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**Including Finance Lease Liabilities in
Public Sector Net Debt:
*PFI & Other***

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1 Summary

- 1.1 On 20 September 2006, the Public Sector Finances First Release¹ included for the first time estimates of imputed finance lease liabilities. The majority of these are associated with those Private Finance Initiative (PFI) projects judged as being on the public sector balance sheet (not all contracts under PFI projects involve finance leases). The new estimates are the result of a long period of work dating back to 2001 and have been calculated consistent with international guidance, based on the financial statements produced by the public sector, which are subject to audit.
- 1.2 The estimate of the total public sector imputed finance lease liability at the end of March 2005 (the last financial year for which most data are available) is £4.92 billion. This revises public sector net debt (PSND) up from £419.6 billion to £424.5 billion for that period, an increase equivalent to 0.4 per cent of GDP. The estimate of imputed finance lease liability at the end of March 2006 is £4.95 billion.
- 1.3 This article starts by explaining what a finance lease is, and the standards for recording liabilities under finance leases. Since those PFI projects that are judged as being on the public sector balance sheet make up the majority (by capital value) of public sector liabilities incurred under finance leases, and because PFI is often an area of interest, the article includes a section (4) on how PFI projects are treated in the National Accounts and Public Sector Finances. This is followed by sections (5-7) addressing the main measurement issues facing the compilers of national accounts and public sector finances, which are:
- i. whether an asset which is legally owned by the private sector should be scored on the public sector balance sheet, thus incurring a finance lease liability for the public sector;
 - ii. at what point in time should a finance lease liability appear on the public sector balance sheet;
 - iii. how should the value of the finance lease liability be estimated (imputed) at the appropriate point.
- 1.4 The complexity and variety of PFI schemes poses significant measurement challenges, but ONS and HMT have established that the audited accounts of central and local government and public corporations can be drawn on for the purpose of estimating the finance lease liability. The judgements of government and company accountants, and their independent auditors, are therefore used to answer question (i) above, using accounting rules consistent with international national accounting guidelines (to the extent that the latter exist).
- 1.5 The article also seeks to clarify why the resulting revision to PSND is not the same as the frequently quoted values of ‘PFI liability’, or the capital value of ‘on balance sheet’ projects. In short, the fact that National Accounts do not include liabilities which are contingent on, for example, completion of construction or delivery of services, means

¹ <http://www.statistics.gov.uk/pdfdir/psf0906.pdf>

that the scope of liabilities covered and their time of recording on balance sheets is different.

- 1.6 The final section of the article (9) considers further work to be undertaken, particularly in relation to the quality of private investment data where there are problems in surveying the PFI project companies (special purpose vehicles), and there are implications for whole economy investment where PFI projects are recorded either on the balance sheets of both the public and private sectors, or on neither.

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3 Background – Public Sector Net Debt and leases

3.1 Public Sector Net Debt

- 3.1.1 Public sector net debt is used to define, and measure performance against, the Government's Sustainable Investment Rule, one of its two main fiscal rules. Budget 2006 states (page 18) that to meet this rule, "public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level". It also states that "other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle."
- 3.1.2 In simplified summary, public sector net debt (PSND) is the public sector's financial liabilities less the public sector's holdings of liquid financial assets². In 2001 it was decided that PSND should be updated to include imputed debt, in particular those liabilities associated with finance leasing that were part of the General Government Gross Debt definition used for European Union fiscal purposes. This moved the definition of PSND further away from being the stock equivalent of the Public Sector Net Cash Requirement. Until August 2005 liabilities comprised financial instruments such as gilt-edged securities and national savings, with explicit and clearly designated monetary values. Some liabilities do not have explicit monetary values, however, and their value has to be estimated or "imputed". In August 2005 imputed debt associated with securitised bonds issued by London & Continental Railways was included in PSND. This was the first time imputed bonds had been included.
- 3.1.3 The finance lease liability associated with public-private partnerships (PPPs), private finance initiative (PFI) and conventional projects also has to be imputed. The need to estimate an imputed value for many complex projects, with differing characteristics, and the lack of suitable data sources are the main reasons it has not been possible to estimate the imputed finance lease liability before now. It has now been established that the audited accounts of central and local government and public corporations can be drawn on for the purpose of estimating the finance lease liability.

3.2 Accounting for leases

- 3.2.1 Assets can be leased by one party (the lessee) from another (the lessor). Two types of lease are distinguished: finance leases and operating leases. A finance lease is defined as a lease which transfers substantially all the risks and rewards of ownership of an asset to the lessee. All other leases are operating leases.
- 3.2.2 Accounting for leased assets, and their impact on measures of indebtedness, is a complex area. Where the public sector is judged as taking economic ownership of an asset that it is leasing – that is, when it assumes the risks of ownership, such as the obligation to make

² For further information on the definition of PSND see the article "Government and public sector debt measures" available on the National Statistics website.

repairs – it is said to have entered into a finance lease. At that point public sector net debt is increased by the value of the imputed finance lease liability. This usually happens when the asset becomes operational. Under such “on balance sheet” projects both the asset and the liability appear on the public sector’s balance sheet. The public sector payments made under the lease to the private sector partner, who remains the legal owner of the asset, include – along with service and interest charges – debt repayments that reduce the outstanding liability.

3.2.3 The finance lease debt in the public sector is the liability to pay lease payments in the future for assets that are economically owned by the public sector. There can only be a public sector finance lease liability for operational assets, as prior to that the public sector would not be the economic owner of the asset.

