

***Auditor General***

DEPARTMENT OF EDUCATION AND CULTURE O'CONNELL DRIVE ELEMENTARY SCHOOL LEASE

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Mr. Roderick MacArthur,
Chief Clerk of the House of Assembly
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Dear Sir:

I have the honour to submit herewith a special report to the House of Assembly which provides the results of my audit of the O'Connell Drive Elementary School Lease. This audit was requested by the Minister of Education and Culture in a letter dated June 5, 1998. This special report is issued pursuant to Section 15 of the Auditor General Act.

I understand that by transmitting two copies to you it will be deemed to have been tabled, and accordingly I am distributing copies to all Members of the Legislative Assembly and releasing it publicly.

Respectfully submitted

E. Roy Salmon, F.C.A.
Auditor General

Halifax, Nova Scotia, July 21, 1998

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Introduction

1. O'Connell Drive Elementary School in Porters Lake was designed and built by Nova Learning Incorporated (a private sector consortium) and is being leased by the Province. The purpose of this Report is to convey my conclusions with respect to whether the Province's accounting for the 20-

year lease for O'Connell Drive Elementary School, signed on March 12, 1998, complies with generally accepted accounting principles.

2. The Minister of Education and Culture requested that I perform this audit. His request letter dated June 5, 1998 is included as Exhibit 1 to the report. Section 15 of the Auditor General Act gives me the mandate to perform special audits and report the results.

3. 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 has made a public policy decision with respect to school construction - schools will be built without adding to the debt of the Province. There are three possible approaches to implementing this public policy - reduce expenses or increase revenues to the extent required to offset the related capital expenditures, or enter into operating leases with the private sector. The government has chosen the latter approach which precludes the Province from considering other options for individual schools that could possibly, in some circumstances, result in better value for money. However, the Department of Education and Culture has stated that operating leases will only be signed if they represent value for the taxpayer, and that other options may be considered where appropriate.

4. The mandate given to me under the Auditor General Act does not extend to assessment of public policy. I, therefore, do not express an opinion 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. The scope of this audit was limited to questions of:

- - compliance with generally accepted accounting principles;
- - relative amounts of risk assumed by the Province and the private sector in the O'Connell Drive Elementary School lease; and
- - to a lesser extent, certain aspects of due regard for economy and efficiency inherent in this specific lease.

5. There are many other important aspects of this arrangement, such as the impact on the education of students and the economy of the Province, that are not addressed in this report.

6. Any observations and conclusions included in this Report are related only to the lease for O'Connell Drive Elementary School and should not be generalized to other schools being constructed, or to be constructed in the future, under arrangements involving the private sector.

7. The private sector has always been involved in building schools in the Province. Traditionally, schools were built by the Department of Supply and Services/Transportation and Public Works using a Design-Bid-Build approach where a firm of architects would be hired to design the school. The Department would then request proposals from the private sector for construction. One school construction project used a variation of the Design-Bid-Build approach termed Design-Build which involved a single request for proposals for both design and construction services. O'Connell Drive Elementary School involved a single request for proposals for all phases of the project - design, construction, financing and operation.

8.O'Connell Drive was the second school to be built by the Province under a P3 arrangement. The school was opened in September 1997, and the lease was signed in March 1998. P3 is a relatively new concept for governments and, as governments and the private sector gain more experience with these arrangements, the process evolves. The O'Connell Drive lease was a learning experience for all those involved, and the lease might have been significantly different if it had been negotiated before construction started rather than after the school was opened. The Department of Education and Culture believes that the experience gained during the O'Connell Drive negotiations has been useful because familiarity with options and alternatives discussed will benefit the Department in future negotiations. The Province has made significant changes to the process for schools to be built in the future. The major changes are described in paragraph 53 below.

Background

9.My 1997 Annual Report which was deemed tabled in the House of Assembly on February 11, 1998 included the results of an audit of the Province's Public Private Partnerships (P3s) for School Construction (page 78). I strongly recommend that readers of this report also read my previous report 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. A copy of the chapter of my 1997 report dealing with Public-Private Partnerships for School Construction is included as Exhibit 3 to this report.

10.When my 1997 Annual Report was issued, the status of the P3 school construction initiative was as follows:

- Eight school construction projects were proceeding under P3 arrangements. Construction had started for four of the schools. The Province had not signed leases for any of the schools although two were occupied (O'Connell Drive Elementary in Porters Lake and Sherwood Park Education Centre - a junior high school in Sydney).
- The Minister of Finance had 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 P3 arrangements.
- In December 1997 Executive Council approved the *Report of the School Capital Construction Committee* dated September 1997. The Province then announced that it would proceed with approximately \$360 million of school construction and renovations, including \$250 million relating to new school construction under P3 arrangements.

11.Since the issue of my 1997 Report, the following major developments have occurred.

- The O'Connell Drive Elementary School won a 1998 Lieutenant Governor's Design Award in Architecture.
- The Governor in Council issued OIC 98-102 on March 10, 1998 which authorized the

Minister of Education and Culture to execute the lease for O'Connell Drive Elementary School. On the same day, OIC's 98-104 to 106 authorized the Minister to negotiate and execute leases and other agreements for the Amherst High School, Hants East Elementary School, and Meadowfields Community School "*meeting all the requirements of an operating lease as set out in Section 3065 of the Handbook of the Canadian Institute of Chartered Accountants.*" The inclusion in the OICs of the requirement for an operating lease reflects the Province's desire to "*build more schools more quickly, without adding to the debt of the province*" (*School Leases Rationale and Highlights*, Department of Education and Culture, March 13, 1998).

- The lease for O'Connell Drive Elementary School and related legal documents were signed by the Province, the private sector consortium, the financing institution, and the Halifax Regional School Board on March 12, 1998.
- The School Board and a private sector company signed a management agreement for the school on June 2, 1998.
- On June 5, 1998 the Minister of Education and Culture requested me to review and comment on the O'Connell Drive Elementary School lease and documentation related to the Amherst Regional High School lease. A copy of his letter to me is included as Exhibit 1 to this report. As the lease on Amherst Regional High School has not been signed as at the date of writing this report, I am unable to comment on it. Therefore, this audit is limited to the O'Connell Drive lease and related documents.
- Leases for Amherst Regional High School and the other schools included in the original eight school construction projects are currently under negotiation. A lease for the Hants East Elementary School was signed in June 1998 and land clearing for the school has begun. A development agreement for Amherst Regional High School was signed in July 1998. No other new school construction has commenced since the release of my previous report.
- A call for expressions of interest for 31 new schools (divided into 6 bundles) was issued by the Province on March 13, 1998. The expressions of interest were to be submitted by April 22, 1998. Those expressions of interest have been reviewed by committees with broad representation and a short list of proponents who have been asked to submit detailed proposals as stage two of the selection process has been approved by Executive Council. Detailed proposals will be received on August 6, 1998 and partners will be chosen shortly after that date.

12.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 the accounting for the O'Connell Drive Elementary Schoollease.

13.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.*

14. My 1997 Annual Report (pages 81-82) includes a more detailed discussion of the impact of the recommendations of the Canadian Institute of Chartered Accountants on accounting for leases as they relate to the Province's financial statements (see Exhibit 3).

15. The following extract from Section 3065 of the *CICA Handbook* describes the CICA's rationale for its recommendations on accounting treatment of leases:

"3065.05 The Recommendations in this Section are derived from the view that property has benefits and risks associated with its ownership. Benefits may be represented by the expectation of profitable operation over the property's economic life and of gain from appreciation in value or realization of a residual value. Risks include possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. In the opinion of the Accounting Research Committee, a lease that transfers substantially all of the benefits and risks of ownership to the lessee [the Province] is in substance an acquisition of an asset and an incurrence of an obligation by the lessee [a capital lease]..."

16. It is important to note that the recommendations of the CICA focus on the degree of risk transfer as the determining factor for the appropriate accounting classification of a lease. The CICA indicates that assumption of substantially all of the benefits and risks of ownership by the lessee (Province) would result in the classification of the lease as a capital lease. Conversely, if the benefits and risks of ownership remain with the lessor (the consortium) then the lease is an operating lease.

Results in Brief

17. The following are the major observations resulting from this audit:

- The government has made a public policy decision with respect to school construction -

schools will be built without adding to the debt of the Province. The government has also indicated that this will be accomplished through operating leases. The mandate given to me under the Auditor General Act does not extend to assessment of public policy. I, therefore, do not express an opinion 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. This public policy decision precludes the government from considering other options for individual schools that could possibly, in some circumstances, result in better value for money. However, the Department of Education and Culture has stated that operating leases will only be signed if they represent value for the taxpayer, and that other options may be considered where appropriate.

