AASB Staff Issues Paper

Service Concession Arrangements (Grantor) Project – Current practice in relation to service concession arrangements (NSW, Victoria and GFS)

Purpose

1 The purpose of this paper is to provide some context on the current practice of service concession arrangements accounting in Australia. To this end, it reviews the current practice by Australian governments on service concession arrangements: first detailing the accounting treatment by the two major players (Victoria and New South Wales), and then providing a broader context by discussing the current government policy of service concession arrangements and related items in Government Financial Statements (GFS).

2 The remainder of this paper is structured as follows:

(a) Background (paragraphs 3-4);

(b) New South Wales and Victoria State Governments (paragraphs 5-9); and

(c) Government Financial Statements (paragraphs 10-15).

Background

3 In a privately funded government project (a service concession arrangement), a public sector entity (grantor) arranges for the private sector (operator) to design, finance, and build infrastructure and provide associated operational or management services for an agreed period (the concession period).

4 As noted in Agenda Paper 7.4, these service concession arrangements take one of two main forms. In order to gain some perspective on how the conceptual considerations relate to a practical reality, this paper details the current practice of Australian government to this – with a particular focus on those two jurisdictions in which the majority of service concession arrangements take place, New South Wales and Victoria.

New South Wales and Victoria State Governments

5 Paragraphs 6-10 discuss the different types of service concession agreements and the current accounting practice adopted by the New South Wales and Victorian treasury departments.

Social service concession arrangements

6 In the more simplistic form, the State pays the operator over the period of the arrangements, subject to specified performance criteria being met. At the date of commitment to the principal provisions of the arrangement, these estimated periodic payments are allocated between a component related to the design and construction of upgrading of the asset and components related to the ongoing operation and maintenance of the asset. These are known as 'social service concession arrangements'.

New South Wales	Victoria
Generally this is considered to be infrastructure purchased under a deferred payment arrangement (or effectively acquired under a finance lease) and is grantor controlled from the beginning of the service period, though in some instances could be recognised earlier if the State is believed to have control during the construction phase. Such infrastructure is recognised as property, plant and equipment and depreciated over its useful life. The corresponding payment is recognised as a liability.	During the period when the project is under construction (i.e. pre-commissioned), the State will only disclose the present value of future service payments as commitments in the notes to the financial statements, with no asset or liability being recognised. Once the project has been commissioned, the service concession assets will be recognised on the balance sheet. In addition, the capital component associated with these agreements will be accounted for as finance lease liabilities in accordance with the State's lease accounting policy, and the remaining operating components are accounted for as commitments for operating costs which are expensed in the comprehensive operating statement as they are incurred.

Economic service concession arrangements

7 The other, less common form of service concession arrangements, is one in which the State grants to the operator, for a specified period of time, the right to collect fees from users of the service concession asset, in return for which the operator constructs the asset and has the obligation to supply agreed upon services, including the maintenance of the asset for the period of concession. These private sector entities typically lease land, and sometimes State works, from the State and construct infrastructure. At the end of the concession period, the land and State works, together with constructed facilities will be returned to the State. These are referred to as 'economic service concession arrangements'.

New South Wales	Victoria
The primary factor in assessment for New South Wales is not which party is the legal owner, but which party has the risks and rewards of ownership. In most instances, the State does not recognise the asset until the end of the concession period, though in doing so applies the concept of an emerging asset so that the service concession asset is progressively recognised during the period, with a corresponding amount of revenue recognised.	No asset or corresponding revenue (or unearned revenue) is recognised. While we are yet to see the end of a concession period, it is proposed that the asset will be recognised by the State at the end of the concession period with a corresponding amount of revenue recognised.

8 Fundamental to the accounting by both State governments is that the State does not believe that they 'control' the asset in these economic service concession arrangements until the point in time in which it is transferred (that is, the end of the concession period) – i.e. control is assessed based on which party has the majority of the associated risks and benefits.

9 A third, relatively rare option available to the government is an instance in which the operator constructs the service concession asset and operates it for its entire useful life. These items are not within the scope of this paper.

Government Financial Statements

10 Chapter 17 of the System of National Accounts provides guidance around the accounting for contracts, leases and licenses in the Government Financial Statements (GFS) reporting framework.

11 In section 5 of Chapter 17, the guidance talks about 'licenses and permits to use a natural resource' advising that there are three different ways this could be licensed:

(a) The owner may permit the resource to be used to extinction;

(b) The owner may allow the resource to be used for an extended period of time in such a way that in effect the user controls the use of the resource during this time with little, if any, intervention from the legal owner; or

(c) The owner can extend or withhold permission to the continued use of the asset from one year to the next.