3.2.4 The box below provides an illustrative example.

Box 1: Illustrative example of finance and operating leases

Take the simple example of a company that needs the use of a lorry. Broadly, the company has three options: it could buy the lorry (the asset) conventionally in a number of ways (e.g. with cash or through a loan from a bank), or it could lease the lorry in one of two ways (under a finance or operating lease). Assume the company leases the lorry for a short period of one year and during that time the company (the lessee) has full use of the lorry. Also, during the year responsibility for maintaining the lorry lies with the lorry owner (the lessor). The lorry is returned in good working order at the end of the year to the lessor. This is an operating lease because the risks and rewards of ownership remained with the lessor due to the responsibility for maintaining the asset and exposure to the general value of the asset. Both legal and economic ownership remained with the lessor the whole time. Alternatively assume the company leases the lorry for a longer period of say 10 years and in that time it has full use of the lorry, but it also has responsibility for maintaining the lorry. The lorry wears out almost completely in that time (i.e. depreciates to minimal value). This is a finance lease. Legal ownership remained always with the lessor, but economic ownership transferred to the company using the lorry. The risks and rewards of ownership transferred substantially to the lessee under the finance lease.

3.2.5 The definition and treatment of finance and operating leases are covered in *UK Generally Accepted Accounting Practice* (UK GAAP), the *European System of Accounts 1995* (ESA95), and the *System of National Accounts 1993* (1993 SNA). As covered later in section 5, as a precursor to applying the 1993 SNA and ESA95 treatment of finance leases, a judgement is needed about which party bears the risks and rewards of the capital asset, and is thus the economic owner of the capital asset.

3.2.6 The guidance in UK GAAP, 1993 SNA and ESA95 states that if the economic owner is not the legal owner of the capital asset, then a finance lease is deemed to be in operation and the asset must, in effect, be moved to the balance sheet of the economic owner. A finance lease is shown in the accounts through an imputed loan and a purchase transaction from the legal owner to the economic owner. The payments under the lease (ostensibly for use of the asset) are considered as repayments of this imputed loan, with an interest component calculated. This can be viewed as the equivalent of the legal owner (the lessor) making a loan to the new economic owner (the lessee) who uses the proceeds in order to buy the asset from the lessor. The national accounts treatment is summarised in Box 2.

- 3.2.7 Finance lease debt is thus defined as the liability of the lessee to make finance lease payments to the lessor for use of an operational asset.
- 3.2.8 Note that finance lease debt does not include any future payments for services provided by the private sector as these are contingent on the services being delivered satisfactorily. National accounts do not include contingent liabilities. Similarly, finance lease liabilities start to be incurred at the point when an asset becomes operational, not while it is being constructed or improved. This is explained further in section 6.2.

Box 2: Key aspects of finance lease debt from 1993 SNA (11.31)

- When there is a finance lease for an operational asset there is a change of economic ownership which is financed by a financial claim, which is the asset of the lessor and the liability of the lessee.
- At the time this change in ownership occurs, the market value of the good is recorded and counterpart entries, as assets/liabilities, are made by the institutional units in the financial account.
- In subsequent periods, the actual rental payment must be divided into interest, which is recorded as property income payable/receivable, and debt repayment (this is the finance lease debt), which is recorded in the financial account and which reduces the value of the asset of the lessor and the liability of the lessee. The financial asset should be classified as a loan.

4 Accounting for PFI projects

4.1 Background - PFI projects

- 4.1.1 Public Private Partnerships (PPPs) are an alternative to conventional government procurement for establishing and bringing into service new capital assets such as schools, hospitals and prisons or for developing existing assets such as roads. A commonly used form of PPP is the Private Finance Initiative (PFI). In basic terms the public sector entity will enter a long term contract with a private sector consortium for the construction (or development) and operation of an asset with or without a maintenance and service delivery element. Under PFI projects the private sector companies involved in the consortium will set up a special or single purpose vehicle (SPV) to run and account for the project.
- 4.1.2 There is no agreed definition of PFI or PPP and the terms are often used interchangeably. In general, however, the term PPP can be thought of as wider than PFI. For convenience, the term PFI will be used in this article.
- 4.1.3 The Government's approach to PFI is described in HM Treasury publications³ and PFI contracts are required to conform to HM Treasury guidance⁴. Further information can be obtained from the Treasury website⁵.

³ HMT documents 'PFI: meeting the investment challenge' (July 2003), and 'PFI: strengthening long-term partnerships' (March 2006)

⁴ Implementation of Standardisation of PFI Contracts (SoPC)

⁵ http://www.hm-treasury.gov.uk/documents/public_private_partnerships/key_documents/ppp_keydocs_index.cfm

- 4.1.4 According to Treasury estimates about ten per cent of public sector procurement is undertaken via PFI. This equates to over 700 signed projects in the UK, with a total capital value of over £46 billion (total capital value is defined in section 6.2).
- 4.1.5 The aim of PFI is that the risk involved in the project is shared between the parties, with each party managing the risks they are best able to, with, ideally, the risk associated with delivering capital works projects being borne by the private sector. PFI does this by typically asking the private sector to raise capital to finance the creation of an asset, to take the financial and technical risk on its construction and, thereafter, on its subsequent operation and maintenance. In return, the public sector agrees to pay for this mixture of capital asset rental and service provision over an extended period, typically 30 years.
- 4.1.6 The accounts of individual organisations, both public and private, and the National Accounts for the economy as a whole, of which the public finances are a key component, have to account properly for these transactions and associated balance sheet assets and liabilities.

