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

BACKGROUND

5.1 The Minister of Finance announced in the April 1997 Budget Address to the House of Assembly that all future school construction projects in the Province would be built under public-private partnership (P3) arrangements. The P3 school-construction initiative in the Province is extensive: 8 schools were originally announced; 31 additional schools were announced in December 1997; and an additional 17 schools were subsequently announced.

5.2 We have issued three previous reports relating to certain aspects of the public-private partnership process for school construction.

- *1997 Report of the Auditor General (Chapter 8, page 78)* - This chapter reported results of a detailed audit of the P3 process.

- *July 23, 1998 Report on the O'Connell Drive Elementary School Lease* - This was an audit of the first P3 school lease signed by the Province. It was performed in response to a request from the Minister of Education and Culture, and the Special Report was tabled in the House of Assembly.

- *1998 Report of the Auditor General (Chapter 7, page 85)* - This chapter reported progress of the government's P3 school initiative as at December 1998. At that time, two school leases had been signed. Three development agreements for a total of 16 schools had also been signed and other agreements were awaiting signatures or being negotiated.

5.3 We strongly recommend that readers of this Report also read our prior reports to gain a fuller understanding of the issues associated with P3 schools in the Province, and to establish an appropriate context for the current Report.

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

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

- An *operating lease* is a lease in which the lessor (private sector) does not transfer substantially all the benefits and risks incident to ownership of property. Lease rentals under an operating lease should be included in the determination of net income over the lease term on a straight-line basis. *The Province under an operating lease is, in effect, committing to fund expenditures from its annual revenues for each of the next 20 years. In the Province's financial statements, classification as an* *operating lease results in payments being recorded as expenditures when incurred, and no liability for future lease payments is recorded.*

- A *capital lease* is a lease that, from the point of view of the lessee (Province), transfers substantially all the benefits and risks incident to ownership of property to the lessee. A capital lease would be accounted for by the lessee as an acquisition of an asset and an assumption of an obligation to reflect the substance of the transaction in the year in which the lease was signed. *In the Province's financial statements, classification as a capital lease results in 100% of the cost of a leased asset being recorded as an expenditure and a liability when the lease is signed. Over the 20-year period, the only impact on annual results will be interest expense related to the outstanding liability.*

RESULTS IN BRIEF

5.6 The following are the principal observations resulting from this review.

- There was significant progress under the P3 school construction initiative during 1999. Of the first 39 schools, 11 are completed and occupied, 27 are under construction and 1 is in the planning phase. There are signed leases/service agreements for 28 schools, and there are signed development agreements for 11 schools.

- During our audit of the government's financial statements for the year ended March 31, 1999 we raised issues with respect to the government's proposed accounting treatment for the leases signed during the year. The government had planned to account for these as operating leases. In all three cases, we believed that significant risks had been transferred to the Province and that accounting for these as capital leases would be more appropriate. The government agreed, and decided to account for all four signed leases (the three signed in 1998-99 and O'Connell Drive Elementary School) as capital leases. We concur with the government's decision.

- We have audited only four of the signed leases/service agreements to date. We have audited only accounting classification; we have not attempted to determine whether the government made these expenditures with due regard for economy and efficiency. We will audit the accounting classification of the remaining ones as part of our audit of the government's financial statements for the years in which the agreements are signed.

- The government has issued a call for proposals for a review of the P3 process. The report is expected in December 1999.

- The Canadian Institute of Chartered Accountants' Public Sector Accounting Board (PSAB) has issued recommendations for accounting for tangible capital assets. These recommendations are not the same as those for the private sector, nor are they the same as the government's current accounting policy for tangible capital assets. The Province intends to comply with PSAB's recommendations for tangible capital assets for the 1999-2000 financial statements, but the entire cost of assets acquired under capital leases will still need to be reflected in the Province's net direct debt.

SCOPE OF REVIEW

5.7 The objective of this follow-up review was to determine and report the status of certain aspects of the Department of Education's school construction initiative.

5.8 Our approach was based on correspondence with management of the Department of Education and examination of documentation provided.

