finance historical data. Government obligations to step in to provide service will only arise with 8% chance and if they do the magnitude of the impact is only based on the damages to be remediated and the quantum of security both of which cannot be determined reasonably. This example illustrates an inconsistent aspect of the proposed standard where an event with a low probability and an unquantifiable impact is recorded as a full liability on the balance sheet.

**CCPPP recommends** such obligations should be noted as contingent liabilities unless and until they are triggered by default events.

- 4) Use of the term "performance obligation" for the public sector liability is misleading and confusing since the actual performance obligations under a PPP are requirements on the private sector partner.



Should there be a continuing need for the term then **CCPPP recommends** using the term “Self-supported user pay obligation” which better reflects the nature of any potential liability.

- 5) The proposed approach leaves little room for reflecting different types of user pay transactions including the more nuanced approach of user pay transactions in which risks are shared between government and private sector partners.

**CCPPP recommends** that the Exposure Draft should provide clear guidance on the conditions under which the public sector entity has a meaningful and measurable liability which it should recognize.

- 6) Unlike IPSAS 32 (BC32), the Exposure Draft does not make a distinction between a user pay transaction under which the operator is guaranteed by the grantor a certain level of revenues or net return on investment and one in which demand risk is taken fully by the operator. CCPPP considers this distinction important.

**CCPPP recommends** that the Exposure Draft is amended to reflect this situation to ensure that a public sector liability is not recorded where no meaningful or measurable liability exists.

- 7) Whether or not it is desirable, establishing Fair Value of the asset and the timing and nature of the corresponding liability is extremely challenging. The Exposure Draft implies the same methodology as for a Financial Obligation transaction.

**CCPPP recommends** that, to the extent initial asset measurement is required following CCPPP’s recommendations; the Exposure provides specific guidance on estimation for user pay assets.

- 8) To the extent that the current Exposure Draft approach is retained, CCPPP notes that “performance obligation” liabilities should be clearly distinguished as “self-supported user pay obligations,” which do not reflect a financial liability in the presentation of financial statements.

Overall **CCPPP recommends** that the concept of a performance obligation liability is removed from the standard except in circumstances where the government grantor has a clear liability for a shortfall in revenues. CCPPP also recommends that greater guidance is provided in this regard.

## Public Sector Capital Contributions

The Exposure Draft is silent on the fact that most Canadian Availability Payment transactions include significant payments by the Grantor during construction and at substantial completion and that these payments are financed by taxpayer supported indebtedness that is unrelated to the performance of the project. Such indebtedness should evidently be recorded as a liability.

CCPPP recommends that such unconditional indebtedness should be recorded as a different class of liability from performance payments to the private sector partner, which are conditional in nature. Such indebtedness will typically be incurred at a different finance charge and repayment profile from payments under the PPP and should not be confused with the Contract Rate.

In the typical Canadian availability payment PPP, these grantor payments for construction are now very material relative to long-term private sector financing exposed to performance-based availability payments. This trend is driven by a desire to reduce financing costs in a public sector accounting

environment where no distinction is made between the risks of paying for construction compared to paying for long-term operational performance.

Under CCPPP's Alternative View, these payments are unconditional obligations and should be reflected as such, while availability payments are conditional on performance.

## Discount Rate

CCPPP applauds the decision in the Exposure Draft that the discount rate applicable to calculating initial capital value from a stream of future payments should be the weighted average cost of capital of the private sector partner. The use of any other rate, and in particular the cost of government borrowing, would result in a capital cost that does not reflect reality. For example, the same asset delivered in Gatineau and Ottawa will have two different values simply because the provinces of Ontario and Quebec have different rates.

However, this in itself is not sufficient to determine accurately the fair market value of the infrastructure asset because it is also necessary to distinguish between payments made in respect of the capital cost and payments that are related to the risks of long-term operation, maintenance and life cycle.

Consistent with our Alternative View, **CCPPP recommends** the cost of capital of a transaction could be used as a reasonable proxy for the level of risk transfer and accordingly measurement of the fair market value of a PPP transaction.

## Timing of recognition

The Exposure Draft currently does not address whether Interest During Construction (IDC) should be capitalized. This represents a material difference between conventionally procured assets which do not typically capitalize IDC and PPP transactions which typically incorporate this in the costs to completion. (Section 5.1)

**CCPPP recommends** adding more guidelines on when these development/early works should be capitalized (Section 5.2)

## Subsequent Measurement

CCPPP finds the Exposure Draft needs to be strengthened on the subject of subsequent measurement. While this is beyond the scope of the Exposure Draft alone, CCPPP believes a major impediment to the efficient delivery of infrastructure by the public sector is the lack of timely revaluation or impairment of assets relative to private sector accounting requirements. This encourages, for example, common practices such as the creation of significant maintenance deficits without any discipline imposed by the risk of impairment or reduction in useful economic life. PPPs are a mechanism to introduce commercial disciplines to public sector infrastructure and so impairments can be easily observable. However, CCPPP is concerned that if PPP accounting treatment is the same as that for public sector delivery then many of the potential advantages will be lost.

CCPPP's comments can be summarized as:

- 1) The Exposure Draft currently does not address how a capital cost overrun absorbed by the private sector partner should be treated. Following the Exposure Draft logic of replacement cost equaling historic cost, this should in theory result in an increase in the asset recognized but with no corresponding increase in the public sector liability. The net result would then be a reduction in the finance charge as a percentage of asset value. This makes sense to CCPPP as the higher cost of financing a PPP is intended to cover the risk of cost overruns.
- 2) The Exposure Draft currently does not address how consistent performance deductions of O&M payments should be treated. A similar logic should apply to a capital cost overrun except in this case it could be argued that the asset value is impaired.
- 3) A significant contractual event, such as a termination for default, would not necessarily have any effect on the accounting treatment. **CCPPP recommends** that a contingent event of this nature should result in a change in the asset and liability recorded.
- 4) The Exposure Draft treats significant life cycle expenditure as an expense even if it is necessary to achieve the useful economic life of the asset (for example a new roof). A betterment which would be capitalized is narrowly defined as an investment which expands the service capacity of the asset. **CCPPP recommends** that replacement of a material component of an asset necessary to its useful life should be capitalized rather than expensed.
- 5) Subsequent Measurement under user pay or Performance Obligation transactions is even more important and challenging since there is a likelihood of significant variability in the user pay revenue streams which are used as a proxy for amortization of the performance obligation. Consistent with our recommendations on initial measurement of user pay assets, **CCPPP recommends** the Exposure Draft should provide guidance on fair market valuation of user pay assets if there is a continuing desire to record an asset and liability.

## Presentation and Disclosure

The Exposure Draft is not as clear as IPSAS 32 that PPP transactions (or service concession arrangements) should be presented as a separate and distinct class of assets.

**CCPPP recommends** that more guidance on disclosure should be added. It is important to note why and when a liability is a contingent liability to be disclosed in the financial statements and when it is normal to record a liability (although based on an unlikely scenario) and then disclose that is not an "actual liability or debt obligation"

## Transitional Arrangements

CCPPP does not anticipate any challenges with the transitional arrangements with respect to the current Exposure Draft as the Council believes the proposed approach is not materially different from that current followed by most Canadian jurisdictions. However, **CCPPP recommends** significant additional stakeholder consultation prior to any new standard taking effect. The Council would be happy to provide a platform for this consultation.

## PURPOSE AND SCOPE

**Q1 Do you find the scope to be clear for public-private partnerships? If not, please describe the transactions for which the application of scope is unclear.**

### PURPOSE AND SCOPE

.01 Section PS 3160 establishes standards on accounting for public-private partnerships between public and private sector entities where the public sector entity procures infrastructure using a private sector partner. The private sector partner's obligations include requirements to:

- a) design, build, acquire or better new or existing infrastructure;
- b) finance the transaction past the point where the infrastructure is ready for use; and
- c) operate and/or maintain the infrastructure.

.02 Public-private partnerships are an alternative finance and procurement model available to public sector entities to design, build, acquire or better infrastructure. They include public-private partnerships:

- a) between a public sector entity and a private sector partner for infrastructure project delivery;
- b) with risk allocation that provides for public sector ownership of the asset at any point during the arrangement; and
- c) in which the private sector partner finances capital beyond the point at which the infrastructure is ready for use.

.03 Section PS 3160 does not apply to:

- a) traditionally procured infrastructure where the government controls the asset and bears the associated construction and financial risks, which is accounted for in accordance with TANGIBLE CAPITAL ASSETS, Section PS 3150;
- b) leased infrastructure, which is accounted for in accordance with PUBLIC SECTOR GUIDELINE, PSG-2, Leased Tangible Capital Assets;
- c) operating and maintenance arrangements with a private sector party where it is not necessary to design, build, acquire, better or finance public infrastructure as part of the arrangement. The definition of expenses in FINANCIAL STATEMENT CONCEPTS, Section PS 1000, would apply to such arrangements;
- d) write-downs of infrastructure, which are covered in Section PS 3150;
- e) public private partnerships where there is no financing required by the private sector partner past the point where the infrastructure is ready for use; and
- f) (f) accounting for and reporting a public sector entity's interest in a partnership where the partners co-operate toward achieving significant, clearly defined common goals, which

are covered in INTERESTS IN PARTNERSHIPS, Section PS 3060.

.04 Section PS 3160 should be read in conjunction with the following PSA Handbook Sections:

- a) TANGIBLE CAPITAL ASSETS, Section PS 3150;
- b) ASSET RETIREMENT OBLIGATIONS, Section PS 3280;
- c) CONTINGENT LIABILITIES, Section PS 3300;
- d) CONTRACTUAL RIGHTS, Section PS 3380;
- e) CONTRACTUAL OBLIGATIONS, Section PS 3390;
- f) REVENUE, Section PS 3400;
- g) FINANCIAL INSTRUMENTS, Section PS 3450;

Refer to Appendix A for further guidance on scope of application.

CCPPP's comments can be summarized as:

CCPPP questions the purpose of having a distinct accounting standard in respect of Public-Private Partnership transactions if the provisions of the standard result in the transaction being accounted for exactly as if it had been delivered directly by the public sector entity.

- The scope is unclear on a Design-Build-Finance (DBF) or Build-Finance (BF) model where a portion of the capital cost is gradually released over an extended period 5-10 years without any maintenance and operation mandate. The government entity has retained full control, managing the asset and doing its own maintenance, operation and life cycle.
- It is unclear how the accounting treatment will work for common PPP structures including:
  - a) volume risk transfer with a floor,
  - b) pricing flexibility with a cap,
  - c) availability payments with capital payment protection
- The scope and guiding principles create ambiguity on whether the public entity has full knowledge of all facts and costs and has an accounting treatment similar to the private entity
- The timing of recognition of an asset does not take into account the concepts of "commissioning," "payment" and "acceptance" that typically lead to a contractual obligation and accounting treatment
- The basis for conclusions should explain why the approach of risks and rewards was not retained knowing that Canadian availability payment PPPs have a high degree of standardization with limited ambiguity

- The application of “lease” standard and PS 3160 are very similar. Perhaps, the standard should start with an explanation of why “lease” provisions do not apply to availability models with guaranteed capital repayments.

## DEFINITIONS

**Q2 Do the definitions assist you with the interpretation and application of the standard? If not, what further clarifications or additional definitions are necessary?**

CCPPP generally agrees the definitions provided assist with the interpretation and application of the standard.

CCPPP recommends that the following definitions need clarification or to be added:

- Price control using International PSAS and Australian PSAS
- Betterments in a context of non-commissioning
- Other parties step in rights and government obligation to cure (performance obligation)
- Definition of contingent liability versus liability and in what scenarios P3 obligations are treated either liabilities or contingent liabilities with disclosure
- Unitary payment if the private sector only bids a design concept and a payment for the concession to the government entity. How are the concession contract and the concession asset accounted for separately or even defined?
- For greater clarity the Council recommends the Financial Liability model should clearly refer to availability payments.
- Significant asset residual

## RECOGNITION OF INFRASTRUCTURE ASSET

**Q3 Is the control guidance clear as it relates to the recognition of infrastructure? If not, what further clarifications are necessary?**

### RECOGNITION OF INFRASTRUCTURE ASSET

.06 A public sector entity should recognize infrastructure, or a betterment to infrastructure as an asset, where, through the terms and economic substance of the public-private partnership the public sector entity controls:

- a) the purpose and use of the infrastructure;
- b) access to the future economic benefits and risks of the infrastructure asset; and
- c) any significant residual interest in the infrastructure at the end of the public private partnership's term.

.07 Infrastructure identified in a public-private partnership arrangement meets the definition of an asset for the public sector entity when all of the following are met:

- a) The public sector entity expects to benefit from the use of the service capacity of the infrastructure to provide goods and services and is exposed to the risks. The services the public sector entity contracts to have delivered through the arrangement will be provided by the private sector partner. The future economic benefits and risks related to the infrastructure will be realized by the public sector entity as these services are provided.
- b) Through the terms of the arrangement, the public sector entity controls the infrastructure and access to the related future economic benefits and is exposed to the risks. The terms specify:
  - (i) the purpose and use of the infrastructure;
  - (ii) who may access the infrastructure;
  - (iii) its related future economic benefits; and
  - (iv) any significant residual interest in the infrastructure that exposes the public sector entity to the risks associated with the asset.
- (c) The signed and executed public private partnership agreement comprises the past event that gives control of the infrastructure to the public sector entity.

.08 Normally, the terms of the public-private partnership result in the recognition criteria being achieved over the construction period. When this occurs, the public sector entity recognizes the infrastructure over that period. A public sector entity would defer recognition until substantial completion of the infrastructure asset when the recognition criteria are met at the end of construction period. An example of this would be if the public sector entity is not exposed to the risks of completing the project even when the private sector partner fails to complete construction.



## Control

### Purpose and use

.09 Controlling the purpose and use of the infrastructure means that the public sector entity determines what the infrastructure will be used for and what services it will provide. For example, when a private sector partner is engaged to build and maintain a building, a public sector entity would control the purpose and use of the building by requiring it to be a hospital and use it to provide health-care services.

.10 Controlling the purpose and use of the infrastructure allows the public sector entity to benefit from the infrastructure through its capacity to provide goods and services.

.11 The terms of the arrangement may also, in varying degrees, specify the nature, extent and quality of the services to be provided with the infrastructure and to whom. The terms may also restrict the infrastructure's use for anything other than the specified purposes or prevent the private sector partner from using other assets to fulfill its service obligation.

.12 Other indicators of the public sector entity controlling the purpose and use of the infrastructure may include, but are not limited to, the public sector entity:

- a) requiring the infrastructure fit within an existing public sector infrastructure network;
- b) assigning responsibility for the performance of the infrastructure; and
- c) participating actively in key operating activities assigned to the private sector partner.

### Access to future economic benefits

.13 The terms of the arrangement would determine the degree to which the public sector entity can deny or regulate access to the infrastructure and its benefits. For example, the public sector entity can deny or regulate access by controlling who has access to the public services provided, or the price of those services, or both.

.14 Controlling access to the infrastructure includes limiting other parties from accessing the future economic benefits the infrastructure generates. For example, the public sector entity could control access to a student residence by requiring that tenants attend the institution with which it is associated. Mandating open and free public access may also be an indicator of the public sector entity's control of the infrastructure.

.15 The degree to which the public sector entity may affect the service price (where applicable) is an important factor in determining if the public sector entity controls access to the future economic benefits and risks of the infrastructure asset.

.16 For example, if the public sector entity sets free access of the service through the public private partnership agreement, it would demonstrate the public sector entity has control over

access to the future economic benefits and risks related to the infrastructure asset. On the other hand, if the public sector entity permits the private sector partner a great deal of discretion over pricing the service, then other factors would have to be considered in determining whether the public sector entity controls access.

.17 A public sector entity's regulation of an economic resource does not, in and of itself, constitute control of an asset. A public sector entity may establish the regulatory environment in an industry or sector in which organizations operate and impose conditions or sanctions on its operations, which does not indicate control.

.18 For example, a provincial transportation ministry may have the authority to set quality and safety standards for all roads in the province. However, this power does not constitute control of a specific public private partnership road because the authority's interest extends only to the regulatory use of the economic resources and does not include controlled access to the future economic benefits related to the specific public private partnership road.

## **Residual interest**

.19 Control of significant residual interest, if any, indicates the public sector entity's exposure to benefits and risks associated with the economic resource beyond the term of the agreement.

.20 Significant residual interest may exist at the end of a public private partnership arrangement in the form of an asset with service potential remaining or a liability that accrues to the public sector entity.

.21 For example, factors to consider in determining whether residual interest exists may include the following:

- a) The public sector entity legally owns or retains control of the land on which the infrastructure is located (e.g., a road built on a government-owned land).
- b) The infrastructure is integral to the public sector entity's operations or its existing infrastructure network (e.g., when a public private partnership road connects an existing series of publicly owned highways).
- c) The public sector entity will be responsible for liabilities and the ongoing maintenance related to the infrastructure even when the infrastructure itself has no service life remaining. Examples may include asset retirement obligations or liabilities for contaminated sites.
- d) The public sector entity's control over any significant residual interest would restrict or deny the private sector partner's ability to sell or pledge the infrastructure.

.22 Public private partnerships require the private sector partner to maintain and/or operate the infrastructure. While this transfers certain risks to the private sector partner during the public private partnership's term, the public sector entity continues to be exposed to risks associated with the residual interest at the end of the term.

CCPPP's concerns with respect to control guidance can be summarized as follows:

- 1) Control provisions are very broad and would capture virtually all PPP transactions. They also do not make a distinction between Lease and PPP accounting. The way the Exposure Draft is currently drafted, the PPP standards appear to be a duplicate of lease accounting standards. This matters in particular because asset and liability recognition guidance is essentially binary with limited flexibility. CCPPP's view is that there are different degrees of control requiring different recognition of assets and liabilities. This could be achieved through amended control guidance or through amended initial measurement guidance or a combination of both. The Council recognizes there may be a preference to provide any flexibility through asset and liability measurement since control provisions should result in either the private sector partner recognizing the asset and liability under IFRS or the public sector grantor recognizing the asset and liability but not both.
- 2) The definition of Purpose and Use of infrastructure assets are imprecise and overlap with access to future economic benefits and risks.
- 3) The control provisions make no distinction between an availability payment and a user pay PPP.
- 4) The distinction between PPP transactions, which are typically governed by a project specific contractual agreement, and other types of regulated infrastructure transactions, which may be governed by an industry wide regulatory model, is arbitrary.
- 5) Many of the features of PPP transactions that would trigger recognition of control are in the public good and regulatory in nature rather than exposing the public sector grantor to specific benefits or liabilities. The combination of 1, 2 & 3 above leads to concerns with respect to unintended incentives where a public sector grantor may seek to avoid regulatory control mechanisms that are in the public interest in order to avoid recognition.
- 6) The proposed control guidance appears inconsistent with and more onerous than both IPSAS 32 and control guidance in other areas of the PSAB Handbook including on operation and price setting control.
- 7) In particular, the Exposure Draft provides no guidance as to the risk exposure of the public sector grantor, although control depends upon exposure to risks.
- 8) The Exposure Draft removes price control as a necessary element of control, further broadening the criteria.
- 9) The condition in respect of "significant residual interest" could lead to unintended incentives and requires greater definition and interpretation guidance.

These comments are addressed in more detail in each of the points below.