- 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. If the Province was to acquire the school at the end of the lease term, the present value to the Province for use of the school for its full economic life under the lease arrangement would be \$8.3 million (excluding operating and maintenance costs) as opposed to \$8 million if the Province owned the school and financed it with debt. (Note that this assumes that the Province acquires ownership at the end of 20 years. Alternatively, the Province could decide to renew the lease or "walk away".)
- The Province has been successful in transferring some risk to the private sector, but the majority of the risk remains with the Province. For example, the risks related to capital improvements, operating costs, and technology refreshment all remain with the Province. The major risk transferred to the private sector is residual value but, because the private sector will have recovered 88.9% of the investment in the property at the end of the lease term and the property should have some value at that time, the residual value risk is limited.
- 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. Responsibilities for certain aspects of the P3 process in government, including the appropriate accounting classification, have also been clearly assigned within the government organization.
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Audit Scope

18. The objectives of this audit were:

- - to determine whether the Province's accounting treatment of the O'Connell Drive Elementary School lease and related arrangements complies with generally accepted accounting principles; and
- - to gain an understanding of the risks transferred as part of the O'Connell Drive Elementary School lease and related arrangements.

19. As noted above, 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 P3 arrangements. The mandate given to me under the Auditor General Act does not extend to a direct assessment of public policy. This audit, therefore, does not express an opinion on whether schools should be constructed and financed through the use of operating leases to keep the debt off the Province's balance sheet. The objectives of the audit are limited to questions of compliance with generally accepted accounting principles, relative amounts of risk assumed by the Province and the private sector under this specific arrangement, and, to a lesser extent, due regard for economy and efficiency.

20. It is important to note that my objectives for this audit do not specifically include a review of due regard for economy and efficiency (i.e., value-for-money). The issues with respect to economy and efficiency fall into three main categories and I have provided information relating to those issues, to the extent possible, as follows:

- *Construction costs* - My observations relating to this aspect of economy and efficiency were included in my 1997 Report. That report included comparisons of the O'Connell Drive construction costs and costs related to other schools built and operated by the Province under traditional methods (Those pages are reproduced on pages 39 and 40 of this Report). However, financing costs were not included in those comparisons as the lease for O'Connell Drive had not been finalized.
- *Financing costs* - My comments on the economic implications of the financing decisions are

included in this report (see paragraphs 41 to 44). Those paragraphs include a comparison of owning and leasing the school under two scenarios - assuming the Province exercises its right to buy the school at the end of the lease term, and assuming the Province terminates the arrangement at the end of the lease term.

- *Lifecycle costs* - My comments on the economy and efficiency of the lifecycle costs under the lease-related arrangements are included in this report under the headings of property management (see paragraphs 45 to 48) and technology refreshment (see paragraph 49).

21. My audit approach was based on discussions with management of the Departments of Education and Culture and Finance and examination of documentation provided. My staff also discussed specific issues with management of the Halifax Regional School Board, the private sector consortium, the public accounting firm engaged by the Minister of Finance to audit the Province's financial statements, and a public accounting firm hired by the Province to provide advice on this lease.

Principal Findings

Description of lease arrangement

22. On March 12, 1998 the lease and six other supporting legal documents were executed. Those legal transactions involved the Province, the Halifax District School Board, Nova Learning Incorporated (the private sector consortium which constructed the school) and Canapen (Nova Scotia) Limited (a pension fund based in another province). The arrangements are complex and the following is provided as an overview of the substance of the transactions included in the legal documents dated March 12, 1998:

- Nova Learning Incorporated (Nova) purchased the land from the Province. Canapen (Nova Scotia) Limited (Canapen) purchased the building and equipment from the Province. The total purchase price was \$7,750,636 which is equal to the total cost advanced to the consortium as interim financing during the construction process (see paragraphs 8.54 to 8.62 of my 1997 Report) plus the amount paid by the Province to acquire the land.
- Nova leased the land to Canapen for 20 years after which the title to the land will revert to Nova. The title to the building and equipment will also revert from Canapen to Nova after 20 years.
- The Province leased the facility from Canapen for an annual rent of \$705,950 (\$58,829 per month) for 20 years. The lease is structured as a net lease which means that the Province is responsible for all of the operating costs. The Province is also responsible for all costs of repairs (including capital repairs).
- At the end of the lease term, there are three possible outcomes:
 - - the Province has the option to buy the school for \$3,950,000 from Nova (The time value of money is a consideration when reviewing this figure. The present value of this

amount is \$1.1 million.);

- - the Province has the right to renew the lease for two additional five-year lease terms at an amount sufficient to amortize the option price (principal) plus interest over ten years; or
- - the Province can "walk away" and leave title to the school with Nova.

23. In addition to the March 12, 1998 documents, the Province and Nova Learning Incorporated negotiated an amendment to the lease which was signed on July 14, 1998. This amendment is discussed further in paragraph 37 below.

Accounting for lease costs

24. The essence of the CICA's recommendations on accounting for leases (Section 3065 of the *CICA Handbook*) is that the amount of risk transfer is the determining factor for the appropriate accounting treatment. The determination of whether "substantially all" of the benefits and risks of ownership have been transferred to the lessee is a matter of professional judgement, but the CICA provides additional guidance to those making the judgement in the form of three additional criteria which are widely used in the private sector to determine the appropriate accounting treatment.

25. A lease is generally treated as a capital lease if it meets one or more of the following criteria:

- **Ownership** - Lessee will obtain ownership of the property by the end of the lease term or there is a bargain purchase option.
- **Economic life** - Lease term is of such duration that the lessee will receive substantially all of the economic benefits expected from the use of the leased property over its life span. The CICA suggests that a lease term of 75% or more of the economic life would be appropriate for determining whether this criteria is met.
- **Return on investment** - The lessor would be assured of recovering the investment in the leased property and of earning a return on the investment as a result of the lease agreement. This condition would exist if the present value of the minimum lease payments, excluding any portion thereof relating to executory costs, is equal to substantially all (90% or more) of the fair value of the leased property at the inception of the lease.

26. The *CICA Handbook's* recommendations and guidance on accounting for leases have generated a significant amount of discussion in both the private and public sectors recently. There is a strong sentiment among certain members of the accounting profession that the recommendations need to be revisited to ensure that they give appropriate, clear guidance to those who are making classification decisions on leases. Currently, the criteria listed in the *Handbook* lead decision makers to focus on arbitrary, quantitative calculations rather than the substance of transactions. The CICA has not yet issued guidance on accounting for leases in the public sector but has recently launched a project in this area.

27. The Province decided to use the three CICA criteria listed above to determine the appropriate accounting treatment for the O'Connell Drive lease. In the opinion of those making the decision, none of the three criteria were met so the lease was accounted for as an operating lease.

28. I agree that the criteria used by the Province to make that decision were consistent with the CICA Handbook and generally accepted practice.

29. I also agree that the first two criteria (ownership and economic life) are not met. However, my audit of the analysis supporting the decision with respect to the return on investment criterion led me to question certain aspects of that analysis.

30. The analysis prepared by the Province to support the return on investment indicated that the present value of the minimum lease payments is \$7.13 million or 88.6% of the fair market value. In a press release issued on March 13, 1998 (*School Leases - Rationale & Highlights*), the Province described the calculation of that figure as follows:

"The present value of the lease payments, which are paid out into the future over 20 years is \$7.13 M. Monthly lease payments are \$51,529. (Note: the \$58,829 cost reflected in the O'Connell Drive lease includes \$7,300 per month to finance the communications/data link connecting the school and three others. This payment was included in the lease because the link was provided by the private partner. However, that \$7,300 must be subtracted from the total as reflected in the lease to arrive at the net cost for the school alone, of \$51,529.)"

31. The above indicates that the Province assigned a value of \$7300 per month to a communications link provided at no cost to the Province or school board by Nova for the 20 year term of the lease. The Province deemed, therefore, that the monthly payment required under the lease (\$58,829) consisted of two components: rent on the school (\$51,529), and an allocation of \$7300 for the monthly operating cost of the communications link. The accounting for the communications link, and the assignment of a value to it are the critical factors in determining whether the lease is an operating lease or a capital lease as demonstrated in paragraph 39 below.

32. The Communications Link is defined in Section 2.1 (f) of the Lease as:

"a network facility providing a 10 Mb/s (megabits per second) telecommunications/Internet service connecting the Premises [O'Connell Drive Elementary School], Lakeview Elementary School, the Bell Park Academic Center and the West Chezzetcook Elementary School to the Head-End and Internet gateway of [the service provider], together with "raw" access to the Internet via guaranteed 10 Mb/s bandwidth which is not shared by other users in other sites prior to connection with [the service provider's] Head-End."

33. It is a high-speed communications link which was obtained by Nova from a cable company which is a core member of the consortium. At the time that the lease was signed, there were no other schools in the Province with the same type of communications link. The vast majority of schools in the Province use telephone-based links although I know of at least two other schools which have cable-based links, although they are not as high-speed as the O'Connell Drive one. All schools in the Province obtain significant discounts from business rates from providers of communications services.

