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### EDUCATION AND CULTURE - PUBLIC-PRIVATE PARTNERSHIPS (P3s) FOR SCHOOL CONSTRUCTION - FOLLOW-UP REVIEW

#### BACKGROUND

**7.1** The Minister of Finance announced in the April 1997 Budget Address to the House of Assembly that all future school construction projects in the Province would be built under public-private partnership (P3) arrangements. The government made a public policy decision with respect to school construction - schools will be built without adding to the debt of the Province - and the government has also stated that operating leases with the private sector will be used to accomplish its objective.

**7.2** The mandate given to this Office under the Auditor General Act does not extend to assessment of public policy. We, therefore, do not express general comments on whether the debt for school construction should be kept off the Province's balance sheet or whether the Province should seek operating leases with the private sector. We will, however, as part of our mandate for audit of the March 31, 1999 and subsequent Public Accounts comment on the accounting treatment and disclosure issues related to signed leases and other agreements.

**7.3** The government's school construction initiatives under P3 arrangements are extensive. Eight specific schools to be built under P3 arrangements were originally announced. One of those (Sherwood Park Junior High in Sydney) was opened in January 1997. Another (O'Connell Drive Elementary) was opened in September 1997. Two others (Horton High School and Hants East Middle School) were opened in September 1998 and two others (Hants East Elementary and Meadowfields Community School) are currently under construction. A development agreement has been signed for Amherst Regional High and the development agreement for Aspotogan Peninsula Elementary was recently approved by Executive Council, but construction has not started on either school.

**7.4** In December 1997 Executive Council approved the *Report of the School Capital Construction Committee* dated September 1997. The government then announced that it would proceed with approximately \$360 million of school construction and renovations, including \$250 million relating to construction of 31 new schools under P3 arrangements. A two-stage Request For Proposals process was conducted during 1998 to select preferred private sector partners and in September 1998 government announced the selection of three preferred private sector partners to build the 31 schools.

**7.5** We have issued two prior audit reports relating to certain aspects of the public-private partnership process for school construction. We strongly recommend that readers of this report also read our prior reports to gain a fuller understanding of the issues associated with P3 schools in the Province, and to establish an appropriate context for the current report.

- Our 1997 Annual Report (Chapter 8, page 78) included results of a detailed audit of the P3 process. At the date of writing of that report (December 1997) the Province had not signed leases for any of the eight P3 schools that had been announced, although two were occupied (Sherwood Park Junior High and O'Connell Drive Elementary) and construction had started on two others (Horton High School and Hants East Middle School).

- On July 23, 1998 we issued a Report which was tabled in the House of Assembly in response to a request from the Minister of Education and Culture for an audit of the lease on O'Connell Drive Elementary School. This was an audit of the first P3 school lease signed by the Province. The purpose of that Report was to convey our conclusions with respect to whether the Province's accounting for the 20-year lease, signed on March 12, 1998, complied with generally accepted accounting principles. The major findings from that report are included in paragraph 7.11 below.

**7.6** The Canadian Institute of Chartered Accountants (CICA) makes recommendations relating to accounting principles. The CICA identifies two basic types of leases (operating leases and capital leases). An understanding of the distinction between the two is necessary to fully understand the issues related to accounting for P3 schools. The definitions below emphasize that the difference between an operating lease and a capital lease is based on the amount of risk transferred from the lessor (consortium) to the lessee (Province).

**7.7** The main characteristics of operating and capital leases are as follows.

- An *operating lease* is a lease in which the lessor (private sector) does not transfer substantially all the benefits and risks incident to ownership of property. Lease rentals under an operating lease should be included in the determination of net income over the lease term on a straight-line basis. *The Province under an operating lease is, in effect, committing to fund expenditures from its annual revenues for each of the next 20 years. In the Province's financial statements, classification as an operating lease results in payments being recorded as expenditures when incurred, and no liability for future lease payments is recorded.*
- A *capital lease* is a lease that, from the point of view of the lessee (Province), transfers substantially all the benefits and risks incident to ownership of property to the lessee. A capital lease would be accounted for by the lessee as an acquisition of an asset and an assumption of an obligation to reflect the substance of the transaction in the year in which the lease was signed. *In the Province's financial statements, classification as a capital lease results in 100% of the cost of a leased asset being recorded as an expenditure and a liability when the lease is signed. Over the 20-year period, the only impact on annual results will be interest expense related to the outstanding liability.*