### **3.1 Breadth of Control Provisions**

Control provisions are very broad and would capture virtually all PPP transactions, both financial liability (availability payment) and performance obligation (user pay) models, with the exception of those where the term of the arrangement equals or exceeds the useful life.

This matters in particular because asset and liability recognition guidance is essentially binary with limited flexibility. CCPPP's view is that there are different degrees of control requiring different recognition of assets and liabilities. This could be achieved through amended control guidance or through amended initial measurement guidance or a combination of both. The Council recognizes that there may be a preference to provide any flexibility through asset and liability measurement since control provisions should result in either the private sector partner recognising the asset and liability under IFRIC 12 or the public sector grantor recognizing the asset and liability but not both. CCPPP recognizes the challenges if the decision is made that the control test should be the mirror of IFRIC 12. However, CCPPP notes that the Exposure Draft is not a perfect mirror of IFRIC 12.

Under IFRIC 4 in contrast, the control criteria are:

- the purchaser in the arrangement has the ability or right to operate the asset or direct others to operate the asset (while obtaining more than an insignificant amount of the output of the asset)
- the purchaser has the ability or right to control physical access to the asset (while obtaining more than an insignificant amount of the output of the asset)
- there is only a remote possibility that parties other than the purchaser will take more than an insignificant amount of the output of the asset and the price that the purchaser will pay is neither fixed per unit of output nor equal to the current market price at the time of delivery.

CCPPP also notes that under PPP arrangements the public sector grantor typically and intentionally from a policy viewpoint gives up significant aspects of control.

- a) The grantor provides the private sector partner rights of quiet enjoyment of the asset. This limits non-public access to the asset.
- b) The grantor gives up the right to direct how operations are undertaken. In particular, except through change orders which are contingent events, the grantor does not have the right to either reduce or increase operation, maintenance or life cycle costs.
- c) The grantor gives up the right to discontinue operations or repurpose the asset, except through a termination for convenience which is a contingent event

CCPPP finds the control guidance in the Exposure Draft to be binary. The grantor either controls the infrastructure or it does not. There is no assessment of the nature of control and any specific benefits or liabilities that should be recognized from this. This is problematic especially when combined with measurement criteria that are equally binary in nature and do not reflect the substance of the transaction and its benefits and liabilities.

**CCPPP recommends** the control recognition and initial measurement provisions should operate in combination with each other such that the degree and nature of control exercised is a determinant of asset and liability recognition and measurement.

The Council notes no example is provided of a PPP transaction that would not meet the control criteria. Therefore, **CCPPP recommends** such an example be provided.

CCPPP compares the Exposure Draft provisions with those of IPSAS 32 9 (a)

Exposure Draft	IPSAS32 9 (a)
<p>the public sector entity controls:</p> <ul style="list-style-type: none"> <li>(a) the purpose and use of the infrastructure;</li> <li>(b) access to the future economic benefits and risks of the infrastructure asset; and</li> <li>(c) any significant residual interest in the infrastructure at the end of the public private partnership's term.</li> </ul>	<p>The grantor controls or regulates what services the operator must provide with the asset, to whom it must provide them and at what price.</p>

**CCPPP recommends** that the control provisions clearly distinguish between control over the economic benefits compared to control over the service potential (purpose and use) of the PPP asset. The Council feels these concepts are mixed and overlap in the Exposure Draft.

Control over both should be required in order to require recognition.

### 3.2 Purpose and Use

The Council considers purpose first. A key commercial principle of PPP transactions undertaken through the financial obligation (availability payment) model is that the public sector entity defines the service performance expected but that the choice of how to deliver that service potential in terms of the mix of capital assets and operating and maintenance inputs is left to the private sector partner.

In CCPPP's view it is challenging to argue that control over an infrastructure asset is the same regardless of whether the public sector entity defines the purpose of a specific infrastructure asset (such as a bridge) or defines a service which requires to be met (which may mean a bridge, a tunnel or the use of ferries).

Detailed specification of performance standards is much less common in performance obligation (user pay) models, since the transfer of demand risk is assumed to incentivize quality performance. However, infrastructure assets tend to be of an essential nature with limited competition and as a result some level of performance regulation is typically appropriate even under user pay PPPs.

**CCPPP accordingly recommends** that control over the purpose of an infrastructure asset should require rights to make payment deductions or obtain damages (including default) should an infrastructure asset not meet specifications or performance standards not be met.

The Australian PSAB adds an additional management condition (manage at least one management service): For example if the PPP transaction is a school DBFM but the grantor administers and hires teachers with the Operator managing maintenance and cleaning, it **is still not considered a service concession**.

IPSAS 32 leaves room for interpretation and not using the concession standards depending on transaction facts in section AG5

AG5. The assessment of whether a service concession asset should be recognized in accordance with paragraph 9 (or paragraph 10 for a whole-of-life asset) is made based on all of the facts and circumstances of the arrangement.

The Exposure Draft appears to equate control over access to the infrastructure asset with access to economic benefits. For example, BC 20: “*Ultimately if a public sector entity specifies the purpose and use, controls access and is exposed to a significant residual interest, these three criteria are sufficient to demonstrate control over the infrastructure asset.*”

CCPPP considers that *access to the infrastructure asset* is the same thing as *use of the infrastructure asset*.

**CCPPP accordingly recommends** that access to *economic benefits and risks* of the infrastructure asset should be clearly distinguished from purpose and use. Otherwise the same criteria can be used to satisfy both of these control criteria, rendering the criteria excessively broad.

**CCPPP recommends** that *economic benefits and risks* including “future” risks and benefits are clearly defined. The Council proposes specific approaches to this in sections 3.3 and 3.5 below.

The way in which the Exposure Draft defines access or use is also very broad. Both the ability to mandate open access and the ability to restrict or regulate access are seen as measures of control.

Consider IPSAS 32 AG6 “The ability to exclude or regulate the access to others to the benefits of an asset is an essential element of control that distinguishes an entity’s assets from those public goods that all entities have access to and benefit from.”

**CCPPP recommends** that regulation of access should only be evidence of control where it drives economic benefits or risks for the public sector entity. As discussed below, the Council struggles to see where this condition would be met except where the public sector entity uses control over price to regulate access.

### 3.3 Future Economic Benefits and Risks

Access to future economic benefits
.13 The terms of the arrangement would determine the degree to which the public sector entity can deny or regulate access to the infrastructure and its benefits. For example, the public sector entity can deny or regulate access by controlling who has access to the public services provided, or the price of those services, or both.
.14 Controlling access to the infrastructure includes limiting other parties from accessing the future economic benefits the infrastructure generates. For example, the public sector entity could control access to a student residence by requiring that tenants attend the institution with which it is associated. Mandating open and free public access may also be an indicator of the public sector entity’s control of the infrastructure.
.15 The degree to which the public sector entity may affect the service price (where applicable) is an

important factor in determining if the public sector entity controls access to the future economic benefits and risks of the infrastructure asset.

.16 For example, if the public sector entity sets free access of the service through the public-private partnership agreement, it would demonstrate the public sector entity has control over access to the future economic benefits and risks related to the infrastructure asset. On the other hand, if the public sector entity permits the private sector partner a great deal of discretion over pricing the service, then other factors would have to be considered in determining whether the public sector entity controls access.

CCPPP considers the Exposure Draft definition of control over future economic benefits and risks to be excessively broad.

The Council notes that IPSAS 32 BC 12 says that “Economic benefits are only likely to arise from a service concession arrangement in circumstances where the operator is granted the right to earn revenue from third party users, of either the service concession asset or another revenue generating asset.”

CCPPP believes this is an appropriate definition.

In this context the tests of control over future economic benefits in Exposure Draft 13-18 are related to purpose and use rather than economic benefits.

They cover regulation of access to infrastructure assets and price. Each of these is analyzed in more detail below in sections 3.4 and 3.5.

The Council also notes that, although the control provisions require that the public sector grantor controls “*access to the future economic benefits **and risks** of the infrastructure asset*” there is almost no guidance on risks in the Exposure Draft. This is discussed in more detail in section 3.5 below.

### 3.4 Price Control

.15 The degree to which the public sector entity may affect the service price (where applicable) is an important factor in determining if the public sector entity controls access to the future economic benefits and risks of the infrastructure asset.

.16 For example, if the public sector entity sets free access of the service through the public-private partnership agreement, it would demonstrate the public sector entity has control over access to the future economic benefits and risks related to the infrastructure asset. On the other hand, if the public sector entity permits the private sector partner a great deal of discretion over pricing the service, then other factors would have to be considered in determining whether the public sector entity controls access.

The Exposure Draft regards the ability of the public sector grantor to affect the service price as an important factor in determining control over access to the future economic benefits and risks of the infrastructure asset. Unlike IPSAS 32, however, price control is not a necessary condition for control.

IPSAS 32 AG 7 also notes that the public sector grantor does not require complete control over the price but that it is sufficient for regulatory control to be exercised either directly through the PPP agreement or indirectly through an industry wide regulator.

CCPPP regards regulatory control over pricing as being a normal and typical feature of a regulatory environment exercised in the public good. The Council does not believe that it reflects any control over future economic benefits or risks.

CCPPP regards control over price as being a necessary but not sufficient criterion for control and accordingly recommends that consistent with IPSAS 32 price control is a necessary condition for economic control.

**CCPPP recommends** that in order to be sufficient evidence of control the public sector grantor should also share in the risks of the price being set at a level which does not generate sufficient revenue through a liability to make shortfall payments or a right to share in the benefits through a revenue sharing arrangement.

### 3.5 Economic Benefits: Risk and Reward

07 Infrastructure identified in a public-private partnership arrangement meets the definition of an asset for the public sector entity when all of the following are met:

- a) The public sector entity expects to benefit from the use of the service capacity of the infrastructure to provide goods and services and is **exposed to the risks**. The services the public sector entity contracts to have delivered through the arrangement will be provided by the private sector partner. The future economic benefits and risks related to the infrastructure will be realized by the public sector entity as these services are provided.
- b) Through the terms of the arrangement, the public sector entity controls the infrastructure and access to the related future economic benefits and is **exposed to the risks**. The terms specify:
  - (i) the purpose and use of the infrastructure;
  - (ii) who may access the infrastructure;
  - (iii) its related future economic benefits; and
  - (iv) any significant residual interest in the infrastructure that **exposes the public sector entity to the risks** associated with the asset.
- c) The signed and executed public private partnership agreement comprises the past event that gives control of the infrastructure to the public sector entity.



CCPPP is of the view that the Exposure Draft does not provide enough focus or clarity on the economic benefits and risks associated with the infrastructure asset.

In this regard the Council finds greater clarity in the requirements in PS 3210 that a public sector entity should be exposed to the risks associated with the economic resource in order to control that resource. These are copied below.

<b>Control</b>	
.16	A public sector entity controls the economic resource and access to the future economic benefits when it: <ul style="list-style-type: none"><li>a) can benefit from the economic resource through its capacity to provide goods and services, to provide future cash inflows or to reduce cash outflows;</li><li>b) can deny or regulate access to those benefits by others; <b>and</b></li><li>c) is exposed to the risks associated with the economic resource.</li></ul>
.22	Control of an economic resource and of access to the future economic benefits are essential characteristics of an asset, whereas possession or ownership is not. For example, a public sector entity may control the economic resource and access to the future economic benefits through a capital lease arrangement yet not own the economic resource.
.25	It is the occurrence of a past transaction or event on or before the financial statement date that distinguishes a present economic resource controlled by a public sector entity from an economic resource that may be controlled by a public sector entity in the future.
.26	The past transaction or event that gives rise to control of an economic resource resulting from exchange agreements or contracts usually occurs at the point of exchange. This arises when substantially all the benefits and risks of ownership have been transferred to the public sector entity and normally coincides with the disbursement of funds, exchange of other assets or assumption of liabilities.
<b>DISCLOSURE</b>	
.30	An economic resource may meet the definition of an asset. However; <ul style="list-style-type: none"><li>a) it is not capable of being recognized in the financial statements because an appropriate basis of measurement and a reasonable estimate of the amount involved cannot be made; or</li><li>b) other Handbook Sections prohibit its recognition.</li></ul>

**CCPPP recommends** that the public sector grantor controls access to the future economic benefits when it:

- a) can benefit from the economic resource through its capacity to provide goods and services, to provide future cash inflows or to reduce cash outflows;
- b) can deny or regulate access to those benefits by others; and

c) is exposed to the risks associated with the economic resource.

CCPPP is of the view that there are a number of circumstances under which the public sector may be exposed to the economic risks and benefits of a user pay PPP transaction:

- a) Where the public sector entity guarantees a payment equal to the shortfall between forecast revenues and actual revenues or similarly guarantees a specified rate of return on investment to the private sector partner.
- b) Where the public sector entity participates in a share of revenues beyond a specified amount.
- c) Where the public sector guarantees a level of utilization of the infrastructure asset and restricts it from competition (denial or regulation of access to those benefits by others)

Note that best practice in Canadian PPPs is to provide compensation to the private sector partner if a competing infrastructure asset is allowed rather than preventing any such competition outright. CCPPP is of the view that such a provision would represent a contingent liability capable of measurement at the point at which a competing asset is allowed and compensation is determined.

### 3.6 Regulatory Control

.17 A public sector entity's regulation of an economic resource does not, in and of itself, constitute control of an asset. A public sector entity may establish the regulatory environment in an industry or sector in which organizations operate and impose conditions or sanctions on its operations, which does not indicate control.

.18 For example, a provincial transportation ministry may have the authority to set quality and safety standards for all roads in the province. However, this power does not constitute control of a specific public private partnership road because the authority's interest extends only to the regulatory use of the economic resources and does not include controlled access to the future economic benefits related to the specific public private partnership road.

CCPPP finds the distinction between contractual control and regulatory control to be artificial. The Exposure Draft risks confusing regulatory controls in the public interest and control over economic interest.

Exposure Draft BC19 states: *"Also consistent with Section PS 3210, control over the infrastructure would not exist merely by virtue of a government's broad and sweeping powers to control an industry through regulation or legislation."*

CCPPP is strongly of the view that many aspects of PPP transactions which could be interpreted in the Exposure Draft to be economic control are in fact regulatory control in the public interest.

It is vital to distinguish between these concepts and only to assess and recognize any economic control at the point it may arise from a decision made in the public interest (for example a termination for convenience, force majeure or default).

PSAB 3210.16 (b): The government can impose regulation including all restrictions on access for PPP sector without having to include the provisions in the Project Agreement.

PSAB 3210.16 (c): Project Co is exposed to all risks and benefits associated with the unpurchased portion of the asset (total capital cost minus payments during construction or at construction completion).

CCPPP is very concerned with respect to the unintended incentives of applying the economic control test inappropriately which may and does (based on current empirical examples) lead to a serious weakening of the public interest in revenue or user pay transactions in attempts to reduce economic accounting impacts.

The risk of an unintended incentive is that public interest controls are set aside in order to avoid recognition of an asset or liability. This is of particular concern given the penal recognition of a performance obligation liability under a User Pay PPP.

**CCPPP recommends** that controls of a regulatory nature are clearly distinguished from those which lead to economic control.

### **3.7 Distinction between Financial Liability and Performance Obligation models**

The control provisions make no distinction between a financial liability (availability payment) and a performance obligation (user pay) PPP.

CCPPP is of the view that a clear distinction can be made. Under financial liability models, the public sector entity has a high degree of control over the purpose and use of the infrastructure asset, enjoys economic benefits and incurs certain risks through making payments for the services received.

As a result, the Council anticipates that virtually all availability payment transactions would fall under the control provisions since the public sector grantor is making a payment for defined services. User Pay transactions would only fall under the control provisions where the public sector grantor makes payments or receives monetary benefits which are capable of reasonable estimation from inception of the transaction.

### **3.8 Mixed Use Assets**

Distinguishing between the different features and consequences of control is particularly relevant in respect of mixed use assets.

A pertinent example is the use of High Occupancy Toll (HOT) lanes to add capacity to existing highways.

Under a HOT lane transaction:

- a private sector partner would make capital improvements including capacity expansion to existing free highway lanes
- the private partner would also build additional lanes which it would have the right to operate as user pay lanes to recover its overall investment in the highway

- the public sector would regulate access to the HOT lanes, for example by requiring free access to vehicles with a high number of passengers (high occupancy) and electric vehicles.
- Pricing would be dynamic and regulated by reference to congestion levels on the highway as a whole

CCPPP notes the Exposure Draft is not detailed in respect of mixed use assets that are partly regulated. CCPPP broadly agrees with the provisions of IPSAS 32 AG 12-13 and AASB 1059 BC25 - 27 in this regard and recommends the Exposure Draft adopts similar guidance.

### 3.9 Significant Residual Interest

Under the Exposure Draft, a necessary condition for control recognition is “any significant residual interest in the infrastructure at the end of the public-private partnership’s term.”

CCPPP contrasts this with IPSAS 32 10, which excludes this control requirement where the service concession arrangement covers the entire useful life of the asset.

This difference leads to the unintended incentive where a PPP transaction under which the public sector grantor may be exposed to significant risks and benefits during the term, but which has a concession term equal to the forecast economic life of the asset, does not meet the control criteria for recognition.

Canadian PPP transactions do not typically run for the entire useful life of any underlying asset because public value for money is typically enhanced by having the option to take back an asset or retender the concession at between 30 to 50 years. Best practice is typically to structure the concession term and handback provisions around significant life cycle maintenance activities such that the public sector is assured a period of useful economic life before significant additional life cycle costs are required.

**CCPPP recommends** that the provisions of the Exposure Draft are amended to be consistent with IPSAS 32.

CCPPP considers that ownership of the land upon which an infrastructure asset is constructed is an important determinant of economic benefits and risks as well as residual value.

BC33: “In the public sector, land, such as Crown Lands not recognized in public sector financial statements, may have no carrying value or nominal value in the financial statements. However, the land may have a substantial market value.”

CCPPP regards a PPP concession allowing an infrastructure asset to be constructed on public sector lands as akin to a lease of the lands. Under this viewpoint the infrastructure asset could be considered as a tenant improvement which should be depreciated over the term of the lease.

Useful Economic Life can also be a challenging definition in PPP transactions. The Council addresses this further below. As the Exposure Draft itself notes useful economic life under a PPP transaction which requires a high level of ongoing maintenance may be longer than traditionally observed metrics. A PPP highway for example may be in substantially new condition at the point of handback at the expiry of a PPP concession. Assets will often have a defined “Design Life” but

achievement of this will usually require significant expenditures in life cycle maintenance. An additional factor is that commercial obsolescence, especially in respect of user pay assets, may be a more volatile risk than asset condition.

CCPPP, accordingly, finds it challenging that a "significant residual *interest*" is the criteria for control but there is no distinction between PPP handback provisions, which provide the public sector with a period of useful economic life following expiry with significant revenue generating potential or without significant life cycle expenditure, and a PPP transaction in which handback represents a liability.

CCPPP recommends that "significant residual interest" is defined as the estimated current value of the asset as if it were already of the age and in the condition expected at the end of the service concession arrangement" (consistent with IPSAS 32 AG9), that this current value must be reasonably capable of estimation at the beginning of the concession and that the residual value should be material in the context of the overall transaction.

In general, CCPPP believes residual risk and benefit, especially in respect of User Pay transactions, is not capable of reasonable estimation at the inception of a long-term contractual arrangement and accordingly should be reflected as a contingent liability until the point at which it can be reasonably estimated.

The Council notes there are a number of other provisions of the PSAB handbook which may be helpful in this regard.