34. The Province and the private sector consortium, based on analysis of communications costs, assigned a value of \$7,300 per month to the communications service which is to be provided at no cost to the Province or school board over the 20-year lease term. My audit of the \$7300 figure revealed that:

- The analysis supporting the \$7,300 figure had been prepared by the Province in consultation with the private sector consortium in July 1997 and it was based on discounted rates available to the Province for similar services in schools. At that time, this appears to have been the only information available to the Province and the consortium on value of the service as high-speed communications service was just beginning to be widely available. The Province and the consortium, however, did know that the price of the link to this school would be significantly discounted. The cost of high-speed data network services for one location (\$1100 per month) was multiplied by four to reflect the fact that the service would be available to four schools, and the cost was increased by an assumed cost of the internet feed (\$2900 per month).
- The analysis was based on current rates, and had not been adjusted to reflect estimated changes over the 20-year period.
- Nova acquired the service from a cable company which is a core member of the consortium at a cost below the \$7,300 value assigned to the service.
- The inception date, which is defined by the CICA as the earlier of the date of the lease agreement and the date of a commitment which is signed by the parties to the lease transaction and includes the principal terms of the lease, is the effective date used for classification of the lease. The Memorandum of Agreement was approved by Executive Council in December 1997.

35. I had concerns about the \$7300 value which had been assigned to the connection by the Province and the private sector consortium. No other schools in the Province (including the Sherwood Park Education Centre which is also a new, high technology school) utilize high speed connections with these costs. Costs incurred by the Province and the Halifax Regional School Board for telephone-based connections to EDnet (the Department of Education and Culture's intranet) were examined and found to be in the following range, depending on whether the connection is high-speed or low-speed:

- **56K (low speed)** - at rate negotiated by the Province for schools, the total cost for four schools would be \$1,000.
- **T1 (1.54 Mbps) (high speed)** - at a rate negotiated by the Province which is available for schools, the total cost for four schools would be \$5,000.

36. The choice of appropriate data network services depends on how the technology will be used. High speed services are more costly but may be required for certain applications. The 10 Mbs connection at O'Connell Drive has a higher speed than any existing services used by the Department of Education and Culture or the Halifax School Board in schools. The way in which the technology is used in the classroom determines the required speed of the data network connection.

37. When my concerns about the value allocated to the data connection services were conveyed to the Department of Education and Culture, the Department decided to undertake negotiations with the consortium to increase the value of services received. On July 14, 1998 an agreement was signed which includes the following:

- Nova Learning Incorporated will provide an additional 10Mbs communication link to Gaetz Brook Junior High School for the lease term.
- Nova will expend \$50,000 on capital improvements to O'Connell Drive Elementary School.

38. I believe that this change in the lease terms results in a total contribution by the consortium of data communication services with a value of \$1,250 to \$6,250 per month for five schools, depending on the required connection speed. A value of \$5,500, which falls in the range of reasonable values, was used by the Department of Education and Culture in a revised analysis of the lease. However, the true value of the communication services will be determined by how well the available capacity is utilized by the schools.

39. The following table illustrates the impact of the value of the cable connection on the calculation of return on investment. The second row represents the return on investment based on the lease as amended on July 14, 1998 using a value of \$5,500 per month for the communications services provided by the consortium.

Monthly Lease Payment	\$ Allocated to Communications Link	\$ Allocated to Lease	Present Value of Minimum Lease Payments	% of Fair Market Value
\$58,829 (Note 1)	\$1,250	\$57,579	\$7,773,921	96.0% (Note 3)
\$58,829	\$5500	\$53,329	\$7,200,115	88.9% (Note 3)
\$60,107 (Note 2)	\$7300	\$52,807	\$7,129,638	88.6%
\$58,829	\$7300	\$51,529	\$6,957,091	86.5%

Note 1

- Payment included in the lease dated March 12, 1998.

Note 2

- Estimated lease payment in December 1997 when the Memorandum of Agreement was submitted to Executive Council and the present value calculations were prepared. The payment was subsequently decreased due to downward change in interest rates.

Note 3

- July 14, 1998 lease amendment resulted in market value change from \$8,045,060 to \$8,095,060 based on capital improvements. These figures are based on the amended fair market value.

40. The table above demonstrates that the amended 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. I recognize that the classification of leases is a matter of professional judgement. However, I believe that 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 CICA's primary recommendation on the accounting classification of leases is quoted in Exhibit 2 to this Report.

Economy of financing arrangement

41. As indicated in paragraph 39 above, the present value of the lease payments of \$58,829 less executory costs of \$5500 per month is \$7.2 million. If the Province had decided to keep the school after it was designed and built by the private sector, rather than leasing it, the present value would have been approximately \$7.9 million.

42. Because Canapen is a pension fund, it operates in a tax-free environment. The Province and Nova were able to take advantage of Canapen's tax-free status to arrange financing at the same rate as the Province would have incurred if it had financed the school from its own sources. Therefore, there was no additional financing cost associated with the P3 arrangement.

43. If the Province was to acquire the school at the end of the lease term, the present value of the option price would be \$1.1 million. Therefore, the cost (present value) to the Province for use of the school for its full economic life under the P3 arrangement would be \$8.3 million (excluding operating and maintenance costs) as opposed to \$8 million if the Province owned the school and financed it with debt. (Note that this assumes that the Province acquires ownership at the end of 20 years. Alternatively, the Province could decide to renew the lease or "walk away".)

44. The Province believes that the premium paid for leasing has benefits. As noted in the press release issued on March 13, 1998 (*School Leases - Rationale & Highlights*), the premium

"... 'buys' the province more flexibility to meet future construction needs. Even more significantly, leasing enables the province to build more than 30 schools - much more quickly - meeting the needs of children while keeping the budget balanced and without adding to the debt of the province."

Property management

45. On June 2, 1998 the Halifax Regional School Board and Oxford Atlantic signed a management agreement for O'Connell Drive Elementary School. The agreement, under which Oxford will operate, maintain and manage the property on behalf of the Board, covers a one-year period from September 1, 1997 to August 31, 1998. Although the agreement was signed in June 1998, Oxford Atlantic has been providing management services since before the school opened in September 1997. The fees for the services performed prior to June 1998 were paid by the Department of Education and Culture but the Department will be reimbursed by the Halifax Regional School Board for costs incurred since September 1, 1997. Oxford is not a member of the consortium that built the

school, nor is it owned by members of the consortium.

46. The agreement requires the school board to pay \$16,554 per month to Oxford for management of the school. Those funds are to be used to pay for operating expenses such as caretaker salaries, heat, electricity and maintenance. The payment to the management company also includes an administration fee of 15% of expenses (estimated administration fee is \$23,000 per year).

47. Although the required payments to Oxford total \$198,648 annually (\$3.52 per square foot plus HST), the following clause is included in the agreement:

" 3.06

As soon as reasonably practical following the end of the Management Year, the Manager shall furnish to the Board an accounting in reasonable detail of all expenses paid on behalf of the Property, including all fees paid to the Manager, for such Management Year. If any overpayment has been made by the Board to the Manager for such expenses, the Manager shall immediately repay the amount of overpayment to the Board. If the payments by the Board to the Manager have been insufficient to reimburse the Manager for expenses paid on behalf of the Property and agreed fees, the Board shall immediately pay to the Manager an amount equal to the shortfall."

48. This clause has the effect of transferring the risk on the management agreement to the Halifax Regional School Board because the Board will receive any surplus or pay any deficit at the end of the year. It is not possible, until actual results for the year are finalized, to determine the costs of this agreement to the Board and conclude on whether management costs for O'Connell Drive Elementary School are more/less than for similar schools. The Halifax Regional School Board has indicated that, based on budget projections, the operating cost is "*about 20 cents less than the \$3.75 per square foot cost which is the average for Halifax County Schools.*" (letter from Halifax Regional School Board to Deputy Minister of Education and Culture, dated May 28, 1998)

Technology

49. The lease and management agreement for O'Connell Drive Elementary School do not include provisions for technology refreshment. The Halifax School Board anticipates that the costs of technology refreshment will be borne by the Province, but no agreements to this effect have been signed to date. The risk related to technology rests with the Province and/or School Board.

Risk transfer

50. The Nova Scotia Department of Finance's November 1997 publication *Transferring Risk in Public/Private Partnerships* identifies six risks as applicable to P3's for schools. The following table shows how each of those six risk factors has been allocated in the O'Connell Drive lease.

Risk	Allocation	
	Government/School Board	Private Sector
Residual value - Risk that school building will be worth less than option price.		Private sector will have recovered 88.9% of the initial investment if government "walks away" after 20 years. The private sector's risk, therefore, is limited to recovery of 11.1% of the initial investment plus any future profits. Recovery of the 11.1% is also relatively certain because the land and building should have some value to the private sector at the end of 20 years.
Occupancy - Risk that the utilization rate of a facility will be more or less than expected during all, or part, of its life.	For first 20 years, government bears the risk.	After 20 years, Nova bears the risk although it is reduced by giving the Province the option to buy the school or renew at rates specified in the current lease.
Operating - Risks associated with operation of school building.	Current maintenance agreement assigns this risk to board. Technology risk rests with the Board and Province. The public sector is also responsible for capital improvements.	
Planning - Risk that a proposed project may not meet the required standards or community needs throughout its life.	Government and school board bear this risk.	
Design and Construction - The risk of cost overruns, construction delays, or design and construction flaws.		Private sector bears this risk due to fixed fee construction agreements. The transfer of this risk to the private sector could be accomplished without P3 arrangements (i.e. could be accomplished through ownership of schools and procurement of construction services from the private sector).