12 It goes on to advise that the first option would be considered a 'sale', while the second would lead to the creation of an asset for the user and the third would treat the use of the resource as a lease. It goes on to explain the differentiation between options 1 and 3 via the example of a mobile phone.

13 In considering whether an item is a sale or rent of a resource, the following criteria are provided which might indicate that it is a sale of license[1]:

- *Costs and benefits assumed by licensee: the more of the risks and benefits associated with the right to use an asset are incurred by the licensee, the more likely the classification of a transaction as the sale of an asset as opposed to rent. Thus, pre-agreement on the value of payments (whether by lump sum or by instalments) effectively transfers all economic risks and benefits to the licensee and so point to the sale of an asset… An additional indication of the degree to which commercial risks have been passed to the licensee is to examine the hypothetical case where a licensee goes bankrupt. If, in such a case, the licensor reimburses none of the upfront payment made by the licensee, this would constitute a strong case against a characterization of the transaction as rent, as apparently the licensee has incurred all the commercial risks involved.*

- *Upfront payment or instalment: as with other indicators, the mode of payment is in itself not conclusive for a characterization as asset or rent payment. Generally, the means of paying for a licence is a financial issue and as such not a relevant factor in determining whether or not it is an asset. However, business practice shows that upfront payments of rent for long periods (15-25 years in the case of mobile phone licences) are highly unusual and this favours an interpretation as sale of an asset.*

- *Length of the licence: licences granted for long periods suggest a treatment as the sale of an asset, for shorter periods a treatment as payments for rent.*

- *Actual or de facto transferability: the possibility to sell the licence is a strong indication of ownership and if transferability exists, this is considered a strong condition to characterize the licensing act as the sale of third-party property rights.*

- *Cancellation possibility: the stronger the restrictions on the issuer's capacity to cancel the licence at its discretion, the stronger the case for treatment as a sale of an asset. Conversely, when licences can easily be cancelled at the discretion of the issuer, ownership over benefits and risks has not been fully transferred to the licensee and the transaction qualifies more readily as rent.*

- *Conception in the business world and international accounting standards: businesses, in accordance with international accounting standards, often treat a licence to use the spectrum as an asset. Again, in itself this does not lead to treatment as an asset in the national accounts, and there are other areas where companies choose to present figures in their accounts in ways that are not consistent with the national accounts. But the treatment of the acquisition of mobile phone licences as capital investment in company accounts provides an added incentive to treat them in a similar way in the national accounts.*

[1] System of National Accounts (2008), Chapter 17, section 17.318

14 As with most lists of this ilk, it is not necessary for all these aspects to hold in a certain way for the license to be considered a sale, nor even a simple majority. Similarly, some indications that are not conclusive, but could indicate a license rental are[2]:

- *The contract is of short-term duration, or renegotiable at short-term intervals. Such contracts do not provide the lessee with a benefit when market prices for the leased asset go up in the way that a fixed, long-term contract would. Such benefits are holding gains that typically accrue to owners of assets.*

- *The contract is non-transferable. Non-transferability is a strong but not a sufficient criterion for the treatment of licence payments as rent, because, although it precludes the lessee from cashing in on holding gains, it does not preclude the lessee from reaping comparable economic benefits (for example, using the licence in their business).*

- *The contract contains detailed stipulations on how the lessee should make use of the asset. Such stipulations are often seen in cases of rent of land, in which the owner wishes to retain a control over the usage of the land. In the case of licences, examples of such stipulations would be that the contract states what regions or types of customers should be served, or that it sets limits on the prices that the lessee may charge.*

- *The contract includes conditions that give the lessor the unilateral right to terminate the lease without compensation, for instance for underuse of the underlying asset by the lessee.*

- *The contract requires payments over the duration of the contract, rather than a large upfront payment. Although this condition is essentially financial in character and thus cannot be decisive on the type of the lease, it may indicate a degree of control for the lessor to direct the use of the spectrum. The case for a treatment as rent is further supported if the payments are related to the revenue the lessee derives from the licence.*

15 The section then goes on to talk about how this might be applied to a number of other types of resources from radio spectra to fish, but the key concept is that for the purposes of the GFS, whether an item is considered to be a sale (i.e. recognising revenue upfront) or a rental (in which revenue is recognised over a period) is dependent on the split of risks and rewards between the government and the party who is undertaking the license, which is effectively an adoption of the lease accounting model.

[2] System of National Accounts (2008), Chapter 17, section 17.319