- On PSAB 3210.25, the main purpose of entering into DBFM/DBFOM transactions is for the government to ensure future benefits (asset value) are available at expiry and service is provided in the years leading to asset transfer time and subsequent to that timing. The past event does not occur in the beginning of the transaction.
- On PSAB 3210.26, the point of exchange referred to confirm that asset value exchange is the "**expiry transition test mechanism.**" It starts eight to nine years prior to contract expiry with potential exchange of payment and asset residual transfer occurring during the testing period and at the end of the contract. This process is governed by an independent inspector based on which the Government can reject the asset residual transfer.
- On PSAB 3210.30, CCPPP notes that there can't be any reasonable estimate of the residual asset and liability

### 3.10 Comments on Example One illustrating control

CCPPP has reviewed the example provided in the Exposure Draft with respect to control.

<b>Example 1 — New community recreation centre</b>
B1 A municipal government enters a 25-year arrangement with a private sector consortium to design, build, finance, operate and maintain a new community recreation centre. There are no predetermined annual service payments.
B2 Under the terms of the agreement, the government has specified in the agreement that there

<p>must be free and full access provided to the general public from 9:00AM to 12:00PM and 7:00PM to 10:00PM every day of the week. Outside of these public hours, the private sector partner may run a private fitness club and is permitted full discretion to charge and collect fees for use per visit, or through a membership program. At the end of the 25-year agreement, the recreation centre will become the legal property of the municipal government. The estimated useful life of the building is 40 years.</p>
<p>B3 In determining whether the government controls the recreation centre, the government must control the purpose and use of the recreation centre, access to the facility and any significant residual interest at the end of the term of the agreement (if such interest exists).</p>
<p>B4 Mandatory requirements to keep the recreation centre open for public use and free for those specified hours indicates that the government controls, to a certain extent, the purpose and use of the asset. The government benefits from the purpose and use of the recreation centre and its capacity to provide public services.</p>
<p>B5 Controlling access means that the public sector entity can deny or regulate access to those benefits and is exposed to the risks associated with the recreation centre. Control over pricing is an indicator of controlling access to the infrastructure. In this case, the government controls access by specifying certain hours when the public has full and free access to the recreation centre.</p>
<p>B6 Finally, the recreation centre is expected to be handed back to the government after the 25-year agreement is complete. As a result, the government is again exposed to the long-term benefits and risks of the recreation centre. As the facility is expected to have another 15 years useful life upon handover, it is determined that the government controls a significant residual interest.</p>
<p>B7 The government would recognize the recreation centre as an asset because all three control criteria have been met. It would also recognize a liability representing a performance obligation on the part of the local government for providing the right to charge fees and continual access to the recreation centre to the private sector partner.</p>

For a number of reasons, CCPPP questions whether this example reflects a practical example of a Canadian PPP transaction. From the information provided in this example, the Council has great difficulty in identifying the public sector control over **purpose**. This would be the case, if for example the public sector specified that the facility had to include two ice rinks or three soccer fields or specific facilities for seniors' recreation.

Both use and access to economic benefits are assumed to be met through the public sector entity's right to mandate open and free access during specified hours.

However, these hours could and may well reflect off peak hours that are not material to the economic benefits of the overall facility.

At the practical level, it is far more likely in reality that the public sector entity would specify free or subsidized access for certain groups (school parties, seniors) to certain parts of the facility. This should be quantified.

In CCPPP's view, the focus of determination of control should be the materiality of the economic benefits and risks to which the public sector is exposed "*through the terms and economic substance of the public-private partnership.*"

Consider, if the example granted the private sector party the right to build a recreation centre in the grounds of a school and provided a stream of economic value through a commitment to utilize a portion of the facilities for school programs either through direct payment or indirectly through a guarantee of revenues if private sector fees resulted in a shortfall, or through protections that they would not allow any other competing facilities.

In this circumstance, the economic benefits and risks of the transaction to the public sector entity can be quantified and the materiality of these considered in the context of the overall transaction to determine control.

It is CCPPP's view that determination of control should be proportionate to the amount and value of the economic resource that is being utilized by the public sector entity.

For example, if the public sector entity requires four ice rinks to be available for subsidized school programs for which it pays directly or indirectly and the private sector chooses to build eight ice rinks in total, then it may make sense to determine that 50 per cent of the facility is controlled by the public entity and should be recognized as an asset.

The sacrifice of economic benefits which the public sector is making in this regard would, at the practical level, be the value of publicly owned land on which the recreation centre was constructed. While ownership of the land is not stated in the example, CCPPP can see no economic reason for the private sector partner to enter into this agreement rather than developing a purely private sector fitness facility, unless by doing so it gains access to economically valuable land or permits which would not otherwise be available to it.

The example does not address to what risks the public sector entity is exposed. CCPPP sees no evidence for any risks that would justify "*a liability representing a performance obligation on the part of the local government for providing the right to charge fees and continual access to the recreation centre to the private sector partner.*"

The public sector entity clearly has a residual interest. However, the Council assumes that, in common with most Canadian PPPs, there are handback provisions that ensure the facility can meet its anticipated useful life of 40 years at expiry. The public sector entity accordingly has no capital expenditure risk associated with the transaction. In 25 years' time, the public sector entity will achieve control over the recreation facility. It will make decisions on: how to operate and maintain the facility; who can obtain access and at what, if any pricing; whether soccer fields should be converted into bowling greens.

These and numerous other decisions are contingent and will determine the value of the asset at that point in time. As an example, if the economic value of the recreation centre is underpinned by its

connection to a school and in 25 years' time as a result of demographic change the school has closed and the neighbourhood is aging, then the economic value to the private concessionaire may not be a guide to the residual economic value of the facility.

In respect of the example as presented, CCPPP would conclude that the recreation centre does not meet the definition of control.

- The public sector entity is not defining the **purpose** of the facility or the performance standards which it must meet (other than those of a general regulatory nature).
- The public sector is not materially controlling the **use** of the facility.
- The public sector does not control or share in the economic benefits or risks of the facility.
- Residual interest is contingent and not capable of accurate measurement at inception of the transaction.



## INITIAL MEASUREMENT

**Q4. Do you agree the cost of the infrastructure should be measured initially at the infrastructure asset's fair value as proposed in paragraphs .27-.29? If not, what alternative is more appropriate and why?**

*.27 The initial cost of an infrastructure asset constructed or acquired as part of a public-private partnership arrangement should be measured at its fair value.*

.28 Initial measurement of an asset acquired in an exchange transaction is recognized at its cost, which should be equal to the fair value of the asset. Fair value is the price a market participant would pay for an equivalent infrastructure asset with the same service potential and risk profile.

.29 Where the costs of acquiring or constructing the infrastructure are readily available from the public private partnership process and agreement, these amounts would be used to measure the asset cost. The public-private partnership asset and service components should be separated into capital and operating (and/or maintenance) components. The cost of the infrastructure asset is the present value of the capital portion of annual service payments, lump sum payments and any progress payment using the contract rate (see discount rate guidance in paragraphs .56- .59).<sup>4</sup> Initial cost should not exceed the asset's fair value.

.30 In general, direct costs that are capitalized should be consistent with TANGIBLE CAPITAL ASSETS, Section PS 3150. The cost of constructed infrastructure would normally include direct construction or development costs (such as material and labour) and overhead costs directly attributable to the construction or development activity. The activities necessary to prepare infrastructure for its intended use encompass more than the physical construction of the infrastructure. The activities include the technical and administrative work prior to the commencement of and during construction.

.31 In a public-private partnership arrangement, the private sector partner is compensated for assuming construction related risks, such as design risks, cost overruns, etc., that may not exist in traditional procurement models. Such costs would be included in the capital cost of the asset.

.32 In some public-private partnerships, it may be difficult to determine what the cost of the infrastructure asset is or what portion of the annual service payments relate to the infrastructure asset and what portion relates to operating and/or maintenance costs. In such cases, determining the cost of the infrastructure asset and separating annual service payments would require the public sector entity to allocate costs related to the infrastructure asset separately from costs related to operating and/or maintenance. These allocations would be determined based on the relative fair values of the infrastructure asset and the service contract.

.33 To determine the relative fair values of the infrastructure asset and of the service

portion of the arrangement, an entity uses estimation techniques. These techniques must be appropriate in the circumstances. Sufficient data must be available to determine the asset cost and separate the annual service payments. The public sector entity maximizes the use of relevant and observable inputs and minimizes the use of unobservable inputs.

CCPPP's comments with respect to the proposed use of Fair Value are divided into Financial Obligation (Availability Payment) transactions and Performance Obligation (User Pay) transactions.

Our comments with respect to Financial Obligation transactions can be summarized as:

- 1) The Exposure Draft places excessive reliance on historic cost as the basis for Fair Value
  - Ignores the likelihood of embedded O&M costs in bid prices
  - Establishes capital costs by means of an artificial point in time (Substantial Completion) rather than based on the substance of the costs
- 2) The Exposure Draft provides insufficient and potentially misleading guidance in respect to the separation of capital and operating & maintenance components of a PPP transaction.
- 3) The Exposure Draft is insufficiently clear that a PPP asset should be amortized over its useful life rather than the term of the PPP concession.
- 4) 4) Financial Obligations are recognized and presented in the same way regardless of their nature and conditionality.
  - IPSAS 32 suggests that only unconditional obligations should be recognized as a Financial Obligation.
  - CCPPP notes that IPSAS 32 13 states that "Service Concession assets shall be accounted for as a separate class of assets"

#### **4.1 Excessive reliance on historic cost to determine Fair Value.**

CCPPP considers the concept of Fair Value to be appropriate. However, the Council does not consider the definition of Fair Value used in the Exposure Draft to be appropriate as it relies heavily on the historic costs incurred by the winning private partner during a time period prior to the initial substantial completion of the project.

##### **4.1.1 Reliance on the winning bidder's cost**

The Exposure Draft states in paragraph 29: "Initial measurement of an asset acquired in an exchange transaction is recognized at its cost, which should be equal to the fair value of the asset. Fair value is the price a market participant would pay for an equivalent infrastructure asset with the same service potential and risk profile."

The argument is that as public-private partnerships are the result of a competitive bidding process, cost should be equal to the asset's fair value on day one of the transaction.

This might be accurate if a PPP transaction competed the price of the same asset. The challenge with this is that a PPP transaction competes a service potential that is achieved through a mixture of capital and O&M costs. These costs are accounted for differently. Different bidders may propose very different combinations of capital and O&M costs. The winning bidder, for example, may have included in its costs to completion embedded O&M costs, which are not capital in nature. CCPPP is very concerned about the unintended incentive in this regard that if, in order to reduce the impact of the budget and borrowing cost, a government is incited to choose a PPP proposal with a lower capital cost compared to one which has the lowest overall life cycle cost. The example provided below illustrates this.

**CCPPP recommends** that the Exposure Draft wording is amended to: “Relative Fair Value of the asset and O&M components of the transaction can be estimated from the public sector comparator (or similar estimates of what the government may choose to build) and from the bids submitted as part of a competitive tender process.”

CCPPP considers this more consistent with IPSAS 32 AG32 than the current drafting of the Exposure Draft. We provide further comments on estimation techniques in response to question 6 below.

#### **4.1.2 Excessive reliance on a defined time period to differentiate capital from O&M costs**

Most Canadian PPP transactions have the concept of a construction period financed at least in part by the private partner leading to a (partial or complete) substantial completion at which services commence and the grantor commences making payments. This typically marks the distinction between capital and O&M costs. However, this distinction can be arbitrary and a construct of the way in which the PPP transaction is defined by the grantor or the way in which the winning bidder responds. This can lead to unintended incentives.

The distinction between capital and O&M costs is artificial. In practice it can be very challenging to apply an objective standard to what constitutes capital, life cycle and O&M costs. In the Exposure Draft, the distinction between capital and O&M depends upon whether a cost is financed as part of the costs incurred up to Substantial Completion or is funded directly by a payment from government. A good example would be the common practice under a PPP of completing an initial highway paving sufficient for operations to commence followed quickly by a more long-term repaving. This has the commercial logic of improving pavement surface quality by allowing for settlement but has the side effect under the Exposure Draft of moving the repaving from a capital to an operating expense.

Under a PPP there are likely to be material costs incurred prior to substantial completion, such as the costs of operating and maintaining an existing asset during construction, demolition costs of an existing asset, financing costs (Interest During Construction), embedded O&M or warranty costs, which do not clearly meet the definition of tangible capital assets. There are also costs incurred after achievement of substantial completion that should meet the definition of a Tangible Capital Asset but are funded by the O&M payment stream, such as final completion works and significant life cycle expenditures.

It is for this reason that **CCPPP recommends** below that the Exposure Draft should examine the conditionality or otherwise of the payment obligations in determining both the asset value and the corresponding liability.

In respect of the specific timing issue CCPPP recommends the provisions of IPSAS 32 AG32 to assist in estimation of the Fair Value of the asset and O&M components of the transaction.

CCPPP provides additional recommendations with respect to which costs should be capitalized in our response to question 5 below and recommendations in respect of the recognition of life cycle costs in our answer to question 6 below.

## **4.2 Insufficient and potentially misleading guidance in respect to the separation of capital and operating & maintenance components of a PPP transaction**

CCPPP regards the unitary payment concept as key to quality PPP transactions that satisfy the public good objectives intended from using PPP procurement.

In the view of CCPPP, there are two important elements to the concept of a unitary payment:

- 1) The risk exposure of the private sector partner in respect of payment deductions is the same regardless of whether the underlying cause of the deduction is a problem with the design-build of the asset (capital) or operation and maintenance performance.
- 2) The partners to the PPP transaction should be indifferent as to whether a payment reflects capital or O&M in order to ensure that whole of life optimization decisions are not affected by different payment characteristics.

In practice, it is possible to identify in most Canadian PPPs a stream of payments that are labelled as capital and a stream described as O&M since these are handled differently under different contingent termination provisions. The degree to which payments can therefore be considered separable, however, does not meet the description of the ways in which a service concession agreement may be considered separable laid out in IPSAS 32 AG29.

CCPPP is therefore strongly of the view that the approach to identification of separable payments proposed by the Exposure Draft is inappropriate.

**CCPPP recommends** that the proposed standard includes the wording: "Payments under a service concession agreement should only be considered separable where one of the following conditions is met:

- a) There is part of the payment stream that varies according to the availability of the service concession asset itself and another part which varies according to the usage or performance of certain services with no cross deductions between the two payment streams, or:
- b) Different components of the service concession arrangement run for different periods or can be terminated separately. For example, a material individual service component can be terminated without affecting the continuation of the rest of the agreement, or:
- c) Different components of the service concession arrangement can be negotiated separately. For example, a service component is market tested and some or all (a material portion) of the cost increases or reductions are passed on to the grantor in such a way that the part of the payment by the grantor that relates specifically to that service can be identified.

- d) The grantor has an **unconditional** obligation to make a predetermined series of payments to the operator, consistent with IPSAS 32 AG37-38.

#### 4.3 The nature of different types of Financial Obligation should be reflected

Liability
.36 A liability, recognized in relation to a public-private partnership arrangement should be initially measured at the same amount as the related infrastructure asset, reduced for any consideration previously provided to the private sector partner.
.37 In arm's length transactions, the consideration provided is equal to the value of the good or service received. When a liability is created as a result of the financial liability model and the user-pay model combined, the sum of the liabilities is equal to the fair value of the asset(s) received by the public sector entity.
.38 Additional considerations attributable to other components of the public-private partnership agreement (such as operating and maintenance payments) are excluded from the measurement of the liability.

CCPPP is strongly of the view that:

- 1) The asset that exists at substantial completion should only be recorded as an asset in the grantor's financial statements to the extent that the grantor has made unconditional obligations to pay for it or a portion of it. It is too early at this stage to know whether the asset has achieved its forecast fair value or whether it suffers from impairment. The Council notes that the grantor explicitly does not accept completion of the asset at service commencement. Recognition of the full value of the asset would not be prudent.
- 2) The grantor's liabilities should clearly distinguish between:
  - a) Financial indebtedness
  - b) Unconditional payments
  - c) Payments conditional on performance

In most Canadian PPPs, the obligation to pay future payments is not a financial obligation. It is entirely performance related and subject to deductions. It should, therefore, represent payment for a service proportionately undelivered and accordingly should be expensed. Only where a portion of the future payments are effectively guaranteed (for example through an explicit separation of capital payment and protection against deductions or through capped deductions) should the future payments be recognized as a financial obligation and capitalized.

### 4.3.1 Contingent liabilities

For example, in Europe the accounting rules set by the European System of Accounts excludes liabilities from public sector balance sheets if the private sector bears most of the project's risks and rewards. The types of risk contributing to this test include construction risks (such as cost and time overruns) and demand risks (such as forecasted and actual use of the infrastructure asset).

This is in line with the financial and accounting rules that suggest that the following should be considered "contingent liabilities" off balance sheet as per IFRS requirements below.

AS 37 defines and specifies the treatment of liabilities and considers that a liability may be a legal obligation or a constructive obligation. A constructive obligation arises from the entity's actions, through which it has indicated to others that it will accept certain responsibilities, and as a result has created an expectation that it will discharge those responsibilities. Examples of provisions may include: warranty obligations; legal or constructive obligations to clean up contaminated land or restore facilities; and obligations caused by a retailer's policy to make refunds to customers.

An entity recognizes a provision if it is probable that an outflow of cash or other economic resources will be required to settle the provision. If an outflow is not probable, **the item is treated as a contingent liability.**

### 4.3.2 Grantor Financial Indebtedness

The Exposure Draft is silent on the fact most Canadian Availability Payment transactions include significant payments by the Grantor during construction and at substantial completion and that these payments are financed by taxpayer supported indebtedness, which is unrelated to the performance of the project. Such indebtedness should clearly be recorded as a liability.

**CCPPP recommends** that such unconditional indebtedness should be recorded as a different class of liability from performance payments to the private sector partner, which are conditional in nature. Such indebtedness will typically be incurred at a different finance charge and repayment profile from payments under the PPP and should not be confused with the Contract Rate.

### 4.3.3 Contributed Surplus Move

The Exposure Draft is silent on how to recognize grant financing or similar non-repayable contributions (for example from a senior level of government). **CCPPP recommends** that these should be recognized as a contributed surplus.

### 4.3.4 Conditional Payments

CCPPP believes that it is important to distinguish between payments that are conditional in nature and those that are unconditional. This is important to prevent unintended incentives for a public sector entity to undertake low quality PPP transactions which guarantee certain payments where the risk could be more effectively transferred to the private sector partner. It is also important to accurately reflect the nature of the public sector grantor's liabilities.

The Council notes that IPSAS 32 appears somewhat contradictory in this regard. IPSAS 32 makes repeated references to unconditional and pre-determined payments that the grantor does not have discretion to avoid. However, IPSAS 32 also provides guidance that the existence of the ability to make performance-based payment deductions does not in itself make a payment conditional.

It also notes that section 51-53 of the Exposure Draft sets a high standard of certainty for financial liabilities:

.51 Financial liabilities that arise from a public-private partnership arrangement are liabilities where all of the following are met:

- a) The public sector entity has a present obligation to deliver cash or another financial asset. The public sector entity cannot avoid this obligation.
- b) Settlement in cash or another financial asset results in the reduction in economic resources available to the public sector entity.
- c) The transaction or event giving rise to the liability has already occurred. Based on the public-private partnership's contractual terms, the public sector entity would evaluate which transaction or event gives rise to the liability (e.g., entering the public-private partnership agreement or construction taking place).