PRINCIPAL FINDINGS

Follow-up to Findings and Observations in 1998 Report

5.9 Exhibit 5.1 (page 69) shows some of the more significant findings from our 1998 Report along with an indication of related developments during the last year. As shown in the exhibit, the government has made significant progress in negotiating formal agreements with the developers, and the developers have made significant progress in constructing the schools.

5.10 The following is a summary of the progress made in constructing the first 39 schools:

- 11 schools are completed and occupied
- 27 schools are currently under construction
- 1 school is in the planning stage

5.11 The following is a summary of the progress made in achieving final legal agreements for the first 39 schools:

- There are signed leases/service agreements for 28 schools.
- There are signed development agreements for 11 schools.

5.12 Government announced that it will build 17 additional schools over the period from 2000-01 to 2004-05.

Results of audit activity

5.13 The Office of the Auditor General has audited the first four leases signed. The results of the audit of the O'Connell Drive Elementary School lease, the first P3 school lease signed, were included in a Special Report which was tabled in the House of Assembly and publicly released in July 1998.

5.14 The next three leases were signed during the 1998-99 fiscal year as follows:

- Hants East Middle School - signed September 1998
- Horton High School - signed March 1999
- Sherwood Park Junior High School - signed March 1999

5.15 We audited the accounting classification of those three leases as part of our audit of the government's financial statements for the year ended March 31, 1999. We have not audited any of the other leases/service agreements, but we will audit the accounting classification of the remaining ones as part of our audit of the government's financial statements for the years in which the agreements are signed.

5.16 We have audited only accounting classification; we have not attempted to determine whether the government made these expenditures with due regard for economy and efficiency.

5.17 During our audit of the government's financial statements for the year ended March 31, 1999 we raised issues with respect to the government's proposed accounting treatment for the leases signed during the year. The government had planned to account for these as operating leases. In all three cases, we believed that significant risks had been transferred to the Province and that accounting for these as capital leases would be more appropriate. The government agreed, and decided to account for all four signed leases (the three signed in 1998-99 and O'Connell Drive Elementary School) as capital leases. We concur with the government's decision.

Impact of Government's Planned Change in Accounting Policy for Tangible Capital Assets

5.18 As noted in Chapter 2, page 12 of this Report, the government plans to change its accounting policy for tangible capital assets for the 1999-2000 fiscal year to comply with the recommendations of the Canadian Institute of Chartered Accountants' Public Sector Accounting Board (PSAB). PSAB's recommendations permit some flexibility in how tangible capital assets are disclosed. Therefore, we are not certain as to how government's choice of accounting policy will impact the financial statements.

5.19 However, it appears that a move to compliance with PSAB's recommendations will impact the accounting for leases as follows:

- *Operating leases* - The accounting impact of operating leases will remain unchanged. 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.

- *Capital leases* - The accounting impact of capital leases will change to some extent. On the annual operating statement, 100% of the cost of the leased asset will likely no longer be charged as an expenditure in the calculation of the annual surplus/deficit. The entire cost of the leased asset will be recorded as an asset and a liability. The asset will be amortized over time as the related benefit is consumed. The impact on the annual operating statement will likely be comprised of interest incurred on the liability, the annual asset amortization charge, and operating costs.

  However, PSAB requires that net debt reflect both capital and operating debt. Therefore, it appears that the entire cost of leased assets acquired would have to be included in the calculation of net debt. PSAB's current recommendations (which we understand may be subject to further review) require that the adjustment to show the leased asset in net debt be disclosed on the operating statement as an adjustment in the calculation of the annual surplus/deficit.

5.20 The accounting for tangible capital assets and capital leases in the public sector is in a state of change. The foregoing is meant to describe our understanding of how these changes will impact the financial statements of the Province. The final decision with respect to choice of accounting policies rests with the government, and the impact may be different than what we have described.

5.21 The reader should note that PSAB's recommendations in this area are not the same as those for the private sector, nor are they the same as the government's current accounting policy for tangible capital assets. It appears that the entire cost of assets acquired under capital leases will still need to be reflected in the Province's net direct debt.