Regulatory and Legislative - The risk that a project's viability will be affected by changes in legislation.	Government bears this risk.	
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51. The Province has been successful in transferring some risk to the private sector, but the majority of the risk remains with the Province. For example, the risks related to capital improvements, operating costs, and technology refreshment all remain with the Province. The major risk transferred to the private sector is residual value but, because the private sector will have recovered 88.9% of the investment in the property at the end of the lease term and the property should have some value at that time, the residual value risk is limited. If, however, the Province did not renew the lease and the building could not be used for another purpose and had to be demolished, the related risk would remain with the private sector. The minimal amount of risk assumed by the private sector under this lease is the reason why I believe it would more appropriately be accounted for as a capital lease. This position is consistent with the recommendations of the CICA (see Exhibit 2).

52. This lease should not be used as a model for an operating lease for other schools or infrastructure because the amount of risk remaining with the private sector in this case is not sufficient to justify classification of similar future leases as operating leases.

Recent changes to the P3 process

53. The government has made significant improvements to the P3 process for schools recently. These include:

- 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. This information should provide valuable input to a thorough analysis of costs and benefits prior to the decision to select a private sector partner and enter into a lease agreement.
 - Responsibilities for certain aspects of the P3 process in government, including the appropriate accounting classification of leases, have been clearly assigned within the government organization. This should help to ensure that appropriate accounting classification decisions are made consistently.
 - Government has approved the establishment of a P3 Secretariat managed by an Executive Director who will be supported by a small professional, administrative staff. We have been informed that this Secretariat, which will manage all P3 projects, will be established prior to receiving the detailed proposals for 31 new schools.
-

Concluding Remarks

54. The amended 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. I recognize that the classification of leases is a matter of professional judgement. However, I believe that 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.

55. I have not commented on whether the debt for school construction should be kept off the balance sheet because that is a public policy decision that has been made by government. I have also not commented on whether the government should pursue operating leases for schools. My mandate under the Auditor General Act does not extend to matters of public policy. However, it must be understood that this public policy decision precludes the government from considering other options for individual schools that could possibly, in some circumstances, result in better value for money. The decision on whether the Province should proceed with P3 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.

56. Each school lease will be unique and my comments relate only to the lease for O'Connell Drive Elementary School which was the second school built in the Province under P3 arrangements. However, 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.

57. The Province has made changes to several aspects of the process for requesting proposals and negotiating leases, as well as reassigning responsibility for certain related functions. These changes include more rigorous review of the appropriate accounting classification of leases. I support the implementation of these changes.

Exhibit 1

LETTER FROM THE MINISTER OF EDUCATION AND CULTURE TO THE AUDITOR GENERAL

Nova Scotia

**Department of
Education and Culture**
Office of the Minister

JUN - 5 1988

PO Box 573
Halifax, Nova Scotia
B3J 2B9

Mr. Roy Salmon
Auditor General
Suite 802
1550 Brunswick Street
Halifax, NS B3J 3J6

Dear Mr. Salmon:

The Department of Education and Culture has carefully considered the comments in Chapter 8 of The Report of the Auditor General 1997. I am pleased to report substantial progress in the P3 process, consistent with the recommendations and conclusions in your report. In particular, your recommendation that leases be finalized before construction begins is now government policy.

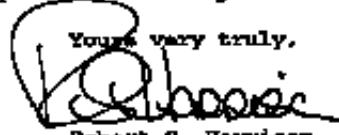
Since you filed your most recent report, the province signed a lease for O'Connell Drive Elementary School. That lease is enclosed. The Government recorded the lease as operating, on the basis that it meets the guidelines set out in the CICA Handbook. The external auditors, Deloitte and Touche, concur that this decision is reasonable. The government has also established benchmarks to govern cost per square foot, square feet per student, and cost per student.

I am pleased to report that leasing arrangements are nearing completion for Hants East Elementary and Meadowfields Community School, in advance of a construction start, in keeping with policy.

The province wants to continue to improve the P3 process so that much-needed schools can be delivered quickly. Therefore, I also enclose documentation for Amherst Regional High School as an example of progress being made. This arrangement was negotiated on behalf of the province by a team of representatives from the departments of Education and Culture, Finance and Justice. It will be reviewed by our external auditors and referred to Cabinet for approval.

It is the wish of the government as well as opposition Members of the Legislature, that you review and comment on the enclosed leases, in the manner you deem most appropriate.

I look forward to your response in this regard.

Yours very truly,

 Robert S. Harrison

Enclosures

Exhibit 2

EXTRACT FROM CICA HANDBOOK SECTION 3065 LEASES

".09 A lease that transfers substantially all of the benefits and risks of ownership related to the leased property from the lessor [the consortium] to the lessee [the Province] should be

accounted for as a capital lease by the lessee and as a sales type or direct financing lease by the lessor. [JAN. 1979]

.10 A lease where the benefits and risks of ownership related to the leased property are substantially retained by the lessor [the consortium] should be accounted for as an operating lease by the lessee [the Province] and lessor [the consortium]. [JAN. 1979]"

Exhibit 3

EXTRACT FROM 1997 REPORT OF THE AUDITOR GENERAL

EDUCATION AND CULTURE - PUBLIC-PRIVATE PARTNERSHIPS (P3s) FOR SCHOOL CONSTRUCTION

Background

8.1 In the April 17, 1997 Budget Address to the House of Assembly, the Minister of Finance stated

"Every new school in Nova Scotia will be built through public-private partnerships. This means more schools will be built more quickly with leading-edge technology. Seven of these schools are now in various stages of planning and construction. Over the coming year, government will outline details of the next round of new school construction." (Budget Address to the Nova Scotia House of Assembly for the fiscal year 1997-98, page 15)

8.2This represents a fundamental shift in the way in which schools are designed, constructed, financed, owned and operated in Nova Scotia.

8.3The following paragraphs include background information which we believe is necessary to understand the issues associated with this transition including:

- the objectives of the public-private partnership (P3) process for school construction;
- the history of school construction financing in Nova Scotia; and
- the recommendations of the Canadian Institute of Chartered Accountants relating to accounting for leases and their impact on the financial statements of the Province.

8.4Chapter 3 of this Report includes additional information which is also relevant to understanding the related issues such as:

- the concept of public-private partnerships (page 28);
- the Cooperative Business Solutions (CBS) procurement process (page 25); and
- the administration of the P3 process within the government of Nova Scotia (page 29).

Objectives for P3 Schools

8.5The Department of Education's objectives for P3 schools are described in the Department of Finance Discussion Paper *Transferring Risk in Public/Private Partnerships November 1997* as follows:

"Schools delivered via a Public Private Partnership will be flexible, high tech learning environments to support programs and services for students during the useful life of the school. All technology will be integrated and provide valuable support tools for students and professional staff.

These schools will be connected electronically to neighbouring schools so that equitable access to technology is accomplished.

The Private Sector will refresh the technology, and refreshed technology will be provided to other schools in the region.

One of the objectives of Public/Private Partnerships is to ensure participatory planning for the facility to accommodate programs and services both now and in the future. Students, staff, School Board, the Province, the community at large and the Private Sector are involved in the design and construction of the facility." (page 4)

8.6In addition to Education's objectives, the Department of Finance has put forward objectives for P3 arrangements in the same publication.

"From the perspective of the Department of Finance, the main objective for P3 is to use it as a mechanism to deliver selected services efficiently and cost-effectively so as to:

- attract private capital to the Province's public initiatives, thereby requiring less investment of public money;*
- transfer expertise to the private sector, thereby creating economic opportunities in the private sector, i.e., increased private sector job creation via increased sales, both external and internal to Nova Scotia;*
- enable the government to devote more of its resources to its "core business," the delivery of essential services;*
- transfer risk to the private sector where this can be done in a cost-effective manner; and*
- realize a net increase in value for public expenditures." (page 4)*

8.7Although not explicitly stated in *Transferring Risk in Public/Private Partnerships November 1997*, the Department of Education and Culture also has the objective of leveraging the annual appropriation available for school construction to fill as many of the urgent school construction requests from school boards as possible.

History of School Construction Financing in Nova Scotia

8.8 In the past, schools were constructed by the Department of Transportation and Public Works (formerly the Department of Supply and Services). Financing was obtained through debentures issued by the Nova Scotia Municipal Finance Corporation. When construction was complete, title

to the school would be transferred to the school board and the asset and the related debt owing to the Municipal Finance Corporation would be recorded on the board's financial statements. The Department of Education and Culture would make capital debt assistance grants to the boards over the life of the debt. The grants were equal to 100% of the required payments on the debt and would be recorded as expenditures of the Province when paid.