.52 Subsequent measurement of a financial liability should be at amortized cost using the effective interest method.

.53 To extinguish all or a portion of a financial liability, the public sector entity must:

- a) discharge the liability by paying the private sector partner cash or delivering another financial asset; or
- b) be legally released from its responsibility for the liability either by law or by the private sector partner.

**CCPPP recommends** that only such portion of the payment which can reasonably be predicted should be accrued as a liability. This could also be used as the basis for recognition of the portion of the asset which is recognized by the public sector entity.

#### **4.4. Initial Recognition of User Pay (Performance Obligation) Transactions**

CCPPP has significant concerns with the application of the Performance Obligation to user pay transactions which can be summarized as:

- 1) Recognition of an asset at inception of a transaction under which the economic risks and benefits have been transferred to a third-party private sector partner for an extended period of time is inappropriate and not prudent.

- 2) Recognition of a corresponding “performance obligation” liability to offset this asset recognition is even more inappropriate.
- 3) Use of the term “performance obligation” is misleading and confusing.
- 4) The proposed approach leaves little room for reflecting different types of user pay transactions including the more nuanced approach of user pay transactions in which risks are shared between government and private sector partners.
- 5) Assuming that it is desirable, establishing Fair Value of the asset and the timing and nature of the corresponding liability is extremely challenging.
- 6) To the extent that the current Exposure Draft approach is retained, “performance obligation” liabilities should be clearly distinguished in the presentation of financial statements.
- 7) Examples 2 & 3 illustrating User Pay and Mixed Consideration transactions are not typical of Canadian PPP transactions and potentially misleading.

The Council expands on each of these points below.

## 4.5 Asset Recognition

CCPPP understands and has sympathy for a line of reasoning that user pay infrastructure procured by government through a PPP reflects both a) an addition to society’s stock of economically beneficial infrastructure generating indirect economic benefits, and b) an asset in which government has a residual interest.

In section 3 above, the Council recommend that control provisions focus on direct economic benefits and liabilities. Under these recommendations, many user pay transactions would either not satisfy or only partially satisfy the control conditions for recognition. This would be consistent with many other types of asset that provide indirect societal benefits but where control rests with the private sector.

By definition, and in contrast to the arguments made in respect of many other types of government infrastructure, user pay infrastructure has a defined commercial value. However, the valuation of user pay infrastructure tends to be volatile. It would be imprudent to recognize a user pay asset at its historic cost if in fact insufficient users are prepared to pay a fee that provides a repayment of that cost. It would also be inaccurate to maintain a historic cost valuation where users have demonstrated a demand for the asset that creates excess returns on investment.

This volatility is even more important when recognizing the government’s direct economic interest in the asset is typically a long dated residual interest that is challenging to value at the inception of the transaction.

CCPPP therefore strongly disagrees with the basis for conclusion that “The Exposure Draft is clear that initial measurement of the infrastructure asset and corresponding liability is driven by the fair value of the infrastructure asset. Fair value of the rights granted to the private sector partner would not be used to measure the infrastructure asset.” (BC36)



## Emerging Asset

**CCPPP recommends** as an alternative that the appropriate asset recognition for a user pay asset is an emerging asset concept. The public sector grantor obtains economic benefits and risks associated with an asset over time:

- a) As a result of a default by the private sector operator,
- b) As a result of a termination for the convenience of the grantor, or
- c) As a residual interest at the expiry of the concession period.

The grantor's interest under a&b are best recognized as a contingent liability if and when these events occur. C) is a known event but is long dated and the residual value of the asset at that time is challenging to determine with prudence at the outset of the transaction. Where the value of the asset could reasonably be expected to be stable it may be appropriate to recognize the portion of the asset financed by users directly as a gain/contributed surplus as the revenues are received. This would constitute a fairer representation of the government's actual economic interest. This concept allows for mixed consideration transactions to be addressed effectively.

It is CCPPP's view that the public sector's residual interest in a long dated user pay transaction has too many uncertainties for the recognition of an asset upon inception of the transaction to be prudent. **CCPPP recommends** that asset recognition should occur only later in the transaction when the value of the residual interested can be estimated with any certainty. A contingent asset could be recognized in the interim. This would remove the pressure on public sector accounting to identify an artificial matching liability.

Based on all the points made above, CCPPP is strongly of the opinion that recognizing a full liability upfront is more erroneous and misleading than recognizing a gain or surplus upfront.

### 4.6 Recognition of a performance obligation liability

The initial Basis for Conclusions based on the Statement of Principles concluded that Stakeholders largely agree that once you record an asset, you must also record a liability equal to that asset upon initial measurement, otherwise a gain or loss would need to be accounted for upfront.

As above, CCPPP strongly disagrees that the government grantor should recognize an asset at historic cost at inception of a user pay PPP transaction. The Council does not see any supporting argument with respect to the recognition of the performance obligation.

The concept of the "performance obligation" liability has been artificially created for matching purposes and to address the concern that a future public sector residual value interest in a user pay asset may either not be recognized or, if recognized from inception, may be inflated. This reflects the challenges of proportionate recognition of a residual interest that is long dated, which the Council addresses above.

CCPPP does not believe the accounting standard should condition a methodology to avoid an outcome.

The Council infers from the Basis for Conclusions that the performance obligation liability should equal the fair value/ historic cost of the asset. In order to achieve this forecast, revenues need to be bifurcated into a) a component that accounts for the volatility of the forecast revenues b) a component which covers operations, maintenance and life cycle costs of the asset c) a component that reflects the finance charge implicit in the agreement, and d) a component that reflects repayment of the initial asset capital cost.

The Council's comments in section 4.1 above, demonstrate how challenging this bifurcation is under an availability payment/ financial obligation model. The Council's comments below expand on the challenges under a user pay model where similar information is unlikely to be available accurately to the grantor.

CCPPP also finds no helpful guidance in the Exposure Draft or the examples provided.

Assuming for a moment that a stream of user revenues can be identified that repays initial capital investment and that these revenues are stable in nature, then the performance obligation liability should presumably be amortized on a straight line basis as revenues are received. If revenues are significantly lower than expected does that mean that amortization is adjusted and the liability is reduced at a slower rate?

**CCPPP recommends** that the concept of a performance obligation liability is removed from the standard except in circumstances, described below, where the government grantor has a clear liability for a shortfall in revenues.

**CCPPP also recommends** that significantly greater guidance is provided in this regard.

.61 Performance obligations that arise from a public-private partnership arrangement are recognized as liabilities where all of the following are met:

- a) The terms of the public-private partnership require the public sector entity to provide the private sector partner ongoing access to the infrastructure to earn revenue from third-party users, representing a present obligation.
- b) In addition to giving up its ability to collect revenues from infrastructure users, its obligation to provide access to the private sector partner requires the public sector entity stand ready to protect the private sector partner's right to earn revenue from the third-party users. This sacrifice of economic benefits can take various forms, including:
  - i) enforcing a payment by third-party users;
  - ii) enforcing exclusive access to the private sector partner; and
  - iii) protecting the rights of the private sector partner.
- c) Providing ongoing access is the result of past events and transactions occurring under the public-private partnership agreement.

## 4.7 Fair Value under User Pay Model

Unlike IPSAS 32, there is no direct statement of how to calculate a performance obligation liability provided in the Exposure Draft. **CCPPP recommends** this deficiency be rectified.

Instead we need to look for guidance as to the Exposure Draft's intentions in the Basis for Conclusions excerpted below.

### Assets acquired with the user-pay model

BC35 PSAB also considered the fact that in some public-private partnerships; the private sector party is compensated using the user-pay model (e.g., the right to charge tolls). The fair value of the infrastructure asset delivered to the public sector may not be equal to the fair value of the fees and tolls the private sector party may collect through operating the infrastructure. For example, if the government compensates the private sector partner by granting the right to charge tolls in exchange for a newly constructed public highway that the private sector will operate and maintain for 30 years, then the fair value of the right to charge tolls would be compensating the private sector partner for all of the following:

- a) the capital costs of the new highway;
- b) ) the value of the operating and maintenance contract; and
- c) (c) risk transfer and return on capital.

BC36 The Exposure Draft is clear that initial measurement of the infrastructure asset and corresponding liability is driven by the fair value of the infrastructure asset. Fair value of the rights granted to the private sector partner would not be used to measure the infrastructure asset.

BC37 PSAB proposes that the infrastructure asset is initially measured at fair value whether the related liability is a financial liability, a performance obligation or both. Stakeholders agree that once the public sector entity records an asset, it must also record a liability equal to that asset upon initial measurement; otherwise an upfront gain would result. Thus, the initial measurement guidance proposed in the Exposure Draft is driven by one measurement attribute: fair value of the asset on initial recognition. Whether the public sector entity pays for the asset with cash over time, with non-monetary assets or through the user-pay model, the initial measurement attribute in the proposed standard remains the same.

## 4.8 Misleading Use of the Term Performance Obligation

The Exposure Draft uses the term "performance obligation" that IPSAS 32 (BC21) recognizes could give rise to confusion.

CCPPP is strongly of the view that the performance obligation is on the private sector not the government grantor and the performance obligation liability is not a fair representation of the public sponsor's actual liability and risk exposure.

Should there be a continuing need for the term, then **CCPPP would recommend** using the term "Self-supported user pay obligation," which better reflects the nature of any potential liability.

#### **4.9 Different types of User Pay/ Revenue PPP Transactions**

CCPPP can identify a number of different types of PPP transaction structures that fall under the broader user pay model. It will be clear from the terms of the PPP agreement under which category the transaction falls.

- 1) User Pay, Pricing Risk, Demand Risk: the private sector partner is exposed to the full risks of whether it will earn its anticipated returns on the transaction including the repayment of any initial capital investment.
- 2) Shadow Tolls, Demand Risk: the private sector is exposed to the full demand risks of the transaction but earns its revenues from a payment by the public sector grantor based on usage.
- 3) User Pay, Demand/ Pricing Risks shared between the public sector grantor under a shortfall or upside mechanism. This differs from 1 & 2 above in that the public sector entity has a shared liability with the private sector partner which should be recognized.

The Exposure Draft does not make any distinctions between these different types of user pay transaction and appears to focus on category three where the government grantor shares in risks associated with the revenue streams and accordingly has some genuine performance obligations and benefits that should be recognized.

The Exposure Draft fundamentally misses the economic substance of a user-pay model and treats the obligation similarly whether the government guarantees the stream of revenues or not. If traffic or ridership numbers are low or non-existent, the money at risk is equity and private debt. If there is ProjectCo default and if the revenues numbers are very low, the fair market value of the asset that the public sponsor pays to ProjectCo will be minimal or nil. CCPPP does not see any logical foundation for recognizing a full liability upfront.

#### **Full Demand Risk**

Unlike IPSAS 32 (BC32), the Exposure Draft does not make any distinction between a user pay transaction under which the operator is guaranteed by the grantor a certain level of revenues or net return on investment and one in which demand risk is taken fully by the operator. CCPPP considers this distinction to be very important.

IPSAS BC 30-32 states "Where the operator **bears the demand risk**.....the grantor does not have a liability because the service concession agreement is an exchange of assets, with the service concession asset being obtained by the grantor in exchange for a transfer of rights to the operator to earn revenue from third-party users of the asset over the period of the service concession agreement."

**CCPPP strongly recommends** that the Exposure Draft is amended to reflect this situation to ensure that a public sector liability is not recorded where no meaningful or measurable liability exists.

### **Shadow Tolls**

IPSAS 32 (AG 49) also provides guidance with respect to shadow tolls that such payments should be expensed and not accrued as a liability due to their uncertain nature. Shadow tolls, in CCPPP's opinion, represent a midpoint between a user pay transaction and an availability payment transaction in passing demand risk but not direct user pay risk to the private sector partner. If shadow toll payments should be expensed rather than accrued as a liability, then CCPPP sees little justification for any demand risk based user pay transaction to be accrued as a liability.

### **Shared Risk and Benefit transactions**

Risks and benefits can be shared in a number of different ways.

### **Pricing controls**

The government grantor can allow the private sector to charge users higher prices where returns are lower than anticipated and lower prices where returns are on or above forecast expectations. While this can be an appropriate method to protect the public interest to adjust returns to appropriate levels, it creates indirect economic benefits and liabilities and, consistent with the IPSAS 32 treatment of shadow tolls should not affect the asset and liability recognition.

### **Concession Payments to/from Grantor**

In many Canadian and international user pay transactions the "consideration in exchange of transferring right to use and charge users" may include either a concession payment to the grantor by the private sector partner or a contribution of capital costs by the grantor. **CCPPP recommends** that these transfers should be recognized as a) a Contributed Surplus or b) a partial interest in an asset. Concession payments by the private sector operator may be made upfront based on forecast revenues or over time based on actual outcomes.

### **Revenue Shortfall Payments**

In some PPP transactions (although currently rare in Canada) the public sector grantor may accept a liability to make shortfall payments to guarantee the private sector partner a certain return or revenue where user payments are insufficient. This should be recognized as a contingent liability.

## **4.10 Fair Value Estimation Challenges**

The approach to determining fair value is even more challenging under a user pay model than a Financial Obligation model, since there is no capital or O&M payment stream to discount and the grantor's access to costs incurred by the private sector partner, whether capital or operations & maintenance in nature, will typically be far more limited than under an availability payment based PPP.

As described above, the revenue stream under a user pay transaction is also unlikely in practice to be straight line and may in fact be highly variable from accounting period to accounting period. In this context does it really make sense for the “performance obligation” to be amortized on a straight line basis.

CCPPP’s recommendations with respect to control above would exclude most user pay transactions from being recognized as an asset at the inception of a concession arrangement.

The Council’s comments on Initial Measurement reinforce its concerns expressed in the control section with respect to recognizing user pay transactions as a grantor asset.

#### 4.11 Misrepresented Financial Statements

By recording a user-pay performance obligation as a liability, the accounting representation will send the wrong signal to rating agencies on the government’s ability to raise taxes in order to meet all liabilities. This will constitute a double counting. The public sector liability is already reflected in the indirect taxation burden of levying a user pay fee which extinguishes any further taxpayer liability. There does not appear to be any proposed differentiation in the Exposure Draft between a Financial Liability and a Performance Obligation. At the minimum **CCPPP recommends** that these two types of liability are clearly differentiated in the presentation of the financial statements.

#### 4.12 Criticisms of Example 2

CCPPP finds Examples 2 (User Pay model) and 3 (Mixed Consideration model) to provide limited guidance in this regard.

##### 4.12.1 Example 2 — User Pay Model Toll highway

B8 A government decides to impose a toll on an existing highway to generate revenues. The government enters into an arrangement where the private sector partner is responsible for collecting tolls on the highway. To compensate the private sector partner the government allows it to keep 50 per cent of toll revenues collected. The government would set the toll rate.
B9 The existing highway has already been recorded on the public sector entity’s books. As part of the arrangement, the private sector partner will install additional infrastructure to electronically charge a toll to drivers who use the highway. The toll system has an estimated cost of \$100 million. At the end of the 10-year public private partnership, the toll-collection system is required to be in good condition and will be handed over to the government with an expected useful life of another 10 years.
B10 This transaction would fall within the scope of public-private partnerships. The government: <ul style="list-style-type: none"><li>a) controls the purpose and use of the toll system;</li><li>b) has access to its data;</li><li>c) sets the toll price each year; and</li></ul>

<p>d) retains the toll infrastructure for another 10 years after the public private partnership agreement expires.</p> <p>Accordingly, the government would record the asset on its books upon initial recognition.</p>
<p>B11 The government would record a toll-system asset at its estimated cost of \$100 million and record a corresponding liability for \$100 million. The liability would represent a performance obligation, as the government must provide the private sector partner with access to the infrastructure and continually maintain the private sector partner's exclusive right to collect tolls on its behalf for 10 years.</p>
<p>B12 As the new toll system has a useful life of 20 years, the government would record annual amortization expense of \$5 million a year. <math>\\$100M \div 20 \text{ years} = \\$5M</math> amortization expense per year. It is determined that the government relieves its performance obligation over time and would record revenues of \$10 million each year of the 10-year agreement. <math>\\$100M \div 10 \text{ years} = \\$10M</math> revenue per year as liability is drawn down.</p>
<p>B13 In addition, as the private sector partner collects toll revenues, it would remit 50 per cent of its collections to the government. The toll revenue remitted to the government would be recognized as it is earned by the government.</p>

This example is very untypical of Canadian PPPs. In practice and often as a matter of government policy, a private sector partner would only be allowed to toll a previously untolled highway having been responsible for the design-build of significant betterments to the useful life and/or capacity of the infrastructure. The private sector partner would then be exposed to the risk of whether toll revenues were sufficient to pay back a return on this investment. In this context, it is highly unlikely the private sector partner would accept a unilateral right on the part of the public sector to set tolls.

It is also practically unlikely that the public sector entity would choose to finance the tolling equipment in this way since recovery of a return on the tolling equipment would likely represent a very small portion of overall toll collection, not the 50 per cent used in the example

CCPPP sees this example as unrealistic and more representative of an operating concession or franchise which would be outside of the scope of this standard.

**CCPPP recommends** that an alternative example be used to better reflect the practical commercial reality of Canadian PPP transactions.

#### **4.12.2 Criticism of Example 3 — Mixed consideration with life cycle costs: College residences**

<p>B14 A college is working with a private sector partner to design, build, finance, operate and maintain a new residence for approximately 500 students on the school's main campus on land the college owns. The private sector partner will be paid for constructing the building through the rents it collects during the 25-year agreement. The private sector partner will be paid an annual service payment for the duration of the 25-year contract in exchange for providing operating and maintenance services. At the end of the agreement, the college will assume all operating and</p>
--

maintenance activities.

B15 The college is obligated to pay \$1 million each year for 25 years for the operating and maintenance service contract. In addition to this, the college must also make two lump-sum payments of \$3 million in Years 20 and 24 relating to life cycle costs. Each \$3-million payment pertains to replacing certain key components of the building that will ensure that the residence has another 25 years of useful life upon hand back for a total useful life of 50 years. In the final year of the agreement, an engineering assessment will be conducted to determine if the building has a useful life of at least another 25 years. Otherwise, the private sector partner is responsible for incurring the costs to upgrade the condition of the building to meet these requirements.

B16 The College is deemed to have controlled the asset and would recognize it at cost which should be equal to its fair value. A liability would also be recognized, representing a performance obligation for the College to maintain exclusive rights for the private sector partner to charge rents to third parties. In this case, the scheduled life cycle payments would not be capitalized. These life cycle costs sustain the building's estimated useful life of 50 years. In this example it is assumed that the college is amortizing the asset using a single useful life for the building and not using the componentization approach. It is also assumed that the incurred life cycle costs do not meet the definition of betterments. The assessment of whether these costs expand the service capacity of the asset is made on a case-by-case basis. It should be consistent with Section PS 3150 and the public sector entity's specific accounting policy on capitalization and betterments. As these costs will not enhance the service capacity of the asset, the college does not treat them as betterments. The building's estimated useful life of 50 years presumes that private sector party will meet its performance obligations.

B17 The payments outlined in the operating and maintenance schedule would be disclosed in accordance with CONTRACTUAL OBLIGATIONS, Section PS 3390. The public sector entity benefits from the private sector partner's service to provide ongoing operating and maintenance over the life of the contract. The \$1 million per year annual service payment with respect to operating and maintenance would be expensed each year for the life of the contract.