Public-private Partnership Review

5.22 In our 1997 and 1998 Reports, we urged government to establish an appropriate process to monitor and evaluate P3 schools which would be independent of those responsible for the P3 initiative. In October 1999, government announced that it would be seeking proposals from private sector consultants for a review of "*costs and benefits of the P3 process for all public infrastructure...The province's experience over the past several years will be evaluated. Issues such as affordability and value for money will also be assessed.*" (Department of Finance News Release dated October 8, 1999) The report is expected to be released in December 1999.

CONCLUDING REMARKS

5.23 The government made significant progress under its P3 school construction initiative during 1999. We believe that evaluation of the P3 process now is timely because there are tangible results to examine - both occupied schools, and final agreements between the Province and developers. It is very important to determine whether this initiative is meeting government's objectives. We commend the government for initiating the review which is to include evaluation of value-for-money considerations. We look forward to the report which is scheduled to be released in December 1999.

Exhibit 5.1

FOLLOW-UP TO COMMENTS IN CHAPTER 7 OF 1998 REPORT OF THE AUDITOR GENERAL

Comments in 1998 Report of the Auditor General	Status as at November 1999
Original eight schools	
• Final leases signed for two schools: - O'Connell Drive Elementary - Hants East Middle (Riverside Education Centre)	• Final leases signed for six schools: - O'Connell Drive Elementary - Hants East Middle (Riverside Education Centre) - Horton High School - Sherwood Park Junior High - Meadowfields Community School - Hants East Elementary (Maple Ridge Elementary) • Remaining two schools are included in signed Service Agreements.
Hants East Elementary and Meadowfields Community Schools	
• Construction had started on these two schools. Development Agreements were approved by Order in Council in 1998.	• Both schools are now open.
• Leases were to be signed when construction was complete in late summer of 1999.	• Leases for both schools were signed in late summer 1999.
• The Development Agreements stated that lease rates were to be based on the market rate for a certain issue of Government of Canada bonds on a certain date in 1999, plus 91 basis points.	• Lease rates were calculated as described in the Development Agreements. The lease rate was 6.85% for one school and 7.01% for the other.
Three bundles totalling 31 schools	
• A Development Agreement for 13 schools for Chignecto-Central Regional School Board, Conseil scolaire acadien provincial and the Halifax Regional School Board was signed in November 1998.	• November 1998 Development Agreement was subsequently amended. • Five schools are now occupied. Construction of all remaining schools is in progress. • Service agreements have been signed for seven schools (five completed ones, plus two in progress). • Service agreements are based on a Provincial borrowing rate of 6.20% as at May 1999.

Comments in 1998 Report of the Auditor General	Status as at November 1999
• A Development Agreement for 13 schools for the Cape Breton-Victoria Regional School Board and the Strait Regional School Board had been approved by Executive Council in December 1998 but not yet signed.	• Development Agreement was signed December 2, 1998 and amended June 8, 1999. • Service Agreements were executed June 8, 1999. • All schools are in progress.
• Management of the Department of Education anticipated that a Development Agreement for the remaining five schools would be signed by the end of December 1998.	• Development Agreement was signed in February 1999. • Four of the five schools are in progress. Remaining school is in the planning phase.
Construction advances	
• As of November 1998, the construction advance account balance was $41.9 million and the related provision for doubtful accounts was $14.4 million. These amounts related to construction advances on Sherwood Park Junior High School and Horton High School.	• The balance in the construction advance account was collected in March 1999 when the Sherwood Park Junior High School and Horton High School legal agreements were completed. Under these agreements, the Province sold the schools and then leased them back from the purchaser. • The provision for doubtful accounts related to P3 schools was reduced to a nil balance. • The $13.8 million proceeds from sale of Sherwood Park Junior High were recorded in the Department of Finance's accounts as unallocated recoveries because the amount had previously been included in the provision for doubtful accounts and, therefore, included in the prior years' expenses of the Department of Education.