8.9In March 1993, to comply with pronouncements of the Canadian Institute of Chartered Accountant's (CICA) Public Sector Accounting and Auditing Board, school debt was recorded in the Public Accounts for the first time. The CICA's recommendations reflect the position that financial statements of a government should include all of its liabilities at the end of the accounting period. The Province's liabilities and net debt were increased by \$217 million at March 31, 1993 to reflect this change in accounting policy.

8.10The other effect of this change in accounting policy was that 100% of the cost of new schools would be expensed when the school was built. This new accounting treatment was consistent with that used for any other Provincial capital asset.

8.11While the change in accounting policy was one important aspect of the history of school construction in this Province, there was a second important change at approximately the same time.

8.12In 1992, Executive Council approved a new school construction prioritization process which included:

- requests for submissions from school boards;
- evaluation by a committee comprised of various stakeholders including school boards;
- pre-determined evaluation criteria; and
- a recommendation that \$30 million be set aside annually for school capital construction to address the projects in the high priority category over the next three years.

8.13The following shows the actual school construction expenditures of the Department of Education and Culture for the years 1992-93 to 1997-98.

Department of Education and Culture

School Construction Expenditures (\$ millions)

Year	
1992-93	\$54.6 - debt service grants
1993-94	\$13.0 - old construction program
	\$2.0 - new construction program
1994-95	\$12.4 - old construction program
	\$6.0 - new construction program

1995-96	\$7.0 - old construction program
	\$17.6 - new construction program
1996-97	\$4.0 - old construction program
	\$38.4 - new construction program
1997-98	\$33.4 - Estimate

8.14Fiscal restraint reduced the amount available for new school construction below the \$30 million recommended by the committee. However, the demand for school construction from the public was great. It appears that the increasing public demand, combined with the Province's inability to devote required resources to this area, led directly to the exploration of public-private partnerships for school construction as a solution.

8.15The Department of Education and Culture's estimates for the 1996-97 and 1997-98 fiscal years included \$.4 million and \$2.56 million, respectively, related to school lease payments.

8.16In December 1997, Executive Council approved the school construction priorities identified in the *Report of the School Capital Construction Committee* dated September 1997. The total value of the schools and repairs called for in the Report is approximately \$360 million of which \$250 million relates to new school construction. The government plans to invest approximately \$25 million annually in P3 leases to permit an immediate start to the school planning process.

Impact on the Province's Financial Statements

8.17The Canadian Institute of Chartered Accountants (CICA) issues accounting standards for profit-oriented businesses and not-for-profit organizations in its Handbook. The CICA'S Public Sector Accounting and Auditing Board (PSAAB) issues Recommendations and guidance with respect to matters of accounting and auditing in the public sector. PSAAB has not yet issued recommendations on accounting for leases in public-sector organizations. In the absence of specific public-sector accounting recommendations, the CICA Handbook becomes the source of professional guidance in accounting for leases.

8.18 The CICA Handbook distinguishes two separate methods of accounting for leases depending on the terms and conditions of the specific lease. It includes guidelines for determining whether a lease should be categorized as operating or capital. The overriding principle is that the accounting for the lease should be based on its substance rather than its form. However, we acknowledge that these quantitative guidelines have tended to be applied strictly as "rules" in both the public and private sectors which might result in different accounting treatment than if the substance of a transaction had been appropriately considered.

8.19Note that evaluation of the substance of an arrangement may include documents other than the actual lease. If other agreements covering certain aspects of the arrangement, such as the operation of the school or the renewal of technology, are an integral part of the public-private partnership then they should also be considered when deciding on appropriate accounting treatment.

8.20A *capital lease* is a lease that, from the point of view of the lessee, transfers substantially all the

benefits and risks incident to ownership of property to the lessee. An example of a capital lease would be one where ownership of the asset at the end of the lease term is virtually assured of transferring to the lessee. For example, if the lease included a bargain purchase option at the end of the lease term it would be classified as a capital lease. 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.*

8.21 An *operating lease* is a lease in which the lessor 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. *In the Province's financial statements, classification as an operating lease results in payments being recorded as expenditures when incurred.*

8.22 The impact of the accounting principles governing lease accounting is significant. If the school leases can be accounted for as operating leases, then the Province can leverage the resources available to build schools and acquire use of more new schools within the appropriation voted by the House of Assembly. If the school leases include terms and conditions that require accounting as a capital lease, then the Province loses the ability to leverage the appropriation to acquire the use of more schools. Paragraph 8.16 illustrates how the Province plans to leverage an annual appropriation of \$25 million through use of operating leases to provide schools with a construction cost of \$250 million.

Results in Brief

8.23 The following are the principal observations resulting from our audit:

- As of the date of writing this Report (December 1997) the Province had not signed leases for any of the eight P3 schools although two schools were occupied. Memorandums of Agreement for two schools (O'Connell Drive and Hants East Middle) were submitted to Executive Council in December 1997 and negotiations on final leases for other schools were proceeding. Government is making changes to ensure that costs are finalized before construction starts for future schools.
- The government did not prepare a formal analysis of the advantages of P3 arrangements in comparison to the traditional approach prior to making the decision to enter into P3 arrangements for school construction. We recommend that government prepare a detailed analysis of risks and rewards prior to entering into any future public-private partnership arrangements.
- The degree of success which the Province has achieved in transferring the risks associated with P3 schools to the private sector cannot be evaluated until the lease arrangements (including operating agreements and technology refreshment) are finalized.
- The Province has stated that school leases will not be signed unless they can be classified as operating leases under CICA guidelines. This will enable the Province to leverage the

resources available to build schools and acquire use of more new schools within the appropriation voted by the House of Assembly. In December 1997, the Province announced plans to use an annual appropriation of \$25 million to make payments on operating leases related to \$250 million of new school construction. The requirement for an operating lease precludes consideration of certain lease provisions which might have been advantageous to the Province in obtaining value-for-money. Until the leases and other agreements are finalized, we cannot evaluate the value-for-money included in the arrangements or whether the proposed accounting treatment is appropriate.

- The Province has been making advances to the P3 consortiums to finance the school construction process. The advances were made on the basis of approved progress claims with certification of the work performed. Management of the Departments of Education and Culture and Finance provided us with a legal opinion indicating that the Departments had "*sufficient statutory authority for these expenditures*" because the lease payments were included in annual appropriations. However, we believe that the Education Act is not clear with respect to the authority of the Minister in relation to P3 schools other than the right to approve plans for school buildings. Executive Council approved the Reports of the School Capital Construction Committee in which each of the P3 schools were listed as priorities but no Orders in Council were issued to approve specific construction and public-private partnership arrangements. We recommend that the legislation be clarified to indicate the type of approval required (Minister or Executive Council) for P3 agreements and construction advances.
- As one of its March 31, 1996 year-end accounting adjustments, the Department of Education and Culture created a Trust Fund of \$1.7 million for Sherwood Park Education Centre in Sydney from its 1995-96 capital appropriation. The amount was charged against the Department's 1995-96 appropriation although it will be used to fund expenditures of future years.
- We cannot conclusively state that construction of P3 schools is more or less costly than traditional schools due to the many factors involved in such a comparison, and the variation in estimates impacting such an analysis. For example, the Horton construction agreement included an estimate of \$28.9 million which was subsequently reduced to \$27.0 million and again reduced to \$25.5 million in December 1997. Department management has provided an explanation for the reduced estimate but we are unable to determine the accuracy of the estimate until construction is complete. Exhibit 8.3 provides information sufficient to enable the reader to compare certain aspects of the costs of these schools but financing, operating and other costs to be incurred over the life of these schools are not included.
- 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.
- On December 11, 1997 the Priorities and Planning Secretariat released *Partnerships and School Construction: A Review* which makes several recommendations to improve government control over P3 school construction initiatives. Implementation of the

recommendations of the Review will improve controls over certain aspects of the process but will not address all of our concerns. For example, the Review does not include a comprehensive analysis of the costs and benefits of leasing versus ownership of schools. The impact of operating leases on the long-term provision of education to students in the Province and the Province's current and future financial position and operating results is significant. Operating leases will result in the ownership of the schools resting with the private sector at the end of the lease term and the costs and benefits of such leases merit thorough consideration.

Audit Scope

8.24The objectives of this audit were to examine:

- - any analysis prepared by the Department of Education and Culture to support the decision to enter into P3 arrangements for school construction;
- - the selection process for private-sector partners in order to evaluate compliance with government procurement policies;
- - the accounting treatment of any school leases and interim financing arrangements for compliance with generally accepted accounting principles and the Province's stated accounting policies;
- - any agreements with private-sector partners to determine whether they incorporate due regard for economy and efficiency; and
- - any agreements with private-sector partners to understand the nature of risk transferred from the public sector to the private sector.

8.25The following general criteria were used in our audit.

- Prior to making the decision to enter into P3 arrangements, the Department should formally analyse the risks, costs and benefits of P3 school financing and construction versus the traditional method.
- The selection of private sector partners for school construction should comply with government procurement policies.
- Accounting should comply with generally accepted accounting principles and the Province's stated accounting policies.
- Key terms and conditions including design, construction, financing and operating agreements should be documented in formal agreements prior to the start of construction.
- P3 arrangements should incorporate due regard for economy and efficiency.
- P3 arrangements should result in transfer of risk to the private sector.