B18 In addition to annual \$1-million operating and maintenance expenses, the college has agreed to make two lump-sum payments in Years 20 and 24 of \$3 million relating to life cycle costs (e.g., replacing the roof, windows and HVAC). In public-private partnership arrangements, the scheduled payments for life cycle costs may not correspond to the timing of when the private sector partner incurs the costs. The private sector partner is responsible for the college residence to have an expected useful life of another 25 years upon handover back to the college. This is different from traditional procurements, where if the college paid for the HVAC system to be replaced, then the costs related to the new HVAC system would be recorded in the period when this life cycle cost was incurred.

B19 The college should expense these costs over the life of the service contract as the benefit of the payments are accrued over the period of the contract. The payments are what ensure that the asset is sustained in a manner that it may last another 25 years, upon handover. In this case, the college determines that the total of all scheduled payments should be spread equally over the 25-year contract. This results in the college recording an expense and accruing a payable for \$1.24M each year. Total of all payments is  $\$25M + \$6M = \$31M \div 25 \text{ years} = \$1.24M$  (time value of money



not accounted for). When the college makes the scheduled payment, it would relieve the accrued liability.

Example 3 is also very untypical of a Canadian PPP transaction. A key commercial objective of PPPs is to ensure the private sector partner responsible for the design and construction of an asset is also responsible for its operation, maintenance and life cycle costs and risks. CCPPP finds it artificial that the payments by the college are explicitly related to the operation and maintenance of the facility and to life cycle costs rather than being a unitary payment to cover a portion of the private sector partner's overall return on its investment.

It seems inappropriate that life cycle costs committed in years 20 and 24, which ensure a further 25 years of useful life, should be amortized over the first 25-year period rather than the second 25-year period. At the minimum it would seem that the life cycle costs should be amortized over the 50-year economic life. It is not entirely clear from the example whether the life cycle costs are expensed or accrued. Overall, the example does not seem to be consistent with the guidance in the Exposure Draft that life cycle costs, which do not represent a betterment, should be expensed rather than capitalized.

The example offers no basis for the conclusion that the College is deemed to control the asset and CCPPP sees little reason to conclude that this should be the case.

A more useful, practical and realistic example would be as follows:

A college is working with a private sector partner to design, build, finance, operate and maintain a new building that will provide academic, recreational, retail and residential facilities for approximately 500 students on the school's main campus on land the college owns. Academic and recreational space is specified by the College. The private partner has flexibility in the specifications of the retail and residential space. The total cost of the building is \$250 million. It is not practical to break out costs of the different components of the space.

The private sector partner will receive revenues of \$12.5m pa escalating annually at the rate of inflation from the College as an availability payment for the performance of the academic and recreational facilities, inclusive of O&M. The private sector partner receives additional revenues from rents it collects from residential and retail facilities during the 25-year agreement. The College has no obligation to ensure the occupancy of the building or to enforce the payment of rent. The College has agreed to limits on the capacity of competing residences on campus. The College has the right to terminate the agreement for convenience by paying out the fair market value of the building. Termination for default compensation is similarly calculated as fair market value less any impairment costs.

The private sector partner is only allowed to rent to accredited students of the college and rents are controlled by reference to a benchmark of accommodation available within a radius of the college.

At the end of the 25-year agreement, the college will take over all activities associated with the building and assume all operating and maintenance activities.

At year 20, prior to the expiry of the agreement, an engineering assessment will be conducted to determine if the building has a useful life of at least another 25 years. Otherwise, the private sector partner is responsible for incurring the costs to upgrade the condition of the building to meet these requirements. Typical of Canadian PPPs, if the engineering assessment finds, for example, estimated costs of upgrading of \$20 million, then \$10 million of availability payments are withheld for the last five years until the works are complete. The College has agreed to make two lump-sum payments in Years 20 and 24 each of \$5 million in money of the day dollars relating to life cycle costs (e.g., replacing the roof, windows and HVAC). Each \$3-million payment pertains to replacing certain key components of the building that will assist in ensuring that the building has another 25 years of useful life upon hand back for a total useful life of 50 years.

This example would provide guidance on how to address a mixed use and mixed consideration asset.

It is CCPPP's view that:

- 1) The building as a whole fails to meet all of the criteria necessary to establish control. It would be neither prudent nor appropriate for the College to recognize the full construction cost of \$250 million as an asset at inception as it does not control the economic risks and benefits until 25 years in the future.
- 2) The proportionate capital costs of the academic and recreational space specified by the College are not capable of reasonable estimation.
- 3) There is no reasonable basis for the bifurcation of the availability payment into capital and O&M payments. Different bidders may have had different approaches to the quality of the building necessary to attract tenants and to meet asset performance and handback requirements resulting in different cost structures.
- 4) The amount of the annual availability payment is not unconditional. It depends upon operational performance and the actual rate of inflation.
- 5) The Weighted Average Cost of Capital of the private sector partner may not be known. Even if this is declared, the weighted average cost of capital will be a function of the design and construction risk, the operational performance and handback risks and the retail and rental revenue risks. These cannot be distinguished.
- 6) CCPPP cannot identify a meaningful or quantifiable performance obligation on the part of the College, except on a contingent basis where it chooses to expand College residences beyond the specified limits and may need to negotiate compensation with the private partner.
- 7) The College clearly has a significant residual interest in the building. However, asset condition risks are borne by the private sector partner. It is challenging to establish the fair market value of the asset in 25 years' time as that will be dependent upon market rents at the time.
- 8) CCPPP concludes it would be most appropriate for the College to record its obligations to make availability payments of \$12.5m pa in today's dollars as a contingent liability.

- 9) The College could recognize an interest in an emerging asset. Each year it would debit the expense of the availability payment and credit a 1/25<sup>th</sup> proportionate interest in the \$250-million asset which it should then amortize over the remaining 50-year economic life. At handback of the building in year 25, the College would hold an amortized historic cost asset of approximately \$177 million which should be updated to a fair market valuation.
- 10) The College's obligation to make life cycle payments of \$10 million should be added to the capital value of the asset and amortized over the remaining 25-year economic life.

## Timing and Nature of Capitalized Costs

**Q5. Do you agree that specific public-private partnership costs required to get the infrastructure asset ready for use should be capitalized as proposed in paragraphs .30-.31? If not, what alternative is more appropriate and why?**

.30 In general, direct costs that are capitalized should be consistent with TANGIBLE CAPITAL ASSETS, Section PS 3150. The cost of constructed infrastructure would normally include direct construction or development costs (such as material and labour) and overhead costs directly attributable to the construction or development activity. The activities necessary to prepare infrastructure for its intended use encompass more than the physical construction of the infrastructure. The activities include the technical and administrative work prior to the commencement of and during construction.

.31 In a public-private partnership arrangement, the private sector partner is compensated for assuming construction related risks, such as design risks, cost overruns, etc., that may not exist in traditional procurement models. Such costs would be included in the capital cost of the asset.

In this section the Council provides:

- a response to Q5 in respect of the definition and nature of capitalized costs, noting that there are significant costs incurred during the construction phase of a PPP transaction that would not typically be treated as capitalized costs under conventional government delivery.
- views on the lack of guidance in the Exposure Draft on the timing of recognition of an asset and associated liabilities
- views on the importance of the Exposure Draft requiring amortization of an asset over its useful economic life, taking into account asset hand back condition requirements under a PPP, rather than over the term of the PPP agreement.
- views on the treatment of government grant contributions during and at the end of the construction period
- views on the subsequent measurement of cost overruns, deductions and modifications to contractual rights
- a critique of Exposure Draft Example 4, which the Council suggests needs additional work to be realistic and relevant.

### 5.1 Definition of Capitalized Costs

The key words in the Exposure Draft are “The cost of constructed infrastructure would normally include direct construction or development costs (such as material and labour) and overhead costs directly attributable to the construction or development activity”

The Council notes there are significant costs incurred during the construction period of a PPP transaction that would not typically be capitalized under conventional delivery but would be captured by the provisions of the Exposure Draft. Interest during construction (IDC) in a PPP transaction can represent as much as 20 per cent of capital value (for a four to five year construction period). IDC and costs of operating and maintaining an existing asset prior to commissioning of a new asset should not be capitalized.

The Exposure Draft is currently silent on whether Interest During Construction (IDC) should be capitalized. This represents a material difference between conventionally procured assets, which do not typically capitalize IDC, and PPP transactions, which typically incorporate this in the costs to completion.

Another significant issue is Insurance Premia. Private sector partners under a PPP will almost invariably purchase Construction All Risks (CAR) insurances and often consequential loss add ons such as Delay in Start up (DSU) and Advanced Loss of Profit (ALOP) insurances. These will typically add several percentage points to the capitalized construction cost in addition to asset value insurances during the operating period. Public sector entities in contrast will often self-insure some or all of these risks resulting in an additional significant difference in capitalized values between PPP transactions and conventional delivery.

All of the above differences are typically taken into account in the value for money reports in which Canadian procurement agencies typically compare the costs of PPP to that of the public sector comparator.

Importantly, the proposed standard appears to limit the flexibility for a public sector grantor to treat these components differently relative to the provisions of IPSAS 32.

**CCPPP recommends** clarification on costs that should be capitalized under a PPP transaction. Costs that would normally be expensed or not recognized under conventional government of delivery should not be capitalized under a PPP arrangement.

## 5.2 Componentization

The Exposure Draft is weak in its guidance on whether it is appropriate to treat different components of a capital asset differently.

CCPPP considers this important in the context of a PPP transaction. For example, a transit project will typically combine civil infrastructure with a design life in excess of 75 years with rolling stock and systems with a useful economic life of approximately 40 years.

CCPPP can recognize the advantages of treating a PPP as a single asset, particularly as the private sector partner's liability for performance deductions or defaults is rarely if ever linked to different component parts.

However, using the example of a transit project, the term of the PPP agreement will typically be set such that it expires shortly before decisions are made with respect to replacement of rolling stock and

systems. This is a deliberate commercial decision to allow for technological change. Rolling stock and systems will typically comprise over 30 per cent of the total capital investment in the project.

**CCPPP recommends** that componentization is required for the purpose of useful economic life where components with significantly different economic life represent more than 20 per cent of the asset value.

### 5.3 Timing of Recognition

The Exposure Draft is unclear on when an asset and liability should be recognized. There is no explicit section of the Exposure Draft relating to timing. Example 5 provides some guidance, but as set out below CCPPP considers this to need additional work.

**CCPPP recommends** the Exposure Draft provide explicit guidance on the timing of recognition of an asset and liability.

The Exposure Draft currently does not address whether Interest During Construction (IDC) should be capitalized. This represents a material difference between conventionally procured assets, which do not typically capitalize IDC, and PPP transactions, which typically incorporate this in the costs to completion. (Section 5.1)

**CCPPP recommends** adding more guidelines on when these development/early works should be capitalized (Section 5.2)

### Contingent Liability

The Council notes the public sector entity incurs a significant contingent liability at inception of a PPP transaction upon signature of the contract before any works have commenced.

**CCPPP recommends** that this should be recorded. CCPPP considers this important because in many respects contract execution is a more significant date in crystalizing the public sector entity's liabilities than either work in progress or substantial completion. The public sector entity will typically reserve the right to terminate the contract at its convenience following execution. However, such termination will typically come with an obligation to reimburse costs including: bidding and development costs, design and mobilization costs (which may not be captured under a percentage of work completed definition), costs of terminating contractual obligations (for example to an operator), make whole costs on debt issued and an opportunity cost return on equity. These costs will typically be significant.

CCPPP provides further detail on its recommendations in respect of the timing and details of recognition in section 5.6 below where the Council provides a critique of Exposure Draft Example 5

### 5.4 Treatment of Government grant contributions during construction

The Exposure Draft is silent on the fact most Canadian Availability Payment transactions include significant payments by the Grantor during construction and at substantial completion and that these payments are financed by taxpayer-supported indebtedness unrelated to the performance of the project. Such indebtedness should evidently be recorded as a liability.

**CCPPP recommends** such unconditional indebtedness should be recorded as a different class of liability from performance payments to the private sector partner, which are conditional in nature. Such indebtedness will typically be incurred at a different finance charge and repayment profile from payments under the PPP and should not be confused with the Contract Rate.

In the typical Canadian availability payment PPP, these grantor payments for construction are now very material relative to long-term private sector financing exposed to performance-based availability payments. This trend is driven by a desire to reduce financing costs in a public sector accounting environment where no distinction is made between the risks of paying for construction compared to paying for long-term operational performance.

Under CCPPP's Alternative View, these payments are unconditional obligations and should be reflected as such, while availability payments are conditional on performance.

## 5.5 Useful Life

<p>.39 TANGIBLE CAPITAL ASSETS, Section PS 3150, applies when accounting for infrastructure assets in periods subsequent to the initial recognition. The cost, less any residual value, of an infrastructure asset with a limited life is amortized over its useful life in a rational and systematic manner appropriate to its nature and use by the public sector entity.</p>
---

<p>.40 In evaluating the asset's useful life, the public sector entity would consider performance requirements that specify the infrastructure asset be maintained at agreed-upon levels through the duration and at the end of the arrangement. Performance requirements would include scheduled improvements of the asset such that there is significant useful life remaining at the end of the arrangement.</p>
---

<p>.41 Infrastructure generates economic benefit to its users over its useful life, which may differ from the length of the public-private partnership agreement. Public-private partnerships often involve a commitment to perform ongoing operating and maintenance activities that may be required to keep the infrastructure asset at an appropriate standard of performance.</p>
---

<p>.42 For example, if the private sector partner is expected to fulfill its obligations to operate and/or maintain the infrastructure asset to a high standard, then the estimated useful life of the asset may be well beyond historical averages for that particular asset class. Alternatively, if the private sector partner does not perform its operating and/or maintenance obligations, the public sector entity would consider the effect of this on the asset's useful life, which would consequently affect the annual amortization charge.</p>
---

The Exposure Draft implies, but in CCPPP's view does not clearly state, that the asset should be amortized over its useful life and not the term of the PPP Concession Agreement. Reference: 50-53. *"useful life which may differ from the term of a public-private partnership agreement."* Furthermore, the Exposure Draft appears to recognize assets delivered under a PPP may have a longer useful life than conventionally procured assets.

Infrastructure assets, particularly those that are well designed, built, operated and maintained tend to increase in value over time both because the economic benefits generated by the infrastructure grow at a faster rate than GDP growth and because the replacement cost indices tend to grow faster than the general rate of inflation.

CCPPP believes this is a valuable component of the proposed standard and one which differs from current practice.

The Council notes the financial or performance obligation amortization over the contract term (e.g. 35 years) and the asset amortization over the useful life (e.g. 50 years) will create mismatches of the net asset fair value.

**CCPPP recommends** the standard should clearly require an analysis of the expected useful life and residual value under the PPP transaction and the amortization period should reflect this analysis.

## 5.6 Subsequent Measurement

<b>Modifications to contractual terms and takeover rights</b>
.64 Modifications, which may include deductions, liquidated damages or penalties, during the life of the public-private partnership occur based on events and circumstances unique to each public-private partnership. Modifications are accounted for when the event occurs, depending on the facts and circumstances of each scenario.
.65 For example, after building a bridge to relieve traffic congestion, a municipality may need to replace stop signs at nearby intersections with roundabouts to improve traffic flow. Such a modification would be accounted as a betterment or a capital asset addition when it occurs.

CCPPP finds the Exposure Draft needs to be strengthened on the subject of subsequent measurement. The Council does not consider it appropriate to rely on the provisions of PS3150 in respect of Tangible Capital Assets because of the substantial differences between PPP delivery and conventional government ownership and management of assets. In particular, PPP transactions provide governments with evidence of the commercial value of assets that may otherwise be lacking.

CCPPP is concerned by the likelihood, if the Exposure Draft is adopted as currently drafted, that material changes to a PPP transaction such as ongoing significant performance deductions or a default by the private partner would not result in any changes to the accounting treatment in the Public Sector Grantor's financial statements. This does not seem prudent and could create unintended incentives to avoid defaults. The Council suggests the Exposure Draft's paragraph .42 be strengthened in this regard and have further comments on revaluation below.

While this is beyond the scope of the Exposure Draft alone, CCPPP believes a major impediment to the efficient delivery of infrastructure by the public sector is the lack of timely revaluation or impairment of assets relative to private sector accounting requirements. This encourages, for example, common practices such as the creation of significant maintenance deficits without any discipline imposed by the risk of impairment or reduction in useful economic life. PPPs are a



mechanism to introduce commercial disciplines to public sector infrastructure and so impairments can be easily observable. However, CCPPP is concerned that if PPP accounting treatment is the same as that for public sector delivery then many of the potential advantages will be lost.

CCPPP's comments can be summarized as:

- 1) The Exposure Draft currently does not address how a capital cost overrun absorbed by the private sector partner should be treated. Following the Exposure Draft logic of replacement cost equaling historic cost, this should in theory result in an increase in the asset recognized but with no corresponding increase in the public sector liability. The net result would then be a reduction in the finance charge as a percentage of asset value. This makes sense to CCPPP as the higher cost of financing a PPP is intended to cover the risk of cost overruns.
- 2) The Exposure Draft currently does not address how consistent performance deductions of O&M payments should be treated. A similar logic should apply to a capital cost overrun except in this case it could be argued the asset value is impaired.
- 3) A significant contractual event, such as a termination for default, would not necessarily have any effect on the accounting treatment. **CCPPP recommends** that a contingent event of this nature should result in a change in the asset and liability recorded.
- 4) The Exposure Draft treats significant life cycle expenditure as an expense even if it is necessary to achieve the useful economic life of the asset (for example a new roof). A betterment that would be capitalized is narrowly defined as an investment which expands the service capacity of the asset. **CCPPP recommends** that replacement of a material component of an asset necessary to its useful life should be capitalized rather than expensed.
- 5) Subsequent Measurement under user pay or Performance Obligation transactions is even more important and challenging since there is a likelihood of significant variability in the user pay revenue streams that are used as a proxy for amortization of the performance obligation. Consistent with our recommendations on initial measurement of user pay assets, **CCPPP recommends** the Exposure Draft provide guidance on fair market valuation of user pay assets if there is a continuing desire to record an asset and liability.

The Council addresses each of these in more detail below.

### 5.6.1 Cost Overruns

Capital cost overruns relative to the initial budget or even contracted amount are unfortunately common in the delivery of major projects. One of the major commercial advantages of PPP transactions is the ability to eliminate or mitigate the risk of such cost overruns for public sector entities while not prejudicing the cost efficiency of future O&M requirements or life cycle costs.

Under conventional delivery the historic cost recorded in the public sector entity's financial statements should be the "as built" cost including any cost overruns. It is much less likely that this would include any sophisticated analysis of additional future O&M or life cycle costs necessary to maintain the forecast economic life of the asset if quality reductions were negotiated in order to mitigate cost overruns.

Under PPP delivery, cost overruns typically:

- 1) Result in an increased lump sum payment from the public sector entity reflecting a relief (or risk sharing) event for which the private sector partner was not responsible, and/or
- 2) An increase in the cost of the private sector partner with no change in the liabilities of the public sector entity.

Under the logic of the Exposure Draft, which seeks the actual historic cost, both of these outcomes would have the same effect in increasing the value of the asset recorded in the financial statements.

**CCPPP recommends** that under b) above any increase in the value of the asset should be reflected as a contributed surplus by the private sector partner.

