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Agenda

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New partnership: public and private financing for asset investment

How can an operational and efficient public sector be maintained in the face of significant spending cuts? George Lynn, Chair of the Asset Finance Division, Finance & Leasing Association, and CFO of Angel Trains Group Ltd, explains how the leasing of assets and effective asset management can be one solution in terms of efficiency savings and risk-sharing

As we find ourselves in mid-2010, there are encouraging signs that Britain is beginning to claw its way out of the deepest recession for almost 70 years. The jury is out on the social and economic longer-term consequences of the Labour government's response of increasing public expenditure and money supply through quantitative easing. However, there is general agreement that there are going to be several tough years ahead.

The previous administration's fiscal stimulus package covering 2008–10 anticipated large-scale public sector borrowing and a significant level of public sector expenditure. The new coalition Conservative–Liberal Democrat government has announced its intention to introduce fiscal tightening, and the scale of spending cuts will be very significant through to 2018. The real detail will emerge in the autumn 2010 Spending Review, but the June Emergency Budget has signalled that these will be tough. The Institute of Fiscal Studies has recently estimated that of the reductions of 6–6.5% GDP expected in the years 2014–16, some 74–77% will be represented by spending cuts.[1]

The government needs to consider these cuts strategically in order to maintain an operational and efficient public sector. Leasing products can provide the foundation for efficiency savings and risk-sharing initiatives to fill this gap. By outsourcing services to external contractors, the public sector will lose knowledge about efficient and effective asset management. The debate should be more about what services should be provided by the state, rather than simply seeking financing routes that avoid public sector debt definitions.

Recent Budget reports under the previous administration identified the key background elements:

- the previous government engaged in a short-term fiscal stimulus package, which by 2009–10 amounted to support of 5% of GDP;
- 2010–11 anticipated the start of a longer-term fiscal tightening of 3.2% GDP, continuing at this level of annual tightening to 2017–18;
- 2009–10: net public sector investment of £49 billion (4.9% of GDP) was expected to be reduced to £26 billion by 2012, and to continue at that level.

As we look now:

- public sector borrowing in 2009–10 increased by £170.8 billion (11% of GDP);
- the June 2010 Budget starts from an overall borrowing of 53.5% GDP, and anticipates that the incremental public sector financial cuts will still lead to a peak level of borrowing of 70.3% GDP by 2014.

The precise details of the planned tightening were unclear prior to the general election in May 2010, and the extent to which new targets have been set has merely intensified the strain on the public sector finances. However, there is no shortage of opinion and lobbying as to what needs to be done, and where we need to get to.

In the coalition's post-election drive to implement public sector savings, there is inevitably more emphasis on immediate and demonstrative results, rather than medium-to-longer-term planned savings. The ageing population of the Western world already places a dramatic burden on future generations, and so we should take care not to increase the intergenerational funding burden through poor planning and implementation of public sector spending cuts.

But how to reduce public spending levels without dramatically upsetting the social and economic framework of the country? In a report published in December 2009, CIPFA (the Chartered Institute of Public Finance and Accountancy) and Solace identified three strategic options to consider as a basis for public sector cost reductions (none of which is mutually exclusive).[2]

1. Redefining the relationship between the state and the individual—ie, how much of current government expenditure can be directly transferred to the individuals who benefit from the services.

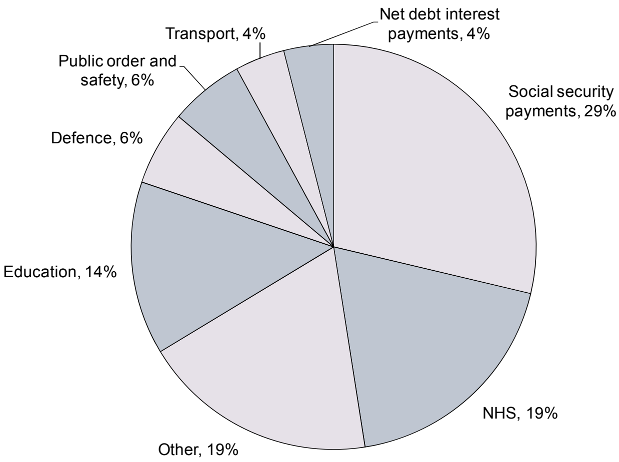
2. A significant de-layering of the public sector, with many more decisions taken locally with minimal oversight, on the twin assumptions that (a) centralised bureaucracy has no added value, and (b) local decisions will be better and more cost-effective.

3. A major initiative to maximise economies by much more effective collaboration between public bodies—for example, attempting to remove duplication of costs created by 'silo' departmental initiatives.

To this list could be added generating cost efficiencies and savings by using modern equipment and private service facilities.

As we move into the next phase in the life of modern Britain, it will be necessary to identify those areas of public spending that have most to offer in terms of cost-effective spending reductions. Spending on equipment will still be required, but will need to be matched by operational efficiencies. Spending on the NHS and education is expected to be 'protected', but be cost-effective so as to maximise the value of money created.

Figure 1 Public spending, 2008–09



Source: Data from Public Expenditure Statistical Analysis tables; HM Treasury.