8.26Our audit approach was based on discussions with management of the Departments of Education and Culture and Finance and examination of documentation provided. For our audit of the procurement process, we examined detailed documentation associated with the Sydney school only.

Principal Findings

Status of P3 School Construction Initiative

8.27There are eight P3 schools. Exhibit 8.1 summarizes the current status of those schools.

8.28As of the date of writing this Report (December 1997) the Province had not signed leases for any of the schools. Memorandums of Agreement for two schools (Porters Lake and Hants East Middle) were submitted to Executive Council in December 1997 and negotiations on final leases for all schools were proceeding.

Analysis to Support the P3 Decision

8.29 As mentioned previously, the decision to enter into P3 arrangements for schools represents a fundamental shift in the way in which schools are designed, constructed, financed, owned and operated in Nova Scotia. We expected that the government would have undertaken a thorough analysis of the advantages of P3 arrangements in comparison to the traditional approach prior to making this significant decision, and that there would have been appropriate documentation prepared to support the analysis. In our opinion, this type of analysis is necessary to:

- - ensure that the potential risks and rewards of the alternatives have been considered; and
- - act as a benchmark when evaluating the effectiveness of a new policy after it has been implemented.

8.30The government did not prepare a formal analysis prior to making the decision to enter into P3 arrangements for school construction. We recommend that government prepare a detailed analysis of risks and rewards prior to entering into any future public-private partnership arrangements.

Procurement Process

8.31The conventional model of school construction in the Province was Design-Bid-Build whereby the Department of Supply and Services would procure the services of an architectural firm to design the school. After a design was agreed upon, the Department would request proposals for construction.

8.32The John C. Wickwire school in South Queens, opened in September 1997, used a variation of the conventional approach which was termed Design-Build. This approach involved a single request for proposals for both design and construction services. The procurement approach used for that school was more similar to the P3 approach which included a single request for proposals for all phases of the project - design, construction, financing and operation.

8.33The procurement process for P3 schools was based on the Co-operative Business Solutions

(CBS) procurement methodology as described in Chapter 3 of this Report (page 25). As noted in Chapter 3, page 25, CBS is a procurement method whereby 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 the preferred supplier is selected.

8.34The procurement process generally consisted of the following:

- There was a public call for expressions of interest for each school (Phase I).
- Expressions of interest were evaluated by a committee with broad representation, and a short list was developed.
- Those on the short list were asked for detailed proposals (Phase II).
- The detailed proposals were evaluated by a committee with broad representation.
- A private-sector partner (preferred supplier) was selected.
- Costs and leases were to be negotiated in Phase III of the selection process.

8.35We examined the procurement process related to Sherwood Park Education Centre in Sydney to determine if it complied with the process described to us, and concluded that it was compliant in most respects.

8.36The process for the Sydney school was competitive. The call for expressions of interest took place in July 1994. The Call for Expression of Interest stated that "*Phase I evaluations will focus on experience, technical competence, managerial ability and proven performance, as well as a vision of the proponents solution.*"

8.37Seventeen proposals were received and evaluated by a committee with membership from the Departments of Supply and Services, Finance, and Education and Culture and the Cape Breton District School Board. The three proponents scoring highest in the evaluation were then requested to submit detailed proposals by October 1994 and those proposals were also evaluated by the committee on the basis of pre-determined criteria which had been previously circulated to the proponents.

8.38For Phase II of the Sydney selection process, proponents were required to submit cost estimates along with their proposed design for the Centre. Cost estimates were not required for subsequent P3 schools as preparation was deemed to be a costly exercise, and costs were subject to change if the design for the school was modified at a later stage. Submission of cost information is not usually part of the CBS process.

8.39The *Report of the Sydney Junior High School Private/Public Partnership Committee* was issued on December 19, 1994. It included the following conclusion:

"Each of the three proponents are technologically capable of carrying out the project and so, as can be expected, the scores are relatively close. The evaluation team noted that none of

the three finalist proponents met with their expectations absolutely. The team also noted that the costs, as projected in the proposals, are in all cases higher than carrying out the project in a conventional way. However, the team believes that negotiations with the private sector partner(s) will result in value for money and a lower overall cost." (page 4)

8.40The Report included the following three recommendations:

- "The Evaluation Team recommends that:
 1. *The province approve of the team commencing negotiations with [the proponents who scored first and second in the evaluation] in an attempt to reach a more favourable financial arrangement.*
 2. *The team identify the most favourable financial arrangement and make an appropriate recommendation to the province.*
 3. *If a favourable financial arrangement is negotiated by the team, work begin immediately to have the facility designed, built, financed and operated by a private sector partner." (page 4)*

8.41 Subsequent to the issue of that Report, the third ranking proponent was advised that they were not successful and a smaller committee was formed to begin detailed negotiation with the two remaining proponents. The smaller committee included the Deputy Ministers of Finance and Education and Culture and the Superintendent of the Cape Breton District School Board. The decision of the smaller committee was conveyed to Executive Council for information in a Memorandum to Cabinet from the Minister of Education and Culture. In April 1995, TR3LC were informed that they were the successful proponent in a letter signed by the Deputy Minister of Education and Culture.

8.42 Costs and leases were to be negotiated and finalized in Phase III of the CBS process. Those involved in the process hoped that arrangements could be finalized prior to the start of construction, or shortly thereafter, but negotiations took longer than anticipated and are still ongoing. Implementation of the recommendations in the Priorities and Planning Secretariat's recently released *Partnerships & School Construction: A Review* (see paragraph 8.63) will ensure that costs are finalized before construction starts for future schools. That Review includes the following recommendations:

"No construction contracts for any new projects should be executed until financing is in place and leases are signed. Leases are to be public documents...The two lead departments...should...prepare Requests for Proposals that include clear financial bottom lines including the total overall cost of each project..." (page 7)

Participatory Planning Process

8.43 One of the Department of Education and Culture's stated objectives for P3 schools is participatory planning as described in paragraph 8.5 above. We visited Sherwood Park Education Centre in Sydney and found it to be a unique, functional school which gives the school community

access to current technology. During that visit, we were told that the school represents the first time that teachers and members of the community were given formal input into the school planning process. This was achieved through consultations carried out by the successful proponent.

8.44We believe that participatory planning processes could be carried out as part of the traditional school construction process as well as under P3 arrangements. The government conducts planning based on consultation in other sectors and could have incorporated this approach in the traditional school construction process. The Department maintains that the private sector consortiums can carry out participatory planning more economically than government but the Department did not provide any analysis to support its position.

Efficiency of the Construction Process

8.45The Department of Education and Culture believes that P3 school construction is more efficient than the traditional approach. For example, the construction period for the Sydney junior high school was nine months (from April 1996 to opening in January 1997). We believe that the amount of time required to build a school varies with the quantity and nature of resources devoted to the task, and the manner in which the project is managed. Therefore, it should be possible to increase the efficiency of the traditional school construction process to meet construction targets. The private sector has been involved with school construction in the Province for many years as project contractors and should be able to meet construction targets set out by the Department whether the arrangement is structured under traditional lines or as a P3.

Requirement for Operating Leases

8.46The Departments of Education and Culture and Finance have been negotiating with the successful consortiums over a lengthy period but, to date, no leases have been signed. The Province and its private-sector partners have not been able to agree on lease terms which qualify for treatment as an operating lease under the CICA guidelines (see paragraph 8.21 above). If the school leases can be accounted for as operating leases, then the Province can leverage the resources available to build schools and acquire use of more new schools within the appropriation voted by the House of Assembly. If the school leases include terms and conditions that require accounting as a capital lease (see paragraph 8.20 above), then the Province loses the ability to leverage the appropriation to acquire the use of more schools. An annual amount of \$30 million for school costs can make lease payments on a number of schools if the leases are structured as operating leases, rather than cover the entire costs of just one or two new schools if the leases are structured as capital leases.

8.47Structuring the leases as operating leases results in the current government making commitments that will govern the level of spending for the Department of Education and Culture for school construction for a number of years. The term of the leases is likely to be in the range of 20 years. As more schools are constructed through P3's, the Province's commitment of annual payments becomes larger and the flexibility, therefore, to construct new schools (and take on additional financial commitments) in the future is reduced.

8.48Similarly, if all the operating leases expire at almost the same time, the Province may be left with a shortage of schools and forced to renew the leases at less than advantageous terms. Management

of the Department of Education and Culture has indicated that operating leases provide more flexibility because of the option to not renew the lease thereby shifting occupancy risk to the private sector. The impact of operating leases on the long-term provision of education to students in the Province is an important factor when making the decision on appropriate lease terms.

8.49We believe that introducing the requirement for these leases to be eligible for treatment as operating leases into the lease negotiations may impact the value-for-money inherent in the final lease agreement. The requirement for an operating lease precludes consideration of certain lease provisions which are inconsistent with classification as an operating lease. For example, the government would not consider a bargain purchase option to be an acceptable component of the final agreement because it would eliminate a lease from treatment as an operating lease.