### 5.6.2 Performance Deductions, Impairment and Revaluation

The Exposure Draft does not provide detailed guidance in respect of impairment and revaluation, referring instead to the provisions of PS3150.

#### PS3150 Write-downs

.31 When conditions indicate that a tangible capital asset no longer contributes to a government's ability to provide goods and services, or that the value of future economic benefits associated with the tangible capital asset is less than its net book value, the cost of the tangible capital asset should be reduced to reflect the decline in the asset's value. [SEPT. 1997]
--

.32 The net write-downs of tangible capital assets should be accounted for as expenses in the statement of operations. [SEPT. 1997 *]
---

.33 A write-down should not be reversed. [SEPT. 1997]
---

.34 A government would write down the cost of a tangible capital asset when it can demonstrate that the reduction in future economic benefits is expected to be permanent. Conditions that may indicate that the future economic benefits associated with a tangible capital asset have been reduced and a write-down is appropriate include: (a) a change in the extent to which the tangible capital asset is used; (b) a change in the manner in which the tangible capital asset is used; (c) significant technological developments; (d) physical damage; (e) removal of the tangible capital asset from service; (f) a decline in, or cessation of, the need for the services provided by the tangible capital asset; (g) a decision to halt construction of the tangible capital asset before it is complete or in usable or saleable condition; and (h) a change in the law or environment affecting the extent to which the tangible capital asset can be used.
--

.35 The persistence of such conditions over several successive years increases the probability that a write-down is required unless there is persuasive evidence to the contrary.
---

.36 When the tangible capital asset no longer contributes to the government's ability to provide goods and services, it would be written down to residual value, if any. This would be appropriate when the government has no intention of continuing to use the asset in its current
---

capacity, and there is no alternative use for the asset.

.37 In other circumstances, it will be necessary to estimate the value of expected remaining future economic benefits. Where a government can objectively estimate a reduction in the value of the asset's service potential to the government, and has persuasive evidence that the reduction is expected to be permanent in nature, the tangible capital asset would be written down to the revised estimate of the value of the asset's remaining service potential to the government.

This does not adequately address the subsequent measurement challenge of how to reflect cost overruns (absorbed by the private sector partner) or performance deductions. Both could be viewed as a reduction in the finance charge.

Both the operating and maintenance costs and the finance charge are expensed in the period to which they apply. **CCPPP recommends** that, performance deductions to the actual operating and maintenance payments should be reflected as a reduction in the finance charge for the period to which they apply. This is because a portion of the finance charge relates to the risk profile.

For example, the annual O&M expenses are \$10 million and the finance charge is also \$10 million based on a five per cent weighted average cost of capital on \$200 million of capital expenditure. A 10 per cent annual performance deduction to the O&M costs would be reflected as a \$1-million reduction in the finance charge making the effective financing rate 4.5 per cent rather than five per cent.

The cost of finance (debt credit spreads and equity premiums charged by lenders and investors) in PPP is not a function of the cost to finance the asset itself but to mainly hedge against construction, operation and maintenance poor performance and default. The higher the scope of maintenance and operation (including revenue risk), regardless of the asset value, the higher will be the private sector rate. CCPPP addresses these issues under Subsequent Measurement above where it discusses the implications of a cost overrun absorbed by the private sector partner or performance deductions to availability payments on the finance charge component of the expense. Simplified, if the financing premium compared to a government cost of borrowing is seen as an insurance premium to cover certain risks, then the financing charge should be reduced to the extent that such risks are crystalized. Hence, the CCPPP recommendation that a performance deduction should not be reflected as a reduction in O&M expense but as a reduction in the finance charge expense. This represents a classification but does not change the substance of the accounting as both are expenses. CCPPP finds it much harder, under the framework used by the Exposure Draft, to accept an argument that a cost overrun in construction of an asset absorbed by the private sector partner should be capitalized and then reflected as a reduction in the finance charge expense. There would be a certain logic to this, but it would not be consistent with the approach used throughout the Exposure Draft and the accounting treatment of capitalized and expensed liabilities is very different.

## 5.7 Life Cycle Expenditures and Betterments

<b>Betterments</b>
.43 Betterments, as defined in TANGIBLE CAPITAL ASSETS, Section PS 3150, are added to the carrying amount of the related infrastructure when the future economic benefits of the betterment are controlled by the public sector entity.
.44 Public-private partnerships often have life cycle costs scheduled into the agreement and contribute to the infrastructure asset having longer useful lives as a result. Life cycle costs are those maintenance activities that sustain the asset over its expected useful life. These costs are typically expensed when incurred when using a single-useful-life calculation. Examples would include replacing the roof, the windows and the HVAC system.
.45 When a public sector entity uses the componentization approach to capitalizing assets, betterments that increase the service capacity of specific components of the infrastructure would be capitalized and amortized. For example, if the roof is scheduled to be replaced, the related costs would be capitalized as a part of the roof component and amortized over its useful life. Under the componentization approach to capitalization, old components need to be written off when new replacement components are capitalized in the period the items are replaced.
.46 When the public sector entity is using a single-useful-life calculation for the entire infrastructure asset, life cycle costs would be considered in assessing the asset's useful life and residual interest. Improvements to the infrastructure would only be considered betterments if they increase the service capacity of the infrastructure asset. The assessment of the asset's useful life, considering scheduled maintenance and life cycle costs, would affect the annual amortization charge.

CCPPP respectfully disagrees with the Exposure Draft guidance in respect of the recognition of life cycle costs and betterments.

The Exposure Draft treats significant life cycle expenditure as an expense even if it is necessary to achieve the useful economic life of the asset (for example a new roof). A betterment, which would be capitalized under the Exposure Draft, is narrowly defined as an investment that expands the service capacity of the asset.

**CCPPP recommends** that replacement of a material component of an asset necessary to its useful life should be capitalized rather than expensed and amortized over the remaining useful life of the asset following the life cycle investment.

As discussed above, CCPPP is concerned that, where a significant life cycle investment is necessary to extend the useful economic life of the asset, the asset is amortized over this extended life from initial recognition on the assumption that the investment would be made. Under this scenario, a bidder who designed and built an asset capable of meeting a 50-year economic life from the outset

may be penalized relative to a bidder who relies on investment in a new roof at year 25 to achieve a 50-year life. Where the life cycle investment is material, **CCPPP recommends** that a component approach is taken to recognition of the useful economic life.

## 5.8 Criticisms of Example 5: Multi-year example with financial compensation: City Bridge

B33 A city agrees to a public-private partnership arrangement with a P3 consortium to design, build, finance, operate and maintain a new bridge for the city after a competitive bidding process. The cost of the bridge is \$400 million based on the information provided in the agreement and the information available to the city through the procurement process, such as the financial model. The government bears the construction risk of the project.

B34 The city plans to set up separate accounts for the major components of the infrastructure to more accurately track costs and depreciation. The core bridge structure is expected to have a useful life of 75 years and represents 60 per cent of the total capital cost. The road bed and surface are expected to have a useful life of 50 years and represent 40 per cent of the cost. The city will also be installing signs and traffic signals before the bridge is opened for use, which are expected to have a useful life of 20 years. These signs and traffic signals are outside the scope of the public private partnership agreement and the city will be responsible for these costs.

- B35 Additional details about the agreement and procurement process are as follows:
- The city is required to make a lump-sum milestone payment of \$100 million when construction reaches 40 per cent of substantial completion.
- There is a commissioning lump-sum payment of \$100 million to reflect the bridge is ready to use by the public (i.e., 100 per cent complete).
- Before the bridge is ready for use, the city will install signs and signals which will cost \$3 million.
- The capital cost of \$400 million less the two milestone payments above leaves a remaining \$200 million to be financed by the P3 consortium over the 30-year term of the public private partnership agreement.
- For the first year the bridge is operational in 2X23, the annual service payments will total \$16.51 million. The capital portion of the annual service payments are \$13.01 million per year and the non-capital portion is \$3.5 million per year (adjusted annually for inflation).
- Based on the capital portion of the annual service payment and the \$200 million of capital costs being financed through the P3 consortium, the rate implicit in the agreement is f per cent.
- Thirty annual payments of \$65 million to equal a present value of \$685 million implies a discount rate of 8.715 percent is being used.
- $11 \$685\text{M capital cost} \div 75 \text{ years} = \$9.13\text{M}$

B36 Key dates in the public private partnership are as follows:

<b>Key Milestones</b>	<b>Date</b>
City year-end	December 31
Financial close	February 1, 2X20
Construction start	September 30, 2X20
40% construction completed (milestone payment 1 of 2)	December 31, 2X20
70% construction completed	December 31, 2X21
Install signs and signals	August 1, 2X22
100% construction completed (milestone payment 2 of 2)	December 31, 2X22
Bridge is operational	January 1, 2X23

B37 The following table states the capital portion of the annual service payment.

**Payment Terms**

Loan amount	\$200,000,000
Interest rate	5%
Term in years	30
Number of payments	annual payment
Payment	\$13,010,287/yr.

B38 Using the annual service payment calculated in paragraph B37, the following table outlines how the \$200-million financial liability would be calculated and paid down over time as annual service payments are made. Unless the terms of the public private partnership change or are renegotiated, this schedule would be applied until the liability has been completely paid off in 2X52.

<b>Year</b>	<b>Loan Outstanding, Beginning of Year</b>	<b>Interest Calculated at Contract Rate 5%</b>	<b>Principal</b>	<b>Loan Outstanding, Year-end</b>
.1 2X23	\$200,000,000	\$10,000,000	\$3,010,287	\$196,989,713
.2 2X24	\$196,989,713	\$9,849,486	\$3,160,801	\$193,828,912
.3 2X25	\$193,828,912	\$9,691,446	\$3,318,841	\$190,510,070
.4 2X26	\$190,510,070	\$9,525,504	\$3,484,784	\$187,025,287
.5 2X27	\$187,025,287	\$9,351,264	\$3,659,023	\$183,366,264
.6 2X28	\$183,366,264	\$9,168,313	\$3,841,974	\$179,524,290
.7 2X29	\$179,524,290	\$8,976,215	\$4,034,073	\$175,490,218
.8 2X30	\$175,490,218	\$8,774,511	\$4,235,776	\$171,254,442
.9 2X31	\$171,254,442	\$8,562,722	\$4,447,565	\$166,806,877
.10 2X32	\$166,806,877	\$8,340,344	\$4,669,943	\$162,136,933
.11 2X33	\$162,136,933	\$8,106,847	\$4,903,440	\$157,233,493
.12 2X34	\$157,233,493	\$7,861,675	\$5,148,612	\$152,084,881
.13 2X35	\$152,084,881	\$7,604,244	\$5,406,043	\$146,678,838
.14 2X36	\$146,678,838	\$7,333,942	\$5,676,345	\$141,002,493

Public-Private Partnerships: CCPPP Response to the Exposure Draft (PSAB 3160)

.15	2X37	\$141,002,493	\$7,050,125	\$5,960,162	\$135,042,330
.16	2X38	\$135,042,330	\$6,752,117	\$6,258,171	\$128,784,160
.17	2X39	\$128,784,160	\$6,439,208	\$6,571,079	\$122,213,081
.18	2X40	\$122,213,081	\$6,110,654	\$6,899,633	\$115,313,448
.19	2X41	\$115,313,448	\$5,765,672	\$7,244,615	\$108,068,833
.20	2X42	\$108,068,833	\$5,403,442	\$7,606,845	\$100,461,988
.21	2X43	\$100,461,988	\$5,023,099	\$7,987,188	\$92,474,800
.22	2X44	\$92,474,800	\$4,623,740	\$8,386,547	\$84,088,253
.23	2X45	\$84,088,253	\$4,204,413	\$8,805,874	\$75,282,379
.24	2X46	\$75,282,379	\$3,764,119	\$9,246,168	\$66,036,211
.25	2X47	\$66,036,211	\$3,301,811	\$9,708,476	\$56,327,734
.26	2X48	\$56,327,734	\$2,816,387	\$10,193,900	\$46,133,834
.27	2X49	\$46,133,834	\$2,306,692	\$10,703,595	\$35,430,238
.28	2X50	\$35,430,238	\$1,771,512	\$11,238,775	\$24,191,463
.29	2X51	\$24,191,463	\$1,209,573	\$11,800,714	\$12,390,750
.30	2X52	\$12,390,750	\$619,537	\$12,390,750	\$(0)



**Summary of entries during construction**

B39 Entries at December 31, 2X20

Dr. Asset – work in progress \$160M

Cr. Liability to P3 consortium \$160M

Construction is 40 percent complete at the end of the entity’s first reporting period. Asset and corresponding liability are recorded on a percentage of completion basis ( $\$400M \times 40\% = \$160M$ ).

Dr. Liability to P3 consortium \$100M

Cr. Cash \$100M

To record the first milestone to the P3 consortium. Contract stated a lump-sum payment was due once construction was 40 percent complete. The 40 percent completion mark was certified as being met by an independent party.

B40 Entries at December 31, 2X21

Dr. Asset – work in progress \$120M

Cr. Liability to P3 consortium \$120M

Construction is 70 percent complete as at December 31, 2X21. ( $\$400M \times 70\% = \$280M$  - less the \$160M recognized at the prior year-end = \$120M)

B41 Entries at August 1, 2X22

Dr. Asset – work in progress \$3M

Cr. Cash \$3M

To record the signs and signals that the city installs just prior to commissioning.

B42 Entries as at December 31, 2X22

Dr. Asset – work in progress \$120M

Cr. Liability to P3 consortium \$120M

Record the balance of the \$400M asset value and corresponding liability.

Dr. Liability to P3 consortium \$100M

Cr. Cash \$100M

This is to record the second of two milestone payments of \$100 million.

B43 Entries at December 31, 2X22

Dr. Bridge assets	\$240M
Dr. Roads assets	\$160M
Dr. Signals assets	\$3M
Cr. Assets – work in progress	\$403M

To initially record the asset cost once the bridge is ready for use. The city has recorded the bridge asset into three separate components with differing useful lives.

- ○ Bridge – 75 years – (60% of \$400M)
- ○ Roads – 50 years – (40% of \$400M)
- ○ Signals – 20 years – (100% of \$3M).

The assets are amortized over their estimated useful lives, which are well beyond the 30-year P3 contractual arrangement.

**Summary of entries post construction**

B44 Entries at December 31, 2X23

Dr. Interest expense	\$10M
Dr. Liability to P3 consortium	\$3.01M
Dr. Maintenance expense	\$3.5M
Cr. Cash	\$16.51M

Record the first year's annual service payment.

B45 Entries at December 31, 2X23

Dr. Amortization expense	\$6.55\$6.55M
Cr. Bridge asset	\$3.2\$3.2M
Cr. Roads asset	\$3.2\$3.2M
Cr. Signals asset	\$0.15\$0.15M

Record amortization expense of the assets:

<ul style="list-style-type: none"> <li>○ Bridge asset \$240M over 75 years = \$3.2M</li> <li>○ Roads asset \$160M over 50 years = \$3.2 million</li> <li>○ Signals asset amortization \$3M over 20 years = \$0.15M</li> </ul>	
B46 Entries at December 31, 2X24	
Dr. Interest expense	\$9.85M
Dr. Liability to P3 consortium	\$3.16M
Dr. Maintenance expense	\$3.57M
Cr. Cash	\$16.58M
Record the second year's annual service payment (rounded from table above).	
<ul style="list-style-type: none"> <li>• Maintenance expense \$3.57 million reflects adjustment for inflation of 2 percent</li> </ul>	
B47 Entries at December 31, 2X24	
Dr. Amortization expense	\$6.55\$6.55M
Cr. Bridge asset	\$3.2\$3.2M
Cr. Roads asset	\$3.2\$3.2M
Cr. Signals asset	\$0.15\$0.15M
Record the second year's amortization expense of the assets.	

CCPPP finds Example 5 to be misleading in this context of the discussion above.

Example 5 includes a statement that appears to be random, and would not be consistent with the DBFOM PPP delivery described, that *“The Government bears the construction risk of the Project.”* CCPPP recommends this statement be removed.

The Council notes the public sector entity incurs a significant contingent liability at inception of a PPP transaction— signature of the contract. **CCPPP recommends** this be recorded. This is important because in many respects contract execution is a more significant date in crystalizing the public sector entity's liabilities than either work in progress or substantial completion. The public sector entity will typically reserve the right to terminate the contract at its convenience following execution. However, such termination will typically come with an obligation to reimburse costs including: bidding and development costs, design and mobilization costs (which may not be captured under a

percentage of work completed definition), costs of terminating contractual obligations (for example to an operator), make whole costs on debt issued and an opportunity cost return on equity. These costs will typically be significant.

No details are provided in the example of any development or early works that should be recognized. **CCPPP recommends** adding more guidelines on when these development/early works should be capitalized

Public entities expenses on consultant work, de-risking activities may be either expensed or capitalized, additional guidance is recommended

The example implies the percentage of work in progress completed during each reporting period should be recorded as an asset and corresponding liability. However, under the vast majority of Canadian PPP transactions the public sector entity does not accept the works or become liable for any payments until the private sector partner achieves certain milestones. In the case of this example, which would be typical of Canadian PPP transactions, the private sector partner is entitled to receive a milestone payment from the public sector entity when the project is 40 per cent complete. CCPPP also notes many, if not most, Canadian PPP transactions would have no obligation for the private partner to report the percentage of work completed. Even where public sector payments are triggered by “milestones” these will often be defined elements of completion rather than percentage of value expended.

CCPPP recommends that, once the 40 per cent completion milestone has been achieved and payment liability is certain, the value of the work accepted and the payment made should be recorded as an asset and liability. The complete value of work in progress should not be recorded.

In Example 5, a further payment is made by the public sector entity at substantial completion of the project and full recognition of the asset and liability occurs. Substantial completion is considered to be the point at which construction is complete, service provision commences and payments to the private sector partner commence. This may be true for many Canadian PPP transactions, but often service provision commences and operating and maintenance costs are incurred during the construction period and capital costs are incurred after substantial completion.

**CCPPP recommends** that recognition of the asset and liability at substantial completion should depend upon the economic substance of the transaction.

It is CCPPP’s alternative view that there is no acceptance of the asset by the public sector grantor even at the point of substantial completion and as a result this date does not trigger any unconditional obligation to make capital payments. The obligation to make capital payments and the amount of such payments is only triggered by the periodic performance of the asset. **CCPPP recommends** that payment obligations are only recognized as a liability when they become unconditional or capable of reasonable estimation. This will depend upon the certainty of the payment.

The Council notes that Example 5 does not include any Interest During Construction. This distorts both the capital value of private sector investment requiring repayment and the interest rate calculation.

Recognition of the liability and distinguishing between the finance charge to be expensed and amortization of the financial liability is challenging. The example assumes that the financing is structured on a credit foncier or mortgage-style approach where the amount of each payment instalment is equal and comprised of a diminishing finance charge and an increasing repayment amount. This may be accurate for the debt portion of the financing, although many PPPs may use an alternative debt structure. However, it ignores the equity component of the PPP financing that will typically be “repaid” on a much more back ended basis. The Contract Rate is in fact a weighted average cost of capital (WACC) taking into account both debt and equity financing and is not a simple interest rate on a loan.

This can be illustrated in the following example, based on Example 5.

If the \$200 million of private sector capital is funded by 80 per cent debt at an interest rate of four per cent and 20 per cent equity at an anticipated internal rate of return of 12 per cent, then the simple WACC at inception of the transaction will be 5.6 per cent. This WACC will not remain constant over the term of the arrangement as the debt and equity will amortize at different rates.