## RESULTS IN BRIEF

**7.8** The following are the principal observations resulting from this review.

- As of the date of writing of this Report (early December 1998), the Department of Education and Culture and private sector consortiums have signed final leases for two schools (O'Connell Drive Elementary and Hants East Middle). Our audit of the O'Connell Drive Elementary School lease was released in July 1998. We have not audited the accounting for the Hants East Middle School lease.
- Development agreements have been reached for four of the original eight P3 schools announced by government (three have been signed and an additional one was recently approved by Executive Council). Two of these schools are under construction and two are in the planning stage. The development agreements for two of the schools state that leases will be signed when construction is complete.

- A development agreement was signed in November 1998 for 13 schools for the Chignecto-Central Regional School Board, Conseil scolaire acadien provincial and the Halifax Regional School Board. It includes the approved construction costs for each school, the general form of the service agreement, and a schedule of service agreement fees (subject to adjustment for changes in interest rates to date of financial close). Construction has not started on these schools. A development agreement for 13 schools for the Cape Breton-Victoria Regional School Board and the Strait Regional School Board was approved by Executive Council in December 1998.
- As noted in our 1997 Annual Report (page 90), on December 11, 1997 the Priorities and Planning Secretariat released *Partnerships & School Construction: A Review* which made several recommendations to improve government control over P3 school construction initiatives including: “*No construction contracts for any new projects should be executed until financing is in place and leases are signed.*” We are not clear on whether the requirements of the Priorities and Planning Secretariat’s Review have been met for Hants East Elementary School and Meadowfields Community School. The approach that the Province has taken in signing development agreements before construction, and leases at the date of completion, is different from that contemplated by the Review. The development agreements were approved by Executive Council and the Priorities and Planning Committee, and the Department of Education and Culture has indicated that this occurred after a full briefing on the contents of the development agreements.
- As of March 31, 1998 the Department of Education and Culture had recorded construction advances of \$35.9 million to consortiums and a related provision for doubtful accounts of \$16.1 million. These amounts related to construction advances on Sherwood Park Junior High, Horton High School, and Hants East Middle School which are currently occupied. The advance for Hants East Middle School was repaid when the lease was signed and the advances for Horton and Sherwood Park are still outstanding. The construction costs of the two schools currently in progress (Hants East Elementary and Meadowfields) are being financed by the consortiums and/or their lenders.
- Development agreements and leases are being negotiated for the remaining schools.

## SCOPE OF REVIEW

**7.9** The objective of this follow-up review was to determine and report the status of certain aspects of the Department of Education and Culture’s P3 school construction initiative.

**7.10** Our approach was based on discussions with management of the Department of Education and Culture and examination of documentation provided.

## PRINCIPAL FINDINGS

### *July 1998 Report on O’Connell Drive Elementary School Lease*

**7.11** The major observations resulting from our July 23, 1998 report on the O’Connell Drive Elementary School lease follow. (The full report is available from the Nova Scotia Government

Bookstore or on the Internet at [www.gov.ns.ca/legi/audg/pubs.htm#SPCREP](http://www.gov.ns.ca/legi/audg/pubs.htm#SPCREP)). However, our July 23, 1998 report also noted that each school lease will be unique and that our comments related only to the lease for O'Connell Drive Elementary School.