8.50Management of the Departments of Education and Culture and Finance believe that introduction of the requirement for an operating lease to the negotiation process leads to consideration of a broader range of alternatives and, ultimately, better value for taxpayers. Until the leases and other agreements are finalized, we cannot evaluate value-for-money inherent in the arrangements or whether the proposed accounting treatment is appropriate.

Risk Transfer

8.51The government has stated that risk transfer to the private sector is an objective for P3 arrangements (see paragraph 8.6 above). The November 1997 Department of Finance Discussion Paper *Transferring Risk in Public/Private Partnerships* discusses a number of risks that could potentially be transferred to the private sector. For P3 schools, the Discussion Paper identifies the following risks:

- *Residual value risk* - the risk associated with ownership of a school building (including its residual value).
- *Occupancy risk* - the risk that the utilization rate of a facility will be more or less than expected during all, or part, of its life.
- *Operating (availability and performance) risks* - the risk associated with the operations of school buildings under P3.
- *Planning risk* - the risk that a proposed project may not meet the required standards or community needs throughout its life.
- *Design and construction risk* - the risk of cost overruns, construction delays, or design and construction flaws.
- *Regulatory and legislative risks* - the risk that a project's viability will be affected by changes in legislation.

8.52The Discussion Paper focuses on strategies for transferring appropriate risks to the private sector partner. As indicated in the Paper "*The essence of a truly beneficial public/private partnership is the transfer of risk from one partner who has difficulty dealing with the risk to another partner who is better equipped to deal with it.*" (page 1)

8.53The degree of success which the Province has achieved in transferring the risks associated with P3 schools to the private sector cannot be evaluated until the lease arrangements are finalized. This includes the formal lease agreements and agreements governing any other aspects of the P3 schools including school operations and technology refreshment over the lease term.

Interim Financing of Construction Costs

8.54The inability of the Province to finalize leases could have led to delays in starting construction because the consortiums could not obtain financing for construction costs without signed leases to be used as collateral. The Province lent funds to the consortiums to avoid construction delays. Fixed construction costs were agreed upon, in advance, between the Province and the partners and funds were advanced on the basis of the fixed costs.

8.55The advances were to be made on the basis of approved progress claims with external certification of the work performed. The process was similar to the one used in the past for schools constructed by the Department of Supply and Services. For Sydney, the firm which performed the certification of work performed was part of the consortium. This was recognized by the Department of Education and Culture as an aspect of project control that could be improved and it was corrected in subsequent schools by having the certifier employed by the Department.

8.56The advances were accounted for as accounts receivable from the consortiums. The Department's plan was that the leases would be signed in the near future which would allow the consortiums to obtain bank financing. When financing was obtained, the consortiums would repay the debt to the Province.

8.57As at March 31, 1997 there were no leases signed. The Province had an account receivable of \$14.8 million from the consortiums related to the Sydney and Porters Lake schools. Of the \$14.8 million, \$11.9 million related to Sydney and \$2.9 million related to Porters Lake. The Sydney receivable was 85% of the total expected construction cost of the school, and the Porters Lake receivable was 41% of the total expected construction cost of the school.

8.58The Province decided to expense the advances on the March 31, 1997 financial statements. The stated rationale was that the Province was uncertain of being able to negotiate acceptable lease agreements for these schools in the future and, accordingly, decided to recognize the uncertainty with respect to the accounts receivable. The expenditure was recorded as a capital expenditure of the Department of Education and Culture for the year ended March 31, 1997 and was approved by an additional appropriation in April 1997.

8.59We asked the Departments of Finance and Education and Culture for information relating to the specific legislative authority under which the advances to the consortiums were made. The advances were approved by management of the Departments of Education and Culture and Finance. Management of the Departments of Education and Culture and Finance provided us with a legal opinion indicating that the Departments had "*sufficient statutory authority for these expenditures.*" This conclusion was based on the opinion that the advances were made under the authority of the Department of Education and Culture's annual appropriation provided in the Appropriations Act, 1996. Note that this appropriation included authority for lease payments, not advances.

8.60The Education Act does not specifically give the Minister the authority to make advances for school construction. Section 141 states:

"The Minister may...

(f) after consultation with a school board, approve plans for school buildings;...

(l) do such other things as the Minister deems necessary to carry out effectively the Minister's duties under this Act."

8.61When schools were constructed by the Department of Supply and Services (DSS), the Minister of Education obtained an Order in Council which included approval of the specific construction project and authority for the Ministers of Education and DSS to "*execute such instruments as may be necessary*". Other Departments must seek OIC's to approve advances to individuals and corporations as required by legislation. Executive Council approved the Reports of the School Capital Construction Committee in which each of the P3 schools were listed as priorities but no Orders in Council were issued to approve specific construction and public-private partnership arrangements.

8.62The Education Act is not clear with respect to the authority of the Minister in relation to P3 schools other than the right to approve plans for school buildings. We recommend that the legislation be clarified to indicate the type of approval required (Minister or Executive Council) for P3 agreements and construction advances.

Review by Priorities and Planning Secretariat

8.63In October 1997, the Premier requested senior officials from the Priority and Planning Secretariat and other agencies of government to review the P3 school construction process to date. The purpose of the review was to "*provide analysis of the process to date, including discussion of any shortcomings, recommendations as to whether or not the process should proceed, and recommendations as to possible safeguards that might allow for a process of school capital construction involving the private sector to go forward.*" (*Partnerships & School Construction: A Review*, page 1)

8.64On December 11, 1997 the Priorities and Planning Secretariat released *Partnerships & School Construction: A Review* which makes 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. Leases are to be public documents.*
- - "*No financing or other partnering arrangements should be accepted without the prior approval of the Priorities and Planning Committee and Executive Council.*
- - "*Future projects for school construction should follow a clearly defined process. The two lead departments, Transportation and Public Works and Education should:*
 - *determine priority order for projects*
 - *obtain cabinet approval*

- *prepare Requests for Proposals that include clear financial bottom lines including the total overall cost of each project,*
- *report back to cabinet for approval on selection of private sector partners,*
- *submit all leases to cabinet for approval prior to proceeding*
- *ensure public tendering on the construction contract(s) for the project,*
- *oversee completion of specific projects, and*
- *administer all aspects of lease arrangements.*" (page 7)

8.65 Implementation of the recommendations of the Review will improve controls over certain aspects of the process but will not address all of our concerns. For example, the Review does not include a comprehensive analysis of the costs and benefits of leasing versus ownership of schools.

1996 Trust Fund

8.66 As one of its March 31, 1996 year-end adjusting accounting entries, the Department of Education and Culture created a Trust Fund in the amount of \$1.7 million for the Sydney school. The Fund was set up from the Department's 1995-96 capital appropriation which included an unexpended amount for the Sydney school. The trust was established in the name of the Cape Breton District School Board with the signing officers being two members of management of the Department of Education and Culture. During the 1996-97 year, \$1.3 million of the Fund was advanced to the private-sector partner for the Sydney school and is included in the amount which is planned to be recovered from the consortium when the lease is signed. The remaining \$.4 million is still in the Fund. Our concern is that \$1.7 million was charged against the Department's 1995-96 appropriation although it is to be used to fund expenditures of future years.

Benchmarking/cost Comparisons of P3 Projects with Similar Schools

8.67 The issue of the relative costs of P3 and traditional schools has been discussed in the House of Assembly and reported in the media. We believe that it is not possible to perform a conclusive comparison of the total costs and benefits of P3 schools until all related arrangements are finalized. These arrangements include the terms and conditions governing design, construction, ownership, financing and operation of the school buildings and related technology.

8.68 However, the Province engaged a firm of quantity surveyors (Hanscomb Consultants Inc.) to perform a comparative analysis of school construction costs for P3 schools with schools constructed using the traditional method. These comparisons are referred to as benchmarking and are based on the hard costs of building and equipping similar schools with certain adjustments to make figures comparable. The adjustments include:

- *Escalation adjustment* - to reflect the increase in the general level of construction prices from the date of tender to the date of preparation of the analysis.
- *Location adjustment* - to reflect the differences in labour and materials due to location. The purpose of this adjustment is to recognize that some locations are more costly because of higher construction labour rates and such factors as transportation costs for construction materials.

- *Site differential* - to reflect the differences in cost to make the land suitable for construction. This would reflect the difference in such costs as blasting and excavating.

8.69The benchmarking analysis also includes interim financing costs during the construction period for each alternative. The Hanscomb analysis was tabled in the House of Assembly on December 9, 1997.

8.70We did not verify the calculation of the adjustments made by Hanscomb. The location adjustment is subjective in that it is based on general cost differences applicable to certain locations rather than actual differences in costs incurred on specific school construction contracts. It is not susceptible to audit verification. We reviewed the site differential and escalation adjustments for reasonableness but did not audit these adjustments.

8.71Exhibits 8.2 and 8.3 include cost data for three P3 schools (Sydney, Porters Lake, and Horton) and six traditional schools. The traditional schools were chosen because they are representative of recently constructed schools.