The public sector entity will rarely, if ever, have visibility into the precise financing structure used by the private sector partner. This is because the financing is the private sector partner’s responsibility and liability. The public sector only has a payment obligation, subject to the achievement of performance standards. The private sector partner meets its financial obligations from this payment with no further recourse to the public sector entity.

As a result Example 5 provides a misleading representation of the substance of the transaction. The liability is amortized more slowly than is actually the case.

CCPPP notes that the liability capable of being crystalized at any point in time is the contingent liability associated with a termination for convenience. This reflects a make whole obligation in respect of outstanding debt and equity which is related to market interest rates at the time of termination but does not follow the same profile as the effective interest rate method of amortization.

The Exposure Draft provides guidance to use the same finance charge consistently over the term of the PPP arrangement. For example, the Exposure Draft paragraph 59 says “*The interest rate used to determine the finance charge should remain consistent throughout the public-private partnership arrangement, unless the terms of the arrangement have been renegotiated. In subsequently measuring the liability, the effective interest method should be used in accounting for the liability that has been discounted.*” Similarly, the Basis for Conclusions paragraph 46 describes the Contract Rate “*This will be an average rate that can be applied consistently for the life of the arrangement.*”

CCPPP recommends that the capital payment is amortized on the same profile as the service payment obligation. For example, if the payment is made in equal nominal instalments over 30 years then in Example 5 the \$200-million capital liability should be amortized at the rate of \$6.66 million per annum. The finance charge component of the total capital payment of \$13.01 million would then be a constant \$6.35m pa. This better reflects the substance of the public sector entity’s liabilities.

The details of this example further illustrate why CCPPP is concerned that accounting treatment fails to adequately recognize the economic substance of PPP transactions and why an alternative approach is required.

CCPPP would be very concerned if accounting treatment drove public sector entities to adopt credit foncier (flat nominal) payment structures for accounting simplicity even if these did not reflect the most appropriate commercial risk transfer profile for the PPP transaction.

The Council cross references to its recommendations with respect to how payment deductions for performance should be treated in Section 9 below.

## Payment Bifurcation into Capital and Expense

**Q6 Do you agree that, where costs of the infrastructure are not readily available or the annual service payments are not separable, the relative fair value approach as proposed in paragraphs .32-.34 is an appropriate method to estimate fair value of the infrastructure asset and the service contract (illustration of this guidance in Example 4 – Expansion of bridge for tourism)? If not, what alternative is more appropriate and why?**

.32 In some public-private partnerships, it may be difficult to determine what the cost of the infrastructure asset is or what portion of the annual service payments relate to the infrastructure asset and what portion relates to operating and/or maintenance costs. In such cases, determining the cost of the infrastructure asset and separating annual service payments would require the public sector entity to allocate costs related to the infrastructure asset separately from costs related to operating and/or maintenance. These allocations would be determined based on the relative fair values of the infrastructure asset and the service contract.

.33 To determine the relative fair values of the infrastructure asset and of the service portion of the arrangement, an entity uses estimation techniques. These techniques must be appropriate in the circumstances. Sufficient data must be available to determine the asset cost and separate the annual service payments. The public sector entity maximizes the use of relevant and observable inputs and minimizes the use of unobservable inputs.

.34 Some valuation techniques that may be considered in estimating the cost of the infrastructure and separating the annual service payment under such circumstances include, but are not limited to:

- (a) present value of discounted future cash flows;
- (b) independent market appraisals;
- (c) estimates generated based on relevant past data or transactions; and
- (d) quotes generated by other bidders.

CCPPP's views can be summarized as:

- The Council strongly agrees that in most PPP transactions (including availability/ financial obligation transactions) it is difficult to determine what portion of the annual service payments relate to the infrastructure asset and what portion relates to operating and/or maintenance costs. This is true even where the cost of the infrastructure asset at substantial completion is known or where there is a bifurcation of the availability payments into capital and O&M portions. This is because of importance of the unitary payment principle to PPP transactions

and the reasons set out above. **CCPPP recommends** that estimation techniques are used even where the answer may seem obvious.

- The Council is concerned by the likelihood that rigid bifurcation into capital and O&M costs will distort the efficiency of the choice between capital and O&M inputs, which is at the heart of the commercial rationale for PPP delivery.
- CCPPP feels that the concepts of relative value may be appropriate for the availability (Financial Obligation) model where the public sector grantor will typically have access to the financial model and all the details of both winning and losing bidders. However, The Council feels it is far more challenging and unreasonable to establish relative value under a user pay model.
- CCPPP agrees with the range and types of estimation techniques proposed in paragraph 34
- CCPPP is strongly of the view that Example 4 presents a misleading view of PPP transactions and the appropriateness of various estimation techniques. The Council strongly recommends Example 4 be amended and replaced with an alternative example such as the one provided below.

## 6.1 Fair Value Estimation

The Council finds useful guidance on how to estimate Fair Value without relying on separable payments in IPSAS 32 AG32: “payments and other consideration required by the arrangement are allocated at the inception of the arrangement or upon reassessment of the arrangement into those for the service concession asset and those for other components of the service concession arrangement (e.g.: maintenance and operation services) on the basis of their relative fair values. ***The fair value of the service concession asset includes only amounts related to the asset and excludes amounts for other components of the service concession agreement. ....For example a grantor may estimate the payments related to the asset by reference to the fair value of a comparable asset in an agreement which contains no other components, or by estimating the payments for the other components in the service concession agreement by reference to comparable arrangements and then deducting these payments from the total payments under the arrangement.***”

In practice in most Canadian PPP transactions there is a strong basis for such estimation. Firstly, the grantor prepares a public sector comparator, which estimates the capital, O&M and life cycle costs of the project if it were to be delivered by the grantor through conventional procurement. Secondly, the winning bidder can be compared with the other bidders for the same service concession agreement. CCPPP recommends these estimation techniques be used to ensure the capitalized value of the asset is equivalent to the value of the asset the public sector entity may have constructed under conventional delivery. In other words, public sector entities should be entitled, where they are making future performance-based payments, to treat a portion of the costs as a premium for future risks that cannot be estimated at the point of substantial completion. CCPPP notes that Canadian jurisdictions have used this technique in practice, particularly where they are able to identify a specific construction cost (such as a higher quality roof or a thicker road pavement surface) which is designed to reduce future O&M and life cycle costs.



An alternative way to estimate this is to discount only the portion of the payments that are certain and unconditional in order to determine the capital value.

In these respects, CCPPP suggests Exposure Draft Example 4 be reworked.

## 6.2 Criticisms of Exposure Draft Example 4

While CCPPP supports the broad outcome of Example 4 (i.e.: that estimation techniques are required to separate capital from O&M costs), the details of the example in our opinion display a lack of commercial understanding of PPPs.

The Example 4 states “In reconciling the winning bidder’s reported costs of \$727.19 million and internal estimates of \$685 million, the government noted that private sector partner’s actual costs exceeded its bid submission to the government.” There is no evidence provided for this in the example and it is not clear what this statement means. Why were the private sector partner’s actual costs deemed to have exceeded its bid submission to government?

It is inappropriate to disregard the losing bidders. In tendering the PPP, government was interested in a solution with the lowest NPV, not in a specific asset solution. The example states “*The government does not use information from the two losing bidders. The other two bidders had proposed to expand the existing bridge (and not to build a new one). Their proposals would not reflect the service capacity and risk profile of the newly constructed bridge*” (B26). This is very problematic. Under the PPP model, the government specifies a service capacity and a risk profile (indirectly through the deduction and default regime) and the private sector determines what mix of capital and O&M inputs it will use to deliver this service capacity. CCPPP is aware of several actual Canadian PPP transactions where the private sector partner has been given exactly the same choice between expanding and rehabilitating an existing bridge and building a new one. Lowest net present value cost not accounting treatment should drive this decision.

The focus on the asset which is built rather than the service which is delivered is symptomatic of the problems with the approach taken in the Exposure Draft. The background to the Example 4 itself acknowledges: “*Given the nature of the contract and the fact that the government did not specify the infrastructure that needs to be delivered, three different proposals were submitted and evaluated as part of the procurement process.*”

The higher capital costs of the winning bidder are likely to represent an embedded O&M or life cycle component which should not be capitalized. The wording of the example instead seems to imply that the full cost of the private sector proposal should not be capitalized simply because government’s estimated costs were lower. This would not represent prudent accounting.

The estimate of the cost of financing is also skewed.

### Alternative Example

CCPPP considers a clearer example of the issues to be set out in the alternative example below:

The reason FMV or replacement cost is a challenging initial measurement technique can be illustrated by the following example (which would be typical of empirical experience in the Canadian PPP market).

Having just run a competitive tender process for a project, one would imagine that both FMV and replacement cost would be easy to determine.

However, a PPP procurement does not typically specify an asset in detail. Instead it specifies service level performance criteria that must be delivered over a long-term concession. This requires bidders to make choices between capital and operating costs and would also require a calculation of replacement cost which makes assumptions with respect to the quality of the asset.

The results of the competitive procurement are as follows:

	<b>Public Sector Comparator</b>	<b>Bidder A</b>	<b>Bidder B</b>	<b>Bidder C</b>
Initial Construction Cost	80,000,000	150,000,000	100,000,000	75,000,000
Cost of Capital	6%	8%	10%	12%
Annual "capital" payments	\$4,800,000	\$12,000,000	\$10,000,000	\$9,000,000
O&M Costs	\$15,000,000	\$3,000,000	\$10,000,000	\$15,000,000
Annualized Life cycle costs	\$10,000,000	\$2,000,000	\$5,000,000	\$15,000,000
Total Annual Payments	\$29,800,000	\$17,000,000	\$25,000,000	\$39,000,000

Note annual capital payments will be a function of things such as Interest During Construction and construction schedule. For simplicity CCPPP has assumed all these "soft costs" are equal and incorporated into the construction cost number.

Bidder A chooses a more capital-intensive solution to meeting the performance requirements than Bidder B, and enjoys a lower cost of capital as a result of the lower risks of this approach. Bidder C proposes an aggressive construction approach that is cheaper even than the public sector comparator but has high cost of capital, O&M and life cycle costs as a consequence. Under the proposed approach to accounting, if Bidder A is selected as the operator, the grantor will capitalize on its balance sheet a much higher amount than if Bidder B is successful. Although in theory the total budgetary impact of the two bidders may be the same, many grantors have debt limits in addition to annual budgetary constraints. Accounting treatment may influence the grantor to select Bidder B in preference to Bidder A, despite Bidder B being more expensive overall. However, both bidders could appear to be more expensive than the conventional delivery alternative indicated by the Public Sector Comparator as the NPV of the future payments from PPP delivery could far exceed the cost of the asset which would be capitalized under conventional delivery (because of the O&M and rehabilitation

payments implicit in the total payments, the risk transfer costs, and the higher costs of private financing relative to the cost of government borrowing).

(Based on: Page 3 Public Sector Accounting for Public Private Partnership Transactions in Canada: CCPPP July 2008)

## Betterments

**Q7 Do you agree existing infrastructure that has been bettered using a public-private partnership should be measured at its carrying amount plus costs associated with the betterment of the existing infrastructure? If not, what alternative is more appropriate and why?**

<b>Betterments</b>
.43 Betterments, as defined in TANGIBLE CAPITAL ASSETS, Section PS 3150, are added to the carrying amount of the related infrastructure when the future economic benefits of the betterment are controlled by the public sector entity.
.44 Public-private partnerships often have life cycle costs scheduled into the agreement and contribute to the infrastructure asset having longer useful lives as a result. Life cycle costs are those maintenance activities that sustain the asset over its expected useful life. These costs are typically expensed when incurred when using a single-useful-life calculation. Examples would include replacing the roof, the windows and the HVAC system.
.45 When a public sector entity uses the componentization approach to capitalizing assets, betterments that increase the service capacity of specific components of the infrastructure would be capitalized and amortized. For example, if the roof is scheduled to be replaced, the related costs would be capitalized as a part of the roof component and amortized over its useful life. Under the componentization approach to capitalization, old components need to be written off when new replacement components are capitalized in the period the items are replaced.
.46 When the public sector entity is using a single-useful-life calculation for the entire infrastructure asset, life cycle costs would be considered in assessing the asset's useful life and residual interest. Improvements to the infrastructure would only be considered betterments if they increase the service capacity of the infrastructure asset. The assessment of the asset's useful life, considering scheduled maintenance and life cycle costs, would affect the annual amortization charge.

CCPPP respectfully disagrees with the Exposure Draft. CCPPP's view is that a betterment will often increase the value of an infrastructure asset far beyond the cost of the betterment itself. An example might be the addition of tolling equipment to a previously untolled facility. The Council understands that it is the intention that over the next few years the Canadian public sector will move to a balance sheet approach which more accurately reflects the value of assets and liabilities which they hold. This provision would appear to run directly counter to that objective. Consistent with CCPPP's other comments, this appears to illustrate the problems caused by an excessive focus on historic cost rather than fair value both at the initial measurement and subsequent measurement phases of valuation.

CCPPP also disagrees with the Exposure Draft guidance in respect of the recognition of life cycle costs and betterments.

The Exposure Draft treats significant life cycle expenditure as an expense even if it is necessary to achieve the useful economic life of the asset (for example a new roof). A betterment that would be capitalized under the Exposure Draft is narrowly defined as an investment which expands the service capacity of the asset.

**CCPPP recommends** that replacement of a material component of an asset necessary to its useful life should be capitalized rather than expensed and amortized over the remaining useful life of the asset following the life cycle investment.

As discussed above, CCPPP is concerned that, where a significant life cycle investment is necessary to extend the useful economic life of the asset, the asset is amortized over this extended life from initial recognition on the assumption that the investment would be made. Under this scenario a bidder who designed and built an asset capable of meeting a 50-year economic life from the outset may be penalized relative to a bidder who relies on investment in a new roof at year 25 to achieve a 50-year life. Where the life cycle investment is material CCPPP recommends that a component approach is taken to recognition of the useful economic life.

## SUBSEQUENT MEASUREMENT

**Q8 Do you agree with the guidance provided in paragraph .47 that operating and maintenance costs should be expensed in a rational and systematic manner over the term of the service contract (illustration of this guidance in Example 3 – College residence)? If not, what alternative is more appropriate and why?**

.43 Betterments, as defined in TANGIBLE CAPITAL ASSETS, Section PS 3150, are added to the carrying amount of the related infrastructure when the future economic benefits of the betterment are controlled by the public sector entity.

.44 Public-private partnerships often have life cycle costs scheduled into the agreement and contribute to the infrastructure asset having longer useful lives as a result. Life cycle costs are those maintenance activities that sustain the asset over its expected useful life. These costs are typically expensed when incurred when using a single-useful-life calculation. Examples would include replacing the roof, the windows and the HVAC system.

.45 When a public sector entity uses the componentization approach to capitalizing assets, betterments that increase the service capacity of specific components of the infrastructure would be capitalized and amortized. For example, if the roof is scheduled to be replaced, the related costs would be capitalized as a part of the roof component and amortized over its useful life. Under the componentization approach to capitalization, old components need to be written off when new replacement components are capitalized in the period the items are replaced.

.46 When the public sector entity is using a single-useful-life calculation for the entire infrastructure asset, life cycle costs would be considered in assessing the asset's useful life and residual interest. Improvements to the infrastructure would only be considered betterments if they increase the service capacity of the infrastructure asset. The assessment of the asset's useful life, considering scheduled maintenance and life cycle costs, would affect the annual amortization charge.

.47 Operating and maintenance costs do not extend the service capacity of the asset. Therefore, such costs are expensed in a rational and systematic manner over the term of the service contract in a public-private partnership arrangement that best corresponds to the benefit received from the services being provided.

As also covered in section 6 above, CCPPP disagrees with the Exposure Draft guidance in respect of the recognition of life cycle costs and betterments.

The Exposure Draft treats significant life cycle expenditure as an expense even if they are necessary to achieve the useful economic life of the asset (for example a new roof). A betterment which would be capitalized under the Exposure Draft is narrowly defined as an investment which expands the service capacity of the asset.

**CCPPP recommends** that replacement of a material component of an asset necessary to its useful life should be capitalized rather than expensed and amortized over the remaining useful life of the asset following the life cycle investment.

As discussed above, CCPPP is concerned that, where a significant life cycle investment is necessary to extend the useful economic life of the asset, the asset is amortized over this extended life from initial recognition on the assumption that the investment would be made. Under this scenario, a bidder who designed and built an asset capable of meeting a 50 year economic life from the outset may be penalized relative to a bidder who relies on investment in a new roof at year 25 to achieve a 50-year life. Where the life cycle investment is material **CCPPP recommends** that a component approach is taken to recognition of the useful economic life.

CCPPP's comments with respect to O&M costs can be divided into the Financial Obligation and Performance Obligation models.

### **Financial Obligation Model**

CCPPP agrees with the proposed approach with respect to O&M costs. The challenge is to differentiate routine O&M costs which "do not extend the service capacity of the asset" from life cycle costs that extend the useful life. The Council has recommended above that life cycle costs should be capitalized as an essential part of the asset. Life cycle costs used to be distinguished by their lumpy nature and relatively large size relative to routine O&M costs. Typically, life cycle costs would be a mid-life refurbishment or replacement of key components. The Council notes, however, an increasing trend in the infrastructure sectors in which PPP models are used, towards a continuous maintenance model. This makes it far harder to distinguish between routine O&M costs and life cycle.

### **Performance Obligation Model**

Under the user-pay model where the public sector entity has no means to control such expenses and does not make any payments for those expenses, **CCPPP recommends** that it is inappropriate to expense them.

### **SPV Management Costs**

The Exposure Draft provides no guidance on SPV costs associated with the management of the Special Purpose Vehicle (SPV) established for the purpose of financing the transaction. Some consider these costs to be an operating & maintenance cost and others consider them to be a financing cost associated with protecting the capital repayment. The SPV costs are one clear example of why the attempt to bifurcate capital and performance-expense is challenging and very theoretical.

### **Definitions**

CCPPP assumes that by "rational and systematic manner" the Exposure Draft means that O&M expenses should be recognized and expensed in the period in which they are incurred and payments made. **CCPPP recommends** the Exposure Draft state this explicitly.

## **O&M During Construction**

Consistent with the Council's comments above, CCPPP recommends that O&M expenses during the construction period, whether incurred in respect of existing assets which are being replaced or incurred in respect of the new asset which is a work in progress, should be expensed when incurred rather than capitalized.

### **Example 3: College Residence**

CCPPP provides specific comments on Example 3 above.



## DISCOUNT RATE

**Q9. Do you agree that when a contract rate cannot be observed or reliably derived to calculate finance charges, then another appropriate rate should be used as proposed in paragraph .58? If not, what alternative is more appropriate and why?**

.56 The contract rate would be used to calculate the finance charge embedded in a financial liability related to the public-private partnership for the purposes of expense recognition over the course of the arrangement.

.57 Where the contract rate is not determinable, the weighted average cost of capital specific to the public-private partnership arrangement, or the private sector partner's cost of capital should be used.

.58 Under rare circumstances where these rates are not available, the public sector entity would use another rate that accurately reflects the financing charge embedded in financial liability model.

.59 The interest rate used to determine the finance charge should remain consistent throughout the public-private partnership arrangement, unless the terms of the arrangement have been renegotiated. In subsequently measuring the liability, the effective interest method should be used in accounting for the liability that has been discounted.