**Major Observations from July 23, 1998 Report of the Auditor General on O'Connell Drive Elementary School Lease**

- The decision on whether the Province should proceed with lease arrangements for schools (and also in other sectors) is complex and should be based on a thorough analysis of costs and benefits including the economic impact on the Province now and in future years, and impact on the education of students in this Province. The accounting classification of specific leases is just one of many factors that should be considered when making decisions about whether needed public infrastructure will be made available to residents, and it should not be the determining factor.
- The most appropriate accounting for the O'Connell Drive Elementary School lease would be classification as a capital lease because most of the risks and benefits rest with the Province. The Province and consortium negotiated an amendment to the lease terms in July 1998 through which the consortium contributed additional services to the Province. The revised lease meets the quantitative tests included in the CICA Handbook for classification as an operating lease. Therefore, the Province's decision to account for the revised lease as an operating lease is acceptable.
- The private sector consortium obtained financing for the lease through a pension fund which operates in a tax-free environment. The end result for the Province is that the financing for the school is at the same rate as the Province would have incurred if it had borrowed.
- The Province has been successful in transferring some risk to the private sector, but the majority of the risk remains with the Province.
- This lease demonstrates the potential accounting issues associated with lease agreements where services, in addition to the basic net lease, are acquired. These issues relate to the difficulty in assigning gross lease payments to individual services and the appropriate valuation of those services.
- The Province has made significant, positive changes to the P3 process for future school construction projects. For example, the Stage II Request for Proposals issued in July 1998 for 31 new schools requires the proponents to specifically address risk transfer and financing arrangements in their proposals.

***Eight Original P3 Schools***

**7.12** As of the date of writing of this Report (early December 1998), the Department of Education and Culture and private sector consortiums have signed final leases for two schools:

- O'Connell Drive Elementary (Porters Lake) - opened September 1997
- Hants East Middle - opened September 1998

**7.13** Development agreements have been signed for three schools:

- Amherst Regional High - construction not yet started
- Hants East Elementary - construction in progress
- Meadowfields Community School (Yarmouth) - construction in progress

**7.14** A development agreement was recently approved by Executive Council but has not yet been signed for one school:

- Aspotogan Peninsula Elementary School - construction not yet started

**7.15** The status of the remaining two schools is as follows:

- Horton High - opened September 1998 - lease currently under negotiation
- Sherwood Park Junior High - opened January 1997 - lease currently under negotiation

**7.16** As noted in our 1997 Annual Report (page 90), on December 11, 1997 the Priorities and Planning Secretariat released *Partnerships & School Construction: A Review* which made several recommendations to improve government control over P3 school construction initiatives including:

*“No construction contracts for any new projects should be executed until financing is in place and leases are signed.”*

**7.17** *Hants East Elementary and Meadowfields Community School* - As noted in paragraph 7.13 above, construction is in progress for Hants East Elementary and Meadowfields Community School but leases have not yet been signed. These two schools are being constructed by the same private sector consortium and similar development agreements have been signed by the Province and the consortium for the two schools. The development agreements were approved by Order in Council (OIC 98-289 dated June 18, 1998 for Hants East Elementary and OIC 1998-411 dated August 13, 1998 for Meadowfields).

**7.18** The development agreements for Hants East and Meadowfields include the following:

- approved construction costs;
- construction schedule;
- statement that consortium is responsible for interim financing of construction costs; and
- an agreement relating to the signing of a lease when construction is complete. (The following is in section 11.1c of both agreements: *“On the Completion Date or such other date as the Province, Lenderco [a company to be incorporated by the institutions providing permanent funding for the Facility] and Nova [the consortium] may agree:...(c.)the Province, Lenderco and Nova shall enter into the Lease in the form attached as Schedule H, with the appropriate adjustments in rent pursuant to Schedule A thereof...”*)

**7.19** Schedule H of both development agreements includes an unsigned lease document but the dollar amounts have been left blank. In both leases, the lease payment is to be based on the "Initial Yield" which is defined as "*the yield to maturity, as at the Commencement Date [Hants East - August 1, 1999 and Meadowfields - September 1, 1999], based on the interpolated rate of the 10.25% Government of Canada bonds maturing on March 15, 2014 and the 9.75% Government of Canada bonds maturing on June 1, 2021, compounded and payable semi-annually, plus 91 basis points...*" (Section 2.1(n) of Meadowfields lease and 2.1(l) of Hants East lease).

**7.20** In other words, the lease payments are to be based on market interest rates at a future point in time plus 91 basis points and will not be known with certainty until that time.

**7.21** There is no indication in the development or lease agreements as to whether the consortium has arranged long-term financing for the two schools. However, we received written confirmation from the consortium that "*firm long term financing arrangements are in place for the Hants East Elementary School in Lantz and Meadowfields Community School in Yarmouth.*"

**7.22** We are not clear on whether the requirements of the Priorities and Planning Secretariat's Review referred to in paragraph 7.16 above have been met for Hants East Elementary School and Meadowfields Community School. The approach that the Province has taken in signing development agreements before construction, and leases at the date of completion, is different from that contemplated by the Review. The development agreements were approved by Executive Council and the Priorities and Planning Committee, and the Department of Education and Culture has indicated that this occurred after a full briefing on the contents of the development agreements.