4.2 Coverage of PPP and PFI projects in the National Accounts and public sector finances

- 4.2.1 Most aspects of PFI projects have been, for some time, covered in the UK's National Accounts and public sector finances, the main exception being the public sector finance lease liability for those projects judged to be on the public sector balance sheet which has not been included in estimates of PSND⁶.
- 4.2.2 The aspects of PFI projects that were already captured in the National Accounts are:
- the service charge elements of unitary payments are included in government current expenditure, whether the project's capital assets are judged to be on or off the public sector balance sheet;
 - government capital expenditure, known as gross fixed capital formation (GFCF), is recorded for projects whose assets are judged to be on the public sector balance sheet;
 - private sector GFCF is recorded where the assets are judged to be on the private sector balance sheet;
 - where the public sector has a finance lease liability (on balance sheet projects) then the interest payment on the imputed loans from the contractor is included in government current expenditure;
- 4.2.3 Since the public sector finances are based on National Accounts estimates of current and capital expenditure, estimates of the public sector current budget (PSCB), public sector net investment (PSNI) and public sector net borrowing (PSNB) already take account of PFI projects as described above.

⁶ Estimates of general government gross debt provided to Eurostat for the excessive Deficit Procedure included an allowance for PPP and PFI projects but these were not considered of sufficient quality for use in domestic UK statistics.

- 4.2.4 For PFI projects where the capital assets are judged to be on the public sector balance sheet then the finance lease liability should also be included in estimates of PSND. As explained earlier, this has not been possible until now and the estimates published on 20 September 2006 rectify this omission. As a result, there is now better coverage of all aspects of PFI projects throughout the public sector finances and in all the key fiscal aggregates.
- 4.2.5 Nevertheless this remains a complex and challenging area for statistics and ONS is working to improve the quality of certain aspects of the National Accounts estimates, particularly private sector gross fixed capital formation. The current position on this work is summarised in section 9.1.

4.3 International guidance on treatment of PFI projects

- 4.3.1 The ONS produces the UK National Accounts according to the international standards: the 1993 SNA and the ESA95. The Public Sector Finances are based on the National Accounts framework.
- 4.3.2 The treatment of PFI projects is not addressed specifically in 1993 SNA or ESA95, but guidance is being developed for probable inclusion in the 2008 revision of the 1993 SNA.
- 4.3.3 The Eurostat *Manual on General Government Deficit and Debt* does, however, address public-private partnerships, and introduces the subject as follows (IV, 4.2):
- ...The key issue is the classification of the assets involved in the partnership contract - either as government assets (thereby influencing government deficit and debt) or as the partner's assets. This is a similar issue to distinguishing between operating leases and finance leases, which is explained in annex II of ESA95. the assets involved in a public-private partnership can be considered as non-government assets only if there is strong evidence that the partner is bearing most of the risk attached to the specific partnership.*
- 4.3.4 So, in practical terms, statistical offices need guidance on two recording issues:
- a. assessing which party bears the risks and rewards of the assets, leading to a decision as to which party is the economic owner and whether a finance lease or operating lease is in operation; and
 - b. the recording of finance and operating leases.
- 4.3.5 Whilst, both the 1993 SNA and ESA95 provide full guidance on the recording of finance and operating leases (explained earlier in section 3.2), they do not include guidance on the assessment of who bears the risks and rewards of an asset.
- 4.3.6 Eurostat's *Manual on General Government Deficit and Debt* does provide guidance on the allocation of risk, although the assessment rules are somewhat simplified in comparison to the accounting rules used by government and company accountants. The next section explains how the allocation of risk is decided.

5 Assessment of risk

- 5.1 The Eurostat *Manual on General Government Deficit and Debt* includes the following:
...the assets involved in a public-private partnership can be considered as non-government assets only if there is strong evidence that the partner is bearing most of the risk attached to the specific partnership.
In this context, there was agreement among European statistical experts that the risk assessment should focus on the following three main categories of risk:
- *construction risk - covering events like late delivery, respect of specifications and additional costs;*
 - *availability risk - covering volume and quality of output;*
 - *demand risk - covering variability of demand*⁷.
- 5.2 In practice it would not be practical for the ONS to assess the 700 plus PFI projects against this guidance. Instead, the ONS is taking the pragmatic approach of accepting the judgements of government accountants as to whether the public sector bears the risks and rewards of the capital assets. The judgements of the accountants are audited, where relevant, by the National Audit Office, the Audit Commission or their devolved equivalents.
- 5.3 In general, in the UK government and company accountants follow the UK GAAP or International Financial Reporting Standards (IFRS) as appropriate. These standards have a well developed concept of reporting economic substance as opposed to legal form, and as such, guidance on identifying economic ownership of assets brought into operation under leases is well developed. Additional guidance in the UK on accounting for PFI projects is provided by further application and technical notes. (see Box 3 below and Annex A for more detail).