CCPPP applauds the decision in the Exposure Draft that the discount rate applicable to calculating initial capital value from a stream of future payments should be the weighted average cost of capital of the private sector partner. The use of any other rate, and in particular the cost of government borrowing, would result in a capital cost that does not reflect reality. For example, the same asset delivered in Gatineau and Ottawa will have two different values simply because the provinces of Ontario and Quebec have different rates.

However, this in itself is not sufficient to determine accurately the fair market value of the infrastructure asset because it is also necessary to distinguish between payments made in respect of the capital cost and payments that are related to the risks of long-term operation, maintenance and life cycle.

In this section CCPPP addresses:

- 1) Why the government borrowing rate is an inappropriate discount rate for the calculation of the capital asset and liability
- 2) The recommended definition of the contract rate.
- 3) Methods to estimate the contract rate where it is not clearly stated in the project agreement
- 4) The difference between the weighted average cost of capital specific to the public partnership arrangement and the private sector partner's cost of capital and how to reflect the cost of direct public sector borrowings to finance contributions to the costs of a PPP

- 5) Whether the finance charge should be consistent throughout the term of the PPP arrangement.
- 6) Why the effective interest rate method is not appropriate in the context of a PPP arrangement
- 7) An alternative view in respect of how the cost of capital of a PPP arrangement could be used as a proxy for risk transfer.

## 9.1 Appropriate Discount Rate

CCPPP agrees with the Exposure Draft that the finance charge implicit under the PPP should be the contract rate, which is the rate implicit or explicit in the public-private partnership arrangement. This best reflects the cost of the asset and the borrowing costs charged to the public sector through a public-private partnership transaction for the following reasons:

- 1) Discounting a payment stream (based on a cost to substantial completion financed at a private sector WACC) at a lower government cost of borrowing will result in a higher asset value at initial measurement than is actually the case. This is not prudent and would further skew the PPP transaction towards a capital intensive asset. As the Council has commented above in the section on initial measurement there are already a number of factors which tend to overweight capital at the expense of O&M costs in a PPP transaction. As an example a \$100-million asset financed at a private sector WACC of five per cent over 30 years would be accounted for as a \$146.32m asset if the capital payments were to be discounted at a government borrowing rate of 2.5 per cent.
- 2) The finance charge under a PPP reflects not only the risk of design and construction of the asset but also the risk to the private sector partner of delivering the services over the concession term through operations and maintenance. Empirical evidence suggests that on average in the Canadian market less than 50 per cent of the risk premium over the government cost of borrowing relates to design and construction risks. As CCPPP argues above, it is circular and a truism to calculate the capital cost of an asset by discounting a designated capital stream of payments by the implicit financing rate. The key is to determine what the appropriate allocation of such payments is between capital costs and O&M costs. The use of an inappropriate discount rate can lead us astray but the use of the appropriate discount rate still does not provide the full answer. The Council expands on this below.

## 9.2 Definition of Contract Rate

**CCPPP recommends** the Contract Rate should be better defined in the Exposure Draft. The draft definition used is:

*The **contract rate** is the cost of financing that the private sector partner is charging the public sector entity in the public private partnership. It may also be referred to as the “rate implicit in the contract”. This is the discount rate that causes the aggregate present value of the capital portion of the annual service payments to be equal to the fair value of the financial liability, upon initial measurement. The financial liability is equal to the cost of the asset, less any compensation already made.*

This draft definition has a number of problems:

- 1) It is circular. It is derived from the capital portion of the payments but these simply reflect the application of the contract rate to the estimated fair value of the asset. It is necessary to know any two of the variables to calculate the third. However, as the Council has described above, objective and consistent estimation of the fair value of a PPP asset is challenging.
- 2) The definition refers to the “rate implicit in the contract.” The typical Canadian availability payment PPP has an explicit Contract Rate which is the discount rate used for the purposes of calculating the compensation for termination arising from convenience or default respectively. It is very difficult for this rate to be materially manipulated compared to the actual weighted average cost of capital since to do so would leave the financiers exposed. Note that because most Canadian availability payment PPP transactions are now financed through a long term bond issuance, the explicit contract rate is typically an equity rate of return with bonds subject to a make whole payment dependent upon prevailing market interest rates. Nevertheless, the weighted average cost of capital is typically explicit in the PPP arrangement.
- 3) Under User Pay transactions there is not typically an explicit Contract Rate. Termination compensation is based on current fair market values. Any implicit rate would be challenging for the public sector grantor to identify and could easily be manipulated.
- 4) CCPPP discusses below how the Contract Rate could potentially be manipulated.
- 5) CCPPP discusses below how the Contract Rate includes a significant component which is more appropriately attributed to the long-term performance risks of the project rather than a finance charge associated with the capital asset at completion of construction.

**CCPPP therefore recommends** the following definition of the Contract Rate:

*The Contract Rate is the rate explicitly used in the PPP arrangement to calculate compensation for termination for convenience or for default (where impaired value is not determined by a re-bid) or to calculate the return in respect of change orders.*

*Where the contract rate is not explicit in the PPP Arrangement then it should be the estimated weighted average cost of capital for the project of the private sector partner based on:*

- 1) the known financial structure of the private sector partner;*
- 2) the financial structure of other bidders for the same project. Material differences in weighted average cost of capital should be investigated to determine whether they reflect differences in the fair value of the underlying asset.*
- 3) the estimated private sector weighted average cost of capital of a similar asset with a similar risk profile including the transfer of operational performance and life cycle risks.*

In this respect, the Council finds the guidance provided in IPSAS 32 AG 42 to be helpful:

Where sufficient information is not available, the rate used to determine the finance charge may be estimated with reference to the rate that would be expected in acquiring a similar asset (e.g.: a lease of a similar asset, in a similar location and for a similar term). The estimate of the rate should be reviewed together with:

- a) the present value of the Payments
- b) the assumed fair value of the asset; and
- c) the assumed residual value, to ensure all figures are reasonable and mutually consistent.

CCPPP sets out in detail below some of the issues to be considered.

### **9.3 Methods to ensure the Contract Rate is reasonable and to estimate it where it is not stated**

As described above, the Contract Rate under an availability payment PPP contract will typically reflect the private sector capital structure of the winning bidder. It is difficult to misrepresent this since it would leave the bidder exposed in termination for default or convenience scenarios. Under a user pay PPP, however, there is not typically such a contract rate since termination compensation is based on fair market value.

Under a user pay transaction, the private sector cost of capital may well not be apparent to the public sector partner as it will depend upon a number of variables including the risk profile and variability of the user pay revenue streams. This challenge reinforces our view that it is inappropriate to attempt to recognize a “performance obligation” liability in respect of user pay transactions.

CCPPP understands the desire amongst some public sector accountants, to reflect the premium financing cost in the accounting treatment. A technique which is as old as the history of leasing is to offer a discount on the price of a product (which may be the main evaluation criteria) and make up the difference in a higher finance charge and higher operating fees. The structure of Canadian PPPs offers some protection against this as the whole of life cost is evaluated inclusive of capital, operating and financing costs. However, this is partly dependent upon the discount rate used to evaluate future costs (finance, O&M and life cycle). There is also a risk that more favorable accounting treatment is achieved by an underestimation of the true capital costs.

Canadian availability payment PPPs currently have a very standardized financial structure with small differences in the WACC between different bidders. However, this may not be the case in user pay transactions and may not always be the case if more flexibility is offered to bidders in availability payment transactions.

To resolve these challenges it is important that information from the public sector comparator and from other bidders is used to check the reasonableness of the rate used to reflect the financing charge as described above and in our critique of Example 4.

For example, if the WACC of two losing bidders is five per cent but the WACC of the third winning bidder is 10 per cent, although it has the lowest overall NPV, there may be a perception that applying 10 per cent as the contract rate could distort the initial measurement of the asset fair market value. However, the reason for the higher cost of capital could be that the winning bidder has constructed a lower cost but higher risk asset to deliver the required performance standards.

The same logic should carry through to the discount rate used for estimation and valuation purposes. For bid evaluation purposes, **CCPPP recommends** the estimated weighted average cost of capital of

the private sector partner or the average of the actual cost of capital of the bidders is used. This mitigates potential distortion from an outlier bid.

As a result of the circularity identified above, **CCPPP recommends** that in most cases the public sector entity should directly estimate the capital cost of an asset using information from the successful private sector partner, the public sector comparator estimate of what the public sector would have built conventionally and the losing bidders. The Council describes in detail how to achieve this in its examination of Example 4 and in its proposed alternative example.

**CCPPP recommends** that the Contract Rate estimation method described above could and should then be used as a reasonableness check on this information.

#### 9.4 Direct Borrowing Costs to Fund Government Contributions

The “weighted average cost of capital specific to a public-private partnership agreement” could be interpreted to include contributions made by the public sector entity to the construction costs of the PPP. This would be different from “the private sector partner’s cost of capital, which would relate only to debt and equity financing which is repaid through availability payments or user pay revenues.”

CCPPP has a concern that the level of such public sector contributions may now be reaching excessive levels (sometimes as high as 85 per cent of construction completion costs) relative to private sector financing of asset performance and life cycle risks.

Public sector accounting has a role to play in this. Government contributions during the construction period or at substantial completion are treated as no more certain a public sector liability than performance-based payments made over the long-term. However, the former are near term and, particularly in the case of construction progress payments, not materially dependent upon performance while the latter are subject to significant performance and default risk. Such contributions are attractive because they can be made at the public sector cost of borrowing. The Council further notes that contributions are often funded by higher levels of government (at the federal or provincial level) that currently expense their contributions since the tangible capital asset is recognized at a subordinate level of government. CCPPP believes this leads to significant potential distortions of public sector accounts.

The Exposure Draft is largely silent on how to treat borrowing costs associated with public sector borrowing in order to fund government contributions to construction costs. In a typical Canadian PPP these costs can be significant. It could be argued that such costs are recognized at the level of consolidated financial accounts and do not need to be reflected at the level of individual assets. CCPPP believes it is important to break down such costs at the asset level to present a true and accurate picture. The Council understands many Canadian jurisdictions favour this for large PPP projects.

**CCPPP recommends** above that such contributions should be reflected as a different class of liability.

In respect of the finance charge, **CCPPP recommends** that the cost of public sector borrowing associated with a PPP project should be reflected as a different category of expense to the finance

charge portion of the PPP payment. The two should not be combined into an average rate and should be clearly differentiated in presentation.

## 9.5 Consistency of Finance Charge

The Exposure Draft states that “The interest rate used to determine the finance charge should remain consistent throughout the public-private partnership arrangement.”

This does not address the subsequent measurement challenge of how to reflect cost overruns (absorbed by the private sector partner) or performance deductions. Both could be viewed as a reduction in the finance charge.

Both the operating and maintenance costs and the finance charge are expensed in the period to which they apply. **CCPPP recommends** that performance deductions to the actual operating and maintenance payments should be reflected as a reduction in the finance charge for the period to which they apply. This is because a portion of the finance charge relates to the risk profile.

For example, the annual O&M expenses are \$10 million and the finance charge is also \$10 million based on a five per cent weighted average cost of capital on \$200 million of capital expenditure. A 10 per cent annual performance deduction to the O&M costs would be reflected as a \$1-million reduction in the finance charge making the effective financing rate 4.5 per cent rather than five per cent.

The cost of finance (debt credit spreads and equity premiums charged by lenders and investors) in PPP is not a function of the cost to finance the asset itself but to mainly hedge against poor performance and default during construction, operation and maintenance. The higher the scope of maintenance and operation (including revenue risk), regardless of the asset value, the higher the private sector rate.

CCPPP addresses these issues under Subsequent Measurement above where the Council discusses the implications of a cost overrun absorbed by the private sector partner or performance deductions to availability payments on the finance charge component of the expense. Simplified, if the financing premium compared to a government cost of borrowing is seen as an insurance premium to cover certain risks, then the financing charge should be reduced to the extent that such risks are crystalized.

Hence, the **CCPPP recommendation** that a performance deduction should not be reflected as a reduction in O&M expense but as a reduction in the finance charge expense. This represents a classification but does not change the substance of the accounting as both are expenses. CCPPP finds it much harder, under the framework used by the Exposure Draft, to accept an argument that a cost overrun in construction of an asset absorbed by the private sector partner should be capitalized and then reflected as a reduction in the finance charge expense. There would be a certain logic to this, but it would not be consistent with the approach used throughout the Exposure Draft and the accounting treatment of capitalized and expensed liabilities is very different.

Many Canadian availability PPPs are structured either as a DBF transaction or have shorter term construction period debt that is not exposed to longer term operational performance. As a result, it is possible to estimate the portion of cost of long-term debt that is attributable to construction risks and

the portion that is attributable to long-term operation, maintenance and life cycle risk. Based on this, CCPPP would suggest that on average in Canadian availability payment transactions long-term debt has an approximate 200bp premium over equivalent duration Government of Canada bonds, while construction period debt has an approximate 75bp premium. In other words 37.5 per cent of the finance charge is directly applicable to the design and construction of the asset while the remaining 62.5 per cent of the finance charge is related to the risks of operating and maintaining the project and delivering the performance specifications over the long-term post construction.

Public sector accounting should not, therefore, attempt to artificially pre-suppose these choices by attempting to identify an asset value and corresponding financing cost where there may be an inability to reasonably quantify such a cost.

## 9.6 Effective Interest Rate Method

Subject to CCPPP's comments above on how to treat performance deductions, the Council considers the Exposure Draft guidance to use a consistent **average** rate throughout the term of the PPP arrangement to be reasonable given the significant complexities associated with using a more accurate variable rate.

For the reasons described in its critique of Example 5 above, CCPPP believes the effective interest rate method is not a practical or appropriate way to recognize the amortization of the liability under a PPP transaction. In summary:

- the finance charge reflects a weighted average cost of debt and equity with different amortization and risk profiles making calculation of an effective interest rate very challenging;
- The precise financial structure is unlikely to be visible to the public sector entity, is not a financial risk to the public sector grantor and is likely to vary substantially between different bidders; and
- The finance charge under an availability payment transaction reflects a component (~37.5 per cent) related to the capital asset and a component (~62.5 per cent) related to operational performance. The finance charge under user pay transactions will be even more heavily weighted towards operational risks because of demand uncertainties.

Accordingly, **CCPPP recommends** that any liability is amortized straight line consistent with the payment mechanism and that the finance charge component is recognized as a constant expense based upon the Contract Rate or weighted average cost of capital of the private sector partner.

## 9.7 CCPPP Alternative View

Fundamentally, the application of the control guidance provided in the Exposure Draft is such that in respect of most PPP transactions the public sector will have a tangible capital asset whilst the private sector partner has a financial asset. CCPPP notes there seems to be no concern about the double counting associated with this. The Council suspects that, at least in part, this stems from a long history of lease accounting where the public policy priority was to avoid the tax leakage associated with the private sector obtaining accelerated tax depreciation benefits over expensive infrastructure which it did not control from an economic risk perspective. CCPPP's alternative view is based on the

view that from a book accounting perspective (not necessarily tax accounting) the public sector interest in a PPP asset during the Concession term is often more accurately reflected as a financial asset and liability rather than as a tangible capital asset.

Under its alternative view, CCPPP believes the cost of financing could be used as a mechanism to determine the asset and liabilities associated with a PPP transaction. One option may be to still recognize a financial instrument and offset the asset and the obligation in a swap-like transaction where the government pays premiums to hedge the asset performance and residual risk. The premium cannot be limited to the financing differential between the private and the public sector but rather the entire capital portion is a premium to cover the risk of delivering the required service performance levels and the O&M costs associated with these plus the risk of the asset residual value.

However, this alternative view is significantly outside of the approach and scope of the current Exposure Draft.

Consistent with its Alternative View, **CCPPP recommends** the cost of capital of a transaction could be used as a reasonable proxy for the level of risk transfer and accordingly measurement of the fair market value of a PPP transaction.



## PRESENTATION AND DISCLOSURE

**Q10. Do you agree with the disclosure requirements? If not, what changes would you make to these requirements, and why?**

.66 Presentation and disclosure requirements for infrastructure assets or betterments, including those procured through a public-private partnership arrangement, are set out in TANGIBLE CAPITAL ASSETS, Section PS 3150. Liabilities resulting from public-private partnerships are classified and presented on the statement of financial position according to their substance.

.67 A public sector entity should disclose the following information related to a public-private partnership:

- a) significant terms of the arrangement that may affect the amount, timing and uncertainty of future cash flow payments;
- b) key rights and obligations for the private sector partner under the arrangement;
- c) the accounting policy used by the public sector entity in accounting for public-private partnerships, including the basis for any estimation techniques used; and
- d) changes in the terms of the public-private partnership arrangement occurring during the reporting period.

.68 When deciding the level of detail to disclose, entities consider the usefulness of the information to readers in assessing the nature and extent of an entity's infrastructure asset and associated liability. It may be useful to group similar items together.

.69 Because of the significant assumptions required in measuring the infrastructure asset and liability, it is important to provide financial statements users with information describing any estimation | 11 *Exposure Draft — November 2019* technique used. For financial liabilities, significant terms of the arrangement may include minimum guarantees, renegotiations, repricing, deductions related to non-performance, etc.

.70 There are important rights and obligations that would assist financial statements users in understanding the benefits and risks of the public-private partnership arrangement. Such rights and obligations may include:

- a) renewal options;
- b) terminations options;
- c) rights to receive assets at the end of the arrangement;
- d) obligations to provide the private sector party access; and
- e) rights granted to the private sector party.

.71 A clear description of the accounting policy used by the public sector entity for the public-private partnership would be included in the notes to the financial statements. The description of the accounting policy is necessary for users' interpretation of the public sector entity's financial statements. Where a performance obligation is recognized, the public sector entity would disclose how revenue is being recognized.

.72 The notes to the financial statements would also disclose the basis for any estimation techniques used to measure the infrastructure asset and liability. When a discounted cash flow or another estimation technique is used, the key assumptions, such as the cash flows, discount rate and time period, are disclosed.

.73 Professional judgment is required to determine the location in the notes for disclosures that would provide the most understandable overview of a public sector entity's public-private partnerships for financial statement users.

The Exposure Draft is not as clear as IPSAS 32 that PPP transactions (or service concession arrangements) should be presented as a separate and distinct class of assets.

**CCPPP recommends** that more guidance on disclosure should be added. It is important to note why and when a liability is a contingent liability to be disclosed in the financial statements and when it is normal to record a liability (although based on an unlikely scenario) and then disclose that is not an "actual liability or debt obligation."

## TRANSITIONAL PROVISIONS

.74 Section PS 3160 applies to fiscal years beginning on or after April 12022. This Section may be applied retroactively or prospectively. A description of retroactive and prospective application is provided in Section PS 2120. Earlier adoption is encouraged.

### **Q11 Do you agree with the proposed transitional provisions? If not, what changes would you make to these requirements, and why?**

CCPPP does not anticipate any challenges with the transitional arrangements with respect to the current Exposure Draft as it believes the proposed approach is not materially different from that currently followed by most Canadian jurisdictions.

However, in view of the extent of its comments on the Exposure Draft, **CCPPP recommends** significant additional stakeholder consultation prior to any new standard taking effect. The Council would be happy to provide a platform for this consultation.

CCPPP also believes that transitional provisions should take into account the anticipated transition of public accounting to Balance Sheet accounting gradually in the next three years.