The current allocation of government spending is set out in Figure 1; NHS and education spending account for 33% of the annual spend.

As a simple maxim, a focus on minimising annual operational cash flows will lead to capital and asset investment being an easy target. It is usually incremental investment, and does not have an immediate impact on operational staff costs and effectiveness. However, investment in equipment is needed for efficiency and operational benefits, and to avoid losing momentum in the technological changes.

We know that investment in new technology is vital for Britain to be able to achieve substantial energy consumption savings and thereby contribute significantly to the drive to reduce carbon emissions. It could be argued that the long-term threat to the environment is more pressing than the relatively short-term impact on fiscal policy.

The future does not have to be so problematic. Equipment can be supplied to the public sector, and completely converted into periodic cash flows by leasing transactions, and paid for over the whole, or part, of the economic useful life of the asset.

Prior to changes in tax legislation, UK leasing had become a tax-enhanced form of finance, which HM Treasury viewed, probably correctly, as merely another form of public debt. In the current circumstances, new public debt will not be a sustainable solution, without meeting Treasury 'Greenbook' criteria by incorporating risk transfer to the private sector.

Leasing can be differentiated from simply public debt by a number of core operational advantages for providing equipment:

- 100% finance for assets;
- rental flows can be spread over the useful life of the asset;
- rentals can be varied to match internally generated cash-flow benefits;
- risk in the second-hand value of the equipment can be retained by the lessor, or taken on by the lessee;
- operational risk transfers can be effected in a more transparent manner.

The supply of equipment by leasing with either risk-sharing of the asset value, usage, or service cost benefits that could be derived is much more than the mere provision of finance for assets. Going forward, the public sector needs to be able to measure, monitor and control the operational costs and efficiencies created by the investment in assets.

There is a legitimate question as to whether the private sector is set up to provide the most cost-effective and efficient use of assets used in the public sector. The management of assets in an efficient manner should be seen as a feature of the relationship between the public and private sectors. As risk-transfer mechanisms push more public sector asset provision into service companies, the ability of the public sector to properly manage the use and effectiveness of assets becomes diluted.

There is already a considerable body of work on the historical shifts between state and private sector ownership and the use of assets. From the late 1940s to the 1980s, the UK saw a tremendous transfer of asset ownership and control from private to public sector, and then latterly the reversal of this process. In his book on public sector auditing, Sir John Bourn notes the relationship between the transference of assets under public–private partnership/private finance initiative (PFI)/privatisation mechanisms and the degree to which the state wishes to retain actual control of the assets and services.[3] Ceding monopolistic services to the private sector needs public oversight by independent regulatory bodies (eg, the water industry regulator, Ofwat, the Office of Rail Regulation, and the telecoms and broadcasting regulator, Ofcom).

The dilution of effective asset management in the drive to obtain value for money and measurable 'risk transfer' is illustrated in the following three options, each involving leasing of some form. There is a presumption that more effective (or at least more easily identified) savings and efficiencies can be achieved by contracting with, or outsourcing to, the private sector. In each case the public sector body achieves cost-effective funding, but with diminishing levels of cost transparency.

Figure 2 and Table 1 set out the direct and intermediary relationships between the leasing company and the public sector body in respect of:

- a finance lease arrangement;
- an operating lease arrangement;
- a provision of assets, by way of a service company.

At the simplest level of analysis, the comparison of the provision of assets through a service company against a leasing business will demonstrate that the public sector body can transfer long-term asset risks to the private sector, without increasing the government's long-term debt obligations.

In this analysis of public sector investment, there is a real difference in approach between the procurement of assets as opposed to pure facilities. Newer assets are assumed to provide the potential for operational efficiencies but, as noted above, the realisation of such cost savings requires active asset management.

There are aspects to this outsourcing approach that can be overlooked.

- Projections of asset efficiencies by private sector service companies may not actually be achieved, and a lack of alternative options may result in costs remaining with the public sector.