Box 3: UK Accounting guidance for PFI projects

Application and technical notes used by government and company accountants:

- the Accounting Standards Board guidance in Application Note F *Amendment to Financial Reporting Standard (FRS) 5 – Reporting the substance of transactions: Private Finance Initiative and Similar Contracts* (September 1998);
- HM Treasury’s *Technical Note 1: How to Account for PFI Transactions*. The technical note provides “additional practical guidance”. It was approved by the Financial Reporting Advisory Board (FRAB) to the Treasury and is mandatory for all entities that produce financial statements in accordance with HM Treasury’s *Financial Reporting Manual*;
- *Appendix F* to the Code of Practice on *Local Authority Accounting in the United Kingdom: A Statement of Recommended Practice*. The appendix makes clear that the FRS 5 Application Note applies for local authorities.

- 5.4 The Notes provide guidance on assessing which party bears the risks and rewards associated with the assets, and thus which partner has economic ownership. The outcome

⁷ Demand risk is defined as the risk that the demand for the property will be greater or less than predicted or expected.

of each risk assessment leads automatically to a decision about whether the assets should be recorded on or off the public sector entity's balance sheet; if the public sector entity is judged to be the economic owner then the assets will be recorded on the public sector entity's balance sheet. Thus, both UK GAAP and Eurostat balance sheet recording is based on economic, not legal, ownership and requires an assessment of which party bears the risks of ownership.

- 5.5 To summarise, if the public sector is the economic owner and the private sector partner the legal owner, then the economic reality is represented in public sector, company and National Accounts via a finance lease. Finance leases were described in section 3.2.

6. Project phases, timing and total capital value

6.1 Project phases and time of recording

- 6.1.1 In section 3, the idea was introduced that a finance lease liability is not incurred until an asset becomes operational. The timing of recording on the public sector balance sheet is one of the main measurement issues faced by national accountants. This section explains the phasing and timing of typical partnership projects.
- 6.1.2 Annex E shows a table of the main phases in a typical PFI project, and Annex F sets out a hypothetical example of a PFI project including the major flows and balances and the timing of the change of economic ownership.
- 6.1.3 After the contract is signed and in force, there is usually a **construction or development phase** during which the contractor carries out its construction, development or improvement obligations and puts in place the operational procedures to deliver the service requirement. The construction phase includes the successful private sector project company (special or single purpose vehicle, SPV) taking on its formal structure which up to that point may only have existed in principle.
- 6.1.4 After the construction phase is complete the asset should be usable, the service delivery part of the project should be realisable and the contract consequently enters the **operational phase**. This will usually be the longest phase of a PFI contract with service delivery extending for a period of 25 years or more in some cases. During this phase the SPV may provide support services and may also be responsible for maintaining the facility (e.g. a prison). During the operational phase the public authority pays the SPV regular unitary payments to cover services received, and for projects on the public sector entity's balance sheet, repayments of the imputed finance lease debt.
- 6.1.5 The majority of PFI projects typically involve the creation of new assets, with a reasonably clear demarcation between the construction and operational phases. This is an obvious point at which, for projects judged to be on balance sheet, the public sector assumes economic ownership and balance sheet recording of both the asset and the corresponding finance lease liability.

6.1.6 Other projects, notably the London Underground PPP, involve the improvement of existing assets, where the investment is being made on a continuous basis over the 30 year lives of the contracts. In this case there is no single point of transition from construction to operational phase, but instead the overall project is managed as a series of stages or sub-projects. The London Underground PPP projects are described in more detail in Annex C.

6.2 Difference between finance lease liabilities and total capital value

6.2.1 This section explains the relationship between finance lease liabilities and capital values in the context of the timing of balance sheet recording. The estimates of imputed finance lease liabilities in PSND are much smaller than the capital value of assets for signed projects, which HM Treasury estimated at more than £46 billion in March 2006.

6.2.2 The reasons why the liabilities are much smaller are:

1. finance lease debt and capital value are not the same thing;
2. finance lease debt relates to assets judged to be **on public sector balance sheets only**. HM Treasury has estimated that about half of all PFI assets (by capital value) are either already on or will be on the public sector balance sheet. The total capital value of these assets is estimated to be about £23 billion, of which the London Underground PPP assets make up around £16 billion;
3. **timing of recording** – where the accountants and auditors judge the asset should be on the public sector balance sheet the transfer of economic ownership, and so the recognition of the liability, will usually occur when all of the construction is completed and the asset becomes operational. The finance lease debt is imputed at this point. However, for projects such as the London Underground PPP the accounts will typically show an addition to the value of the asset when a phase of improvements is completed, with a finance lease debt imputed to match this value at the same time.
4. **contingent liabilities are not included** – the capital value of assets for signed projects includes forecasts of future asset values, where the work may be incomplete or not yet started. These liabilities are contingent therefore on the construction or improvement being completed satisfactorily, and contingent liabilities are not included in national accounts.

7 Data sources

7.1 Resource and company accounts / COINS (*Combined Online Information System*)

7.1.1 The main sources of data for the imputed finance lease liabilities are:

- **central government departmental resource accounts.** Since 2000 all government departments have been required to complete a set of annual resource accounts, and these have been examined for all government departments for all years available from 1999-2000;
- **public corporations' financial statements.** Public corporations' accounts have been examined back to 1987.
- **local authority accounts.** These have been more difficult to obtain, although accounts for some authorities for financial years 2003-04 and 2004-05 are available. Local authorities do not have any on balance sheet PFI projects, so that all local authority finance lease liabilities stem from conventional finance leasing.

7.1.2 In the future, HM Treasury's new combined on-line information system (COINS) will be used by ONS as one of the main data sources. COINS currently covers central government departments only, but will be expanded to include local authorities and public corporations.