**7.23** *Amherst High School and Aspotogan Peninsula Elementary School* - The development agreements for Amherst and Aspotogan incorporate an approach different from the other two signed agreements and include general parameters to govern development of a service agreement rather than a lease. The service agreements, including required payments by the Province, have not been signed yet but the Department of Education and Culture has indicated that they will be signed prior to the start of construction. Aspotogan Peninsula Elementary School is included in the development agreement described in paragraph 7.28 below.

**7.24** *Hants East Middle School* - Hants East Middle School was opened in September 1998 and the lease was signed on September 1, 1998. A development agreement had previously been signed and was approved by Order in Council (OIC 1998-335 dated July 1998). The Department of Finance has reviewed the lease and determined that it meets the mathematical tests for classification as an operating lease as set forth in the guidance in the CICA Handbook. We have not audited the Department of Finance's calculations or accounting for this lease but we will need to audit this and any other leases or related agreement in order to express an audit opinion on the March 31, 1999 Public Accounts.

**7.25** *Construction advances* - As of March 31, 1998 the Department of Education and Culture had recorded construction advances of \$35.9 million to consortiums (see page 89 of our 1997 Report) and a related provision for doubtful accounts of \$16.1 million. As of November 1998, the construction advance account balance was \$41.9 million and the related provision for doubtful accounts was \$14.4 million. These amounts relate to construction advances on Sherwood Park Junior High and Horton High School. Advances made for O'Connell Drive Elementary School and Hants East Middle School were recovered when leases were signed.

### ***31 Schools Announced in December 1997***

**7.26** In September 1998, the Department of Education and Culture announced that it had selected preferred private sector partners for the 31 additional schools to be built. There are three private sector consortiums involved. Negotiations between the Province and the consortiums are proceeding, and one development agreement has been signed to date. Another has been approved by Executive Council. Construction has not started on any of the schools.

**7.27** The development agreement signed in November 1998 relates to 13 schools for the Chignecto-Central Regional School Board, Conseil scolaire acadien provincial and the Halifax Regional School Board. It includes the approved construction costs for each school, the general form of the service agreement, and a schedule of service agreement fees (subject to adjustment for changes in interest rates to date of financial close).

**7.28** The development agreement for 13 schools for the Cape Breton-Victoria Regional School Board and the Strait Regional School Board was approved by Executive Council in December 1998 but has not yet been signed. Management of the Department of Education and Culture anticipate that development agreements for the remaining five schools will be signed by the end of December 1998.

### **CONCLUDING REMARKS**

**7.29** The Department of Education and Culture is responsible for negotiating leases with private sector consortiums which comply with government policies including the requirement that the resulting leases be operating leases. The government's Co-operative Business Solutions procurement process has been used to select preferred private sector partners which means that a supplier is selected on the basis of qualifications and capability rather than price, to form a business alliance of shared risks, resources and benefits between the supplier and government. Cost is negotiated after a preferred supplier is selected. The Co-operative Business Solutions procurement process and the requirement for operating leases both restrict the government's negotiating options.

**7.30** These are large projects which require significant financial investments and there are many risks to be considered by the Province and the consortiums. Negotiating these significant items takes time. Development agreements have been reached for 26 of the 31 schools where preferred private sector partners were announced in September 1998. This is a significant improvement over the length of negotiations for the original eight schools.

**7.31** The only lease which we have audited to date is the one on O'Connell Drive Elementary School and the resulting report was tabled in the House of Assembly in July 1998. Accounting for P3 leases will be included in our audit of the March 31, 1999 Public Accounts. Our 1999 Annual Report and future reports will include any related comments.

**7.32** As stated in our 1997 Report, monitoring and evaluating P3 arrangements both during and after implementation is important and we encourage government to establish an appropriate process to monitor and evaluate P3 schools which is independent of those with responsibility for the P3 initiative.