8.72There are several points illustrated by Exhibit 8.3 including:

- Elementary schools generally require less space per student than schools with higher grades. This difference is due to the wider range of facilities required to deliver programs at higher levels.
- The cost estimates for P3 projects in progress are variable. For example, Horton was estimated to cost \$28.9 million in the construction agreement and the estimate was subsequently reduced to \$27.0 million. In December 1997, the estimated cost was reduced to \$25.5 million. Management of the Department of Education and Culture provided the following explanation for the most recent reduction in the estimate:
"The construction contract for Horton includes 'allowances' for mechanical and electrical, technology, and furniture and equipment. We are managing these allowances so that quality is maintained but the mechanical and electrical is \$1 million less, technology is \$.5 million less, and furniture and equipment is \$.5 million less."

We cannot provide an actual cost for the school until construction is complete.

- Costs of school construction vary with the size of the school. Therefore, cost per square foot is one appropriate basis of comparison. The P3 schools generally have a lower square foot construction cost, although Auburn Drive High School (built under the traditional approach) had the lowest cost per square foot of any of the schools other than Horton (based on the December 1997 estimate for Horton).
- Space per student is another factor which influences comparative costs. The recently constructed junior high and high schools include more space per student than older schools. For example, Horton High School includes about 20% more space per student (based on planned capacity) than Auburn Drive High School.

Space per student may be calculated on the basis of planned capacity or actual enrollments.

St. Andrew's Junior High is an example of a situation where the basis chosen for calculating enrollments is significant. That school was planned to have a capacity of 600 students from grades 6-9. The school board later decided to use it only for grades 7-9 with an actual enrollment of 539 for 1997-98. Exhibit 8.3 shows both planned and actual enrollments for each school.

8.73We cannot conclusively state that P3 schools are more or less costly than traditional schools due to the number of variables impacting the analysis. Any attempt to state that one school is more or less costly than another implies that there is a common basis for comparison when a single common basis does not exist. Exhibits 8.2 and 8.3 provide information sufficient to enable the reader to compare certain aspects of the costs of these schools but financing, operating and other costs to be incurred over the life of these schools are not included.

Concluding Remarks

8.74Staff in the Departments of Education and Culture, Finance, and Economic Development and Tourism are very enthusiastic about the benefits of P3 arrangements for school construction. They believe that the process has been a catalyst for the creation of excellent learning environments. We visited the Sydney junior high school and found it to be unique and functional.

8.75In order to make significant decisions like the one to enter into P3 arrangements, government needs a clear understanding of costs and benefits including comprehensive risk analysis. Such an analysis is necessary to achieve good accountability and make the decision process transparent. This was not done for P3 schools, but should be done prior to making the decision to proceed with P3 arrangements in any other government sectors. The Department of Finance's November 1997 Discussion Paper *Transferring Risk in Public-Private Partnerships* is a good first step in analysing such risks.

8.76Monitoring and evaluating these arrangements both during and after implementation is also important and we encourage the government to establish an appropriate process to monitor and evaluate P3 schools which is independent of those with responsibility for the P3 initiative.

8.77The Priorities and Planning Secretariat recently released *Partnerships & School Construction: A Review* which makes several recommendations to improve government control over P3 school construction initiatives. Implementation of the recommendations of the Review will improve controls over certain aspects of the process but will not address all of our concerns. For example, the Review does not include a comprehensive analysis of the costs and benefits of leasing versus ownership of schools. The impact of operating leases on the long-term provision of education to students in the Province and the Province's current and future financial position and operating results is significant. Operating leases will result in the ownership of the schools resting with the private sector at the end of the lease term and the costs and benefits of such leases merit thorough consideration.

8.78Total costs to the Province of school buildings, in the form of final leases for P3 projects, should be known prior to starting construction. Implementation of the recommendations of the Priorities and Planning Secretariat's Review should ensure that this will occur for future projects.

8.79The eventual outcome of the P3 school construction process in terms of achievement of due regard for economy and efficiency cannot yet be determined due to the absence of signed leases. Memorandums of Agreement for two schools (Porters Lake and Hants East Middle) were approved by Executive Council in December 1997 and negotiations on final leases are proceeding. Until the final lease agreements and agreements covering other aspects of the schools including operations and technology refreshment are available, we cannot reach any firm conclusions on the value-for-money implicit in P3 arrangements for school construction or whether the proposed accounting treatment is appropriate.

8.80We will be examining the leases and other agreements when signed and reporting the results of those audits in future Annual Reports.

Exhibit 8.1

STATUS OF P3 SCHOOLS

School	Private Sector Partner	Date of Selection of Private Sector Partner	Formal Agreements in Place	Occupancy Date (planned or actual)	Approved Construction Cost
Sherwood Park Education Centre (Sydney junior high)	TR3LC	April 1995	Pre-development Agreement - Note 5	Jan. 1997	\$14.4 million
O'Connell Drive Elementary (Porters Lake Elementary)	Nova Learning Futures Inc.	Nov. 1995	MOA - Note 1 Construction Agreement Assignment	Sept. 1997	\$7.4 million
Horton High School	Hardman Lindsay School Ventures Inc.	Jan. 1997	Construction Agreement Assignment	Sept. 1998	\$25.5 million (Dec./97 Estimate) \$27.0 million (pre-Dec./97 Estimate) \$28.9 million (per

					Construction Agreement)
Meadowfields Elementary (Yarmouth)	TR3LC Nova	Aug. 1997	Pre-development Agreement - Note 3	Sept. 1998	\$8.0 million - Note 4
Hants East Middle	TR3LC Nova	Feb. 1997	MOA - Note 1 Construction Agreement - Note 2	Sept. 1998	\$17.3 million (per draft Construction Agreement)
Hants East Elementary	TR3LC Nova	Aug. 1997	Pre-development Agreement - Note 3	Sept. 1998	\$7.0 million - Note 4
Amherst Regional High	_____	_____	_____	Sept. 1999	_____
Aspotogan Elementary	_____	_____	_____	Sept. 1999	_____

Note 1 - Memorandums of Agreement between the Province and the consortiums set out general parameters for leases but do not include specifics regarding financing, operating and technology renewal.

Note 2 - This Agreement was unsigned as of the date of writing this Report (December 1997). Construction on the school began in October 1997.

Note 3 - These Agreements are signed by the proponent but not by the Department.

Note 4 - These are preliminary cost estimates prepared by the Department.

Note 5 - Certain of the terms and conditions of this Agreement were not implemented.

Exhibit 8.2

CICA Sections



Exhibit 8.3

DEPARTMENT OF EDUCATION AND CULTURE'S RESPONSE

Department of

Education and Culture
Office of the Minister

P0 Box 578
Halifax, Nova Scotia
B3J 2S9

July 21, 1998

Mr. Roy Salmon
Auditor General
Suite 302
1888 Brunswick Street
Halifax, NS B3J 3J8

Dear Mr. Salmon:

Thank you for your report on the O'Connell Drive Elementary lease. From my perspective, the goal is clear--to build high quality schools as quickly as possible. At the same time, we welcome your advice on accounting issues, so we can continue to strengthen the process, and get on with the job of building urgently-needed schools in more communities.

To comment briefly on your findings, I agree whole-heartedly that the accounting classification of leases should not be the determining factor. In fact, the impact on educating our children and value for taxpayers are key. On these measures, this process delivers--no question.

As you note in your report, O'Connell Drive is an award-winning school. More important than the awards on the walls, however, are the children within them. We're building great schools on a foundation of advice from our teachers, parents, community members and students themselves. The results show everyday in the classroom, as I'm sure your visit to Sherwood Park Education Centre in Sydney confirmed.

With regard to accounting issues, again we share common ground. We are very pleased you have provided a third opinion (shared by the Department of Finance and our external auditors) that it is acceptable to classify O'Connell Drive as an operating lease. You also note the flexibility we have to walk away at the end of 20 years, if the school no longer meets our needs. Should we need the school, you confirm the cost of financing through partnerships is comparable. If we choose to purchase the school, the cost is \$300,000--a small price to pay for the flexibility to walk away and to get much-needed schools without delay.

Your findings are particularly encouraging, given that O'Connell Drive is our first lease, and as such, a starting point. As we continue to build schools, we continue to build improvements into the process that will not only result in more schools, but will strengthen the accounting issues. Even as part of this review, adjustments have been made because all partners want this process to work so we can build schools across the province.

Finally, we appreciate your opinion concerning risk-sharing with the private sector. Again, you

know from discussions with our staff, and from tender documents for upcoming school projects, that future agreements will address this issue. It should be noted, however, that in the past, all risk was assumed by the public sector. The O'Connell Drive lease begins the risk transfer process, and we are building on this in future agreements.

Let me thank you again for your review. You will continue to have the full co-operation of my staff, and all information is available to you at any time as we get on with the job of building urgently-needed schools.

Your very truly,

[original signed by Robert S. Harrison]

Robert S.Harrison

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Comments to: Webmaster at oaginfo@gov.ns.ca