7.1.3 One benefit of using government departments' and public corporations' accounts is that estimates of PFI liability will be derived from a consistent source across the different accounting frameworks: resource accounts, public sector finance statistics, and National Accounts.

7.1.4 The relevant entries in the government and public corporation accounts are made following UK GAAP (Standard Statement of Accounting Practice 21, para 32):

...a finance lease should be recorded in a lessee's balance sheet both as an asset and as an obligation to pay future rentals. At the inception of the lease, the sum to be recorded both as an asset and as a liability should be the present value of the minimum lease payments, derived by discounting them at the interest rate implicit in the lease.

7.1.5 The accounts for central government and public corporations generally give figures for:

- short-term liability – the liability for future finance lease payments over the next 12 months;
- long-term liability – the liability for finance lease payments in the period from the end of the next 12 months until the end of the contract.

7.2 Estimating monthly, quarterly and latest figures

7.2.1 Resource and company accounts provide closing balance sheet values for finance lease liabilities, but give no information about the monthly or quarterly path of liabilities between the ends of each financial year. Since monthly and quarterly data are required for the National Accounts and Public Sector Finances and estimates, estimates must be

interpolated in years for which accounts are available, and estimates must also be extrapolated forwards for more recent periods when accounts are not yet available

7.2.2 A monthly path is derived from the annual data as follows:

1. Any short-term liability is assumed to be completely paid off during each 12 month period, and thus declines following a straight line path.
2. In any month, a sub-total liability is obtained as the sum of the last available long-term liability plus the remainder of the short-term liability to be paid off in that year.
3. Additions to this sub-total are made to take account for any relevant PFI projects known to be starting their operational phase, and thus coming onto the public sector balance sheet. These additions can be made in the correct month using the operational date, capital value and length of operation from the Partnerships UK database. The capital value figure is divided by the length of the operational phase to give an annual capital value figure which is used as an estimate of the short term finance lease liability.
4. It is usually not possible, however, to bring new conventional finance lease liabilities into the total liability sum during the financial year. They will usually appear when new accounts are available, which may lead to steps in the monthly series at financial year end.

7.2.3 For more recent periods, beyond the 12 month horizon of the short-term liability figure, where extrapolation forward is required:

1. A new short term liability is imputed to start at the beginning of the extrapolation period, with a value and payment path similar to that of the previous 12 months.
2. A new long-term liability (for the beginning of the extrapolation period) is derived as the previous long-term liability less the imputed short-term liability.
3. Steps 2 and 3 are the same as above.
4. A new conventional finance lease liabilities are assumed to come onto the balance sheet at the same rate as indicated in the last available accounts. In other words, the same addition to total liability is made at each financial year end for which accounts are not available.

7.2.5 Data are not so readily available for local authorities, in particular, many authority accounts for financial years 2003-04 and 2004-05, and most authority accounts for the financial years prior to 2003-04 are not easily available. The estimation for missing local authority accounts is based on scaling up the known data, from authorities that do have accounts, to a value for all authorities.

7.3 Deviations from resource and company accounts

7.3.1 In a limited number of cases it has been necessary to make adjustments to the finance lease liabilities shown in resource and company accounts. The resource accounts for certain years for the Home Office and the Ministry of Defence do not show PFI related finance lease liabilities, so that ONS has imputed these liabilities from other sources. Department for Transport, on the other hand, shows finance lease liabilities related to the

land on which the channel tunnel rail link is being constructed. Since National Accounts include finance lease liabilities for produced assets only, and not land, the ONS has removed these liabilities from its estimates. More detail is given in Annex D.

8 Results

8.1 Public sector finance lease liabilities

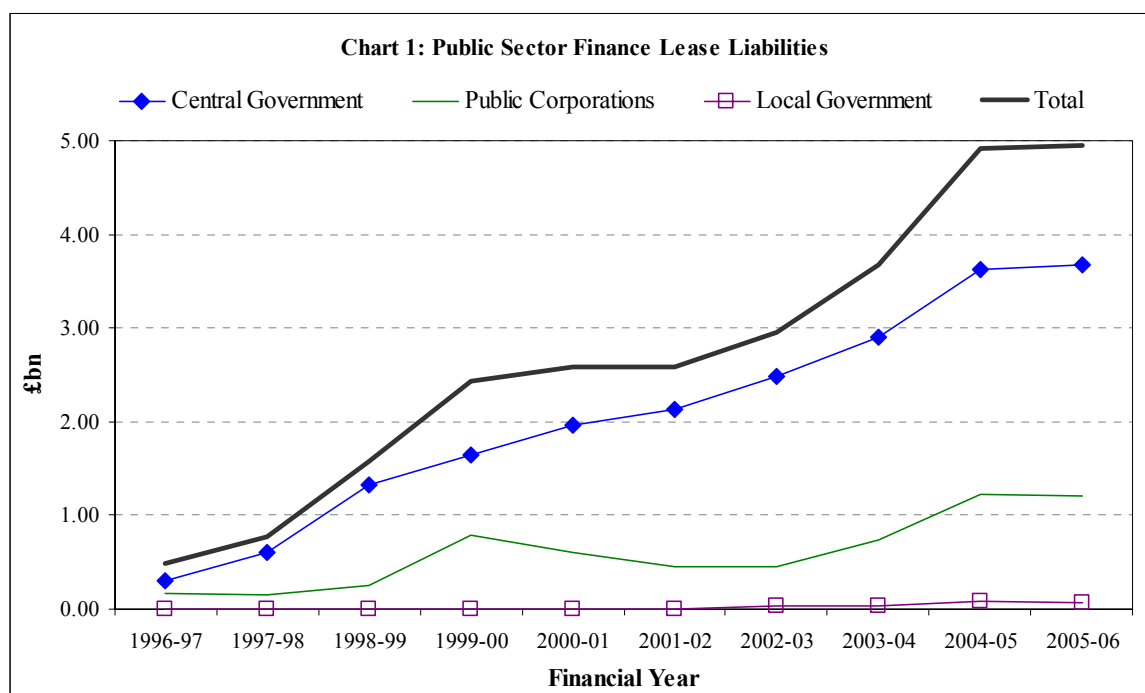
8.1.1 Estimates of public sector imputed finance lease liabilities of the public sector have been made for all years from 1978 to 2006. As described earlier in this article, these mainly arise from PFI, but also stem from conventional finance leasing.