Figure 2 Relationship between leasing company and public sector body

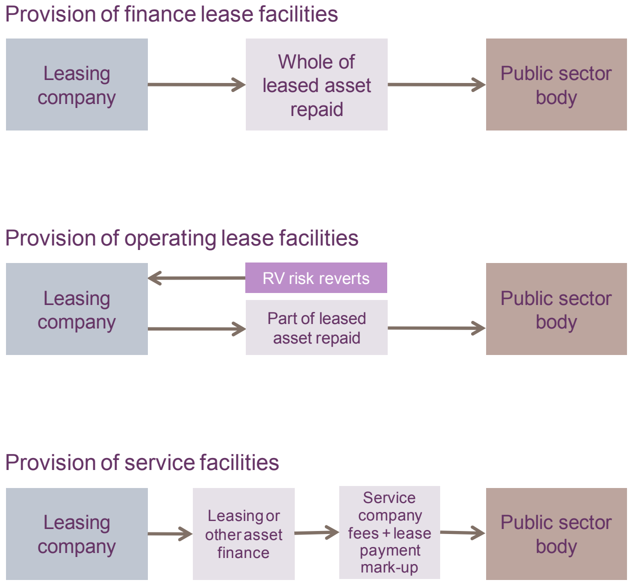


Table 1 Relationship between asset value risk and the public sector

Asset value risk	Public sector position
Majority of risk in future capital value of asset paid for in rents (finance leases)	Public sector body wholly responsible for achieving, and demonstrating, cost efficiencies from use of asset
Majority of risk in future capital value of asset retained by leasing company, and reflected in lower and more usage-related rents (operating leases)	Public sector body avoids risks/rewards from future asset values (from usage and obsolescence), but is responsible for achieving, and demonstrating, cost efficiencies from use of asset
A service company will bid and be offered public service work through a competitive tender. Asset risk continues to be paid for by the public sector to varying degrees of transparency. The measure of cost-effectiveness and efficiency will be measured in service fees	Public sector body is still able to obtain services using the same assets, but transfers asset ownership management and risks to service company. However, loses benefit of evaluating longer-term efficiencies and possibly locks into extended service contracts

- Once a decision is made to outsource rather than develop effective and efficient asset management facilities internally, inevitably the state will have de facto entered into a medium/long-term arrangement, requiring equivalent-term financing.

- The costs of financing for the service company will always be greater than the direct provision of debt to the public sector. These can be retrospectively recovered in the case of the refinancing benefits and tax effects arising from specific PFI transactions, but in the general cases will be lost.

- If it is concluded that a certain service ought to be provided by the state, it is vital that the expertise in ensuring efficient asset use is retained in the public sector.

- Defining the state/individual relationship is limited to the provision of those assets and services that are most easily structured into an outsourcing arrangement, and not necessarily to what the state ought to provide.

In some areas of the public sector, these operating lease benefits have been well established as a form of financing. As of September 1st 2009, NHS Supply Chain, a ten-year procurement and delivery contract run by DHL, took over responsibility for NHS leasing, effectively making a one-stop shop in procurement, financing and maintenance for the NHS. The additional benefit arising from this service is a more streamlined approach to operating lease recognition, and compliance with EU procurement regulation. Clearly, by standardising the operating lease framework, the hope is that rental rates will fall through centralised practices. The gains in centralising procurement, exploiting the full weight of buying power, and pre-selecting lessors and leasing agreements should provide cost savings. The potential downside is that price-level movements will tend to be more 'sticky', and potential gains in greater asset and residual value management will be more difficult to monitor.

The purpose of this article is not to argue for a return to wider state ownership of assets, but rather greater clarity, control and understanding by the state in the assets it uses. It is currently more likely that the provision of an asset through a service company will be judged to meet the government's financial criteria than the equivalent provision of a leased asset (with or without risk transfer). Under a service arrangement, the value-for-money knowledge becomes less transparent than the direct use of the assets.

These arguments may well be self-evident to those of us working in the asset finance and asset management worlds. However, there are a number of barriers to public sector managers being able to capitalise on these benefits more effectively.

- There remains a prevalent culture of ownership rather than active asset use through renting in the UK. Most future trend strategists point to renting as the form of resource use of the future (in terms of assets and people).[4]

- Accounting for leases is changing in a confusing way; the traditional differentiation on a whole-asset basis between financing or operating leasing is shifting to a proposed identification of assets as 'a right of use', and moving towards maximising the recognition in the balance sheet of the lessee.

- Lease recognition for tax, accounting and public sector accounting follows three completely different calculations, which clearly gives the impression that the arrangements are confusing and will involve more complicated analysis, and no doubt drives many potential lessees into 'simple' ownership arrangements.

- Taking assets in a simple owned framework allows users to ignore the recognition of many of the associated costs and downsides with ownership: maintenance, obsolescence and upgrades, consumable costs, and resale and recycling values.

The conclusion of this article is that public sector spending cuts are inevitable. The identification and realisation of such cuts will potentially take the form of either general, unfocused, percentage-based top-down cuts, or a more focused bottom-up delivery of cuts, using more efficient asset management to supplement operating costs. I believe that the public sector should be allowed to be more entrepreneurial in seeking effective and efficient asset management in the sectors that are rightly under public control. Using transparent leasing arrangements, which utilises government credit, it is quite likely that the actual combined cash flow expended by the state will be less than under an equivalent service contract. The long-term value of the asset management skills are then retained by the body most able to benefit from them.

George Lynn

[1] See Tetlow, G., 'Public Finances: More Done, More Quickly', Institute for Fiscal Studies, http://www.ifs.org.uk/budgets/budgetjune2010/tetlow.pdf; and Crawford, R., 'Public Finances: Serious Cuts to Come', Institute for Fiscal Studies, http://www.ifs.org.uk/budgets/budgetjune2010/crawford.pdf.
[2] CIPFA and Solace (2009), 'After the Downturn: Managing a Significant and Sustained Adjustment in Public Sector Funding', December.
[3] Bourn, J. (2007), *Public Sector Auditing: Is it Value for Money?*, Chichester: John Wiley & Sons Ltd.
[4] See, for example *Wired Magazine*, January 2010 issue.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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