8.1.2 Table 1 gives the size of the imputed finance lease liabilities over the past 10 years, how the liability is broken down between the sub-sectors of the public sector (central government, local government and public corporations), and gives an indication of the effect of including these estimates in PSND in terms of the ratio of PSND to GDP. Chart 1 illustrates the evolution of the imputed finance lease liabilities since 1996-97.

Table 1: Public Sector Finance Lease Liabilities (£ billion)
Including "on balance sheet" deals
{=revision to PSND}

Financial Year (end of March)	Central Government	Public Corporations	Local Government	Total	Effect on PSND:GDP ratio
1996-97	0.31	0.18	0.01	0.49	+ 0.1
1997-98	0.61	0.16	0.01	0.77	+ 0.1
1998-99	1.32	0.26	0.01	1.59	+ 0.2
1999-00	1.65	0.78	0.01	2.44	+ 0.2
2000-01	1.97	0.61	0.01	2.59	+ 0.3
2001-02	2.12	0.45	0.01	2.58	+ 0.2
2002-03	2.48	0.45	0.03	2.96	+ 0.3
2003-04	2.90	0.74	0.04	3.67	+ 0.4
2004-05	3.63	1.22	0.08	4.92	+ 0.4
2005-06	3.67	1.21	0.07	4.95	+ 0.4

1. Components may not sum to totals due to rounding.
2. The effect on the PSND:GDP ratio may be offset, or increased, by revisions to GDP, particularly in recent periods.



8.1.3 The majority of the imputed finance lease liabilities arise from PFI projects. The ratio of PFI related liability to conventional finance leasing is around 85:15 for the financial year 2005-06. Across the sub-sectors the split is as follows for 2005-06:

- **central government** – PFI related finance lease liability was roughly £3 billion, with £0.6 billion from conventional finance leasing;
- **public corporations** – PFI related finance lease liability was £1.1 billion, with £0.1 billion from conventional finance leasing;
- **local government** – there are no PFI projects judged to be on the local authority balance sheets, so that the whole finance lease liability of £0.07 billion comes from conventional finance leasing.

8.1.4 Annex B gives the PFI related finance lease liabilities for each central government department and public corporation involved in PFI, with a list of the specific projects included in the new estimates of finance lease liability.

8.2 Effect on Public Sector Net Debt

8.2.1 The estimate of imputed finance lease liability at the end of March 2005 (the last financial year for which audited data are available) is £4.92 billion. This revises PSND up from £419.6 billion to £424.5 billion for that period, an increase equivalent to 0.4 per cent of GDP. The estimate of imputed finance lease liability at the end of March 2006 is £4.95 billion. The effect on the PSND:GDP ratio over time is shown in table 1 above.

8.3 National Accounts revisions

- 8.3.1 The National Accounts have always included an estimate of imputed public sector finance lease liabilities, and an estimate of general government imputed finance lease liabilities consistent with that recorded in National Accounts has been provided to Eurostat for Excessive Deficit Procedure purposes. The estimate most recently sent to Eurostat for calendar year 2005 was £3 billion.
- 8.3.2 Incorporating the new estimates will cause revisions to the National Accounts and to the estimates sent to Eurostat, but the revisions will be smaller than the revisions to PSND because estimates were already included.

9 Further work

9.1 Gross fixed capital formation

- 9.1.1 The ONS is currently working to improve its measurement of private investment (gross fixed capital formation, or GFCF) connected with PFI projects. Investment data are collected using surveys to businesses, including PFI project companies (also known as special purpose vehicles or SPVs). There are currently two problems with this approach: firstly a list of SPVs is not yet available, and secondly SPVs are by their nature very small companies (by employment) and thus below ONS's normal sampling thresholds. It is likely, therefore, that PFI related private sector investment is currently under-recorded in ONS surveys.
- 9.1.2 This under-recording in surveys does not mean, however, that GFCF is necessarily under-recorded in the National Accounts as adjustments are made in an attempt to correct for the possible under-recording. Also, in 2004 to 2005, ONS undertook a detailed assessment of its inquiry sample for the quarterly capital expenditure inquiry to investigate the coverage of SPVs. This project led to the identification of several new SPVs and an improvement in the sample coverage. Further work is required to produce a comprehensive and frequently updated list of SPVs, so that they are easily identifiable at the point that they score GFCF. A full list of SPVs will lead to these companies being separately identified on the inter-departmental business register (IDBR).

9.2 On-on and off-off

- 9.2.1 Since decisions regarding whether or not a body is exposed to the risks and rewards of a PFI project are monitored independently by the private partner's auditors and the public partner's auditors, it is possible that both the public and private sector partners record the capital formation on their own balance sheets (on-on) or for a project to appear on neither balance sheet (off-off).
- 9.2.2 In the national accounts overall this will lead to double-counting of GFCF for on-on projects, and missed GFCF for off-off. This is not necessarily a problem for the parties

concerned or their accountants who are only concerned with the financial statements of a single entity, but it is a problem for the National Accounts which measures the whole economy, and must therefore avoid double-counting or omission of any economic activity, transaction or asset.

10 Conclusions

- 10.1 As a result of the work described in this article, estimates of imputed finance lease liabilities, which mainly arise from PFI projects, are now included in the estimate of PSND in the public sector finances, and estimates of imputed finance lease liabilities in the National Accounts are much improved.
- 10.2 The quality of the National Accounts estimates is considered to be much improved as audited accounts are now available as the primary data source. Nevertheless, this remains a complex and challenging area for statisticians, both conceptually and practically. International guidance is still under development, and more work is required to further improve the recording of PFI projects across the National Accounts, particularly with respect to the recording of investment.

11 Contacts

- 11.1 If you have any questions on the material contained in this article please contact psa@ons.gov.uk. Any questions on the Government's policy on PFI should be referred to HM Treasury. ONS acknowledges the assistance of HM Treasury in collecting and quality assuring the data for this article.

12 References

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13 Annexes

- A Accounting treatment of PFI assets
- B List of projects included in revised finance lease dataset
- C London Underground treatment and results
- D Deviations from resource and company accounts
- E PFI project phases
- F Worked example of a mock hypothetical PFI project

ANNEX A - Accounting treatment of PFI assets

Technical Notes provided by HM Treasury

The principal accounting guidance (issued by the Accounting Standards Board) for accounting for PFI is Application Note (AN) F to Financial Reporting Standard 5 - Reporting the Substance of Transactions: Private Finance Initiative and Similar Contracts (Issued 1998).

The terminology used in accounting for PFI refers to the public sector body requiring services under the PFI contract as the purchaser. The private sector contractor, usually in the form of a special purpose vehicle, providing the services in return for payments from the purchaser, is the operator. The road, hospital etc that is the subject of the PFI contract is referred to as the property, whilst the word asset is reserved for items that are recognised in the balance sheet.

Present practice is not to capitalise contracts for services. However, where a property is needed to fulfil a contract for services it may require the property to be recognised as an asset of the purchaser. The AN requires an analysis to be undertaken to determine:

- i Whether the purchaser in a PFI contract has an asset of the property used to provide the contracted services together with a corresponding liability to pay the operator for it, or alternatively, has a contract only for services, and;
- ii Whether the operator has an asset of the property, or alternatively, a financial asset being a debt due from the purchaser.

Under the general accounting principles a party will have an asset where it has access to the benefits of the property and exposure to the inherent risks. In some cases the PFI contract may be separable - in that PFI payments may operate independently of each other. In process terms once any separable service elements have been excluded PFI contracts can be classed into:

- a. Those where the only remaining elements are payments for the property - akin to a lease (where Standard Statement of Accounting Practice 21 - Accounting for leases and hire purchase contracts) applies; and
- b. Other contracts (FRS 5/AN applies) where the remaining elements include some services.

For those PFI contracts falling within SSAP 21 the key question is whether the lease is a finance lease (where both the asset and liability would be recognised on the balance sheet), i.e. one that substantially transfers all the risks and rewards of ownership of the asset to the lessee. An indication of this is given by comparing the present value of the minimum lease payments over the contract term with the fair value of the asset - often referred to as the 90% test. However, the principle risks and rewards of ownership in a leasing context are usually demand and residual value risk. A lease other than a finance lease is an operating lease, which does not require the recognition of the asset and corresponding liability on the balance sheet of the lessee.

For those PFI contracts falling directly within FRS5/AN, the question of whether a party has an asset of the property is determined by looking at the extent to which each party would bear any variations in property related profits or (losses), using qualitative and quantitative analysis. The principal factors relevant to the assessment of profit or loss variation in the quantitative analysis include:

- o Demand risk
- o The presence of third party revenues
- o Who determines the nature of the property
- o Penalties for underperformance or non-availability
- o Potential changes in relevant costs
- o Obsolescence
- o Arrangements at the end of the contract.

Note that HM Treasury publication Treasury Taskforce Technical Note (TN) 1 (Revised): How to Account for PFI Transactions was issued shortly after the AN. The objective of the TN was to provide additional practical guidance for certain public sector bodies on applying the AN.

Under the terms of the TN when the property is an asset of the purchaser, recognition of the asset and the associated liability in the balance sheet will be when the property comes into use, i.e. when it is operational.

In some PFI transactions where the operator has an asset of the property, all or part of the property (e.g. the land element) will pass to the purchaser at the end of the contract.

Where the contract specifies that this transaction should take place at market value at the date of transfer, no accounting is required until the date of transfer, as this represents future capital expenditure.

Where the contract specifies the amount (including zero) at which the property will be transferred to the purchaser at the end of the contract, the specified amount will not necessarily correspond with the expected fair value of the residual estimated at the start of the contract. Any difference whether positive or negative, will be respectively capitalised or expensed over the life of the contract. For example, if the expected residual value for the property (estimated at the start of the contract) is £2m, and the contract provides for the purchaser to pay £1m for the residual property at the end of the contract, then the purchaser would capitalise £1m of the PFI service payments over the life of the contract as an asset, disclosed in the Fixed Asset note as assets under construction.

Contributions to a PFI contract may take a number of forms, including an upfront cash payment or the contribution of existing assets for development by the operator.

If the contribution of an existing property results in lower service payments, the carrying amount of the property should be reclassified as a prepayment (current asset) and subsequently charged as an operating cost over the period of reduced PFI payments.

If the contribution does not give rise to a future benefit for the purchaser, it should be charged as an expense when the contribution is made.

The operator will account for the property under construction as work-in-progress, and if it is concluded that it will have an asset of the property, then the asset will be recorded initially at cost in the balance sheet, which would be then depreciated to its expected residual value over its economic life. The operator would also have a liability for financing if it had borrowed to fund the construction costs.

Where it is concluded that the operator does not have an asset of the property, it will instead recognise a financial asset on the balance sheet, being a debt due from the purchaser for the fair value of the property. This financial asset is recorded at the outset and reduced in subsequent years as payments are received from the purchaser.

ANNEX B - List of PFI projects included in revised finance lease dataset

PFI/PPP Finance Lease Liability end of March 2006 (£m)		PFI/PPP Project(s)	
Central Government Department			
Department for Constitutional Affairs	55.33	Estimate	CCS (formerly LOCCS) Libra Exeter East Anglia Sheffield
Department for Transport	973.18	Actual	M1-A1 A1(M) A419/A417 A50/A564 M40 A19 A30 A69 A1(M) A249 National Traffic Control Centre
Department for Work and Pensions	57.45	Estimate	Health and Safety Laboratories
Foreign and Commonwealth Office	33.02	Actual	Arteos
HM Revenue & Customs	187.3	Actual	100 Parliament Street - GOGGS east 100 Parliament Street - GOGGS east
HM Treasury	151.9	Actual	1 Horse Guards Road (1HGR) - GOGGS west
Home Office	378.71	Estimate	HMP Altcourse Bridgend HMP Lowdham Grange Pucklechurch HMP Forest Bank Prison Service - Heat/Energy tranche 1 Prison Service - Heat/Energy tranche 2 HMP Rye Hill HMP Dovegate Ashford Peterborough Criminal Records Bureau PPP contract
Ministry of Defence	657.7	Actual	Lossiemouth FQs RAF Flyingdales Defence Helicopter Flying School Defence Animal Centre Naval Communication Provision of Storage facilities Main Building Redevelopment Joint Services Command and Staff College Heavy Equipment Transporter Field Electrical Storage Facilities Defence Electronic Commerce Services Devonport Armada Single Living Accommodation
Northern Ireland Court Service	25.45	Estimate	Laganside Complex PPP
Scottish Executive	206.64	Estimate	Edinburgh Royal Infirmary East Ayrshire Community Hospital New Craigs Hospital
Youth Justice Board for England and Wales	36.69	Actual	Oakhill Medway Rainsbrook Hassockfield
None	310	Estimate	Government Communications Headquarters - New Accommodation Project
Total Central Government	3073.37		

Continued over

Including Finance Lease Liabilities in Public Sector Net Debt: PFI & Other

PFI/PPP Finance Lease Liability end of March 2006 (£m)		PFI/PPP Project(s)	
Public Corporations			
London Underground Ltd	857.7	Estimate	Metronet BCV PPP Metronet SSL PPP Tube Lines PPP
London and Continental Railways	220	Estimate	Channel Tunnel Rail Link (CTRL)
Total Public Corporations	1077.7		
Total Central Government + Public Corporations	4151.07		

Estimate = Finance lease liability for end of March 2006 not available. Value estimated.
 Actual = Finance lease liability is available for end of March 2006.

ANNEX C - Background to London Underground's Public Private Partnership

The London Underground PPP represents the three largest projects by capital value (£16 billion from an estimated total capital value of all PFI "on balance sheet" assets of £23 billion).

The Partnerships UK database entry for these projects says:

"On 20 March 1998 the Deputy Prime Minister, John Prescott, announced that a Public Private Partnership would be introduced to clear the large investment backlog. The plans involve letting 3 contracts for the maintenance and upgrading of trains, stations, tracks and civil infrastructure such as tunnels to three privately owned infrastructure companies (Infracos).

The Infracos are based upon different line groupings - JNP (Jubilee, Northern and Piccadilly lines), BCV (Bakerloo, Central, Waterloo and City and Victoria lines) and the Sub-Surface lines including the District and Circle, Metropolitan, East London and Hammersmith and City lines. London Underground will remain responsible for safety, signalling, and for running the trains."

Also from the Partnerships UK database, BCV has a total capital value of £4,556 million, JNP has a total capital value of £5,484 million and Sub-Surface lines (SSL) has a total capital value of £6,139 million. As explained in this article (Section 6.2) total capital value is different to the imputed finance lease liability. However, the finance lease liability for the London Underground PPP has a large impact on the data.

The London Underground's projects are of the asset development type, with the underground improvement works expected to continue for 30 years. Parts of the asset become operational in phases as sections of the construction work are completed. In these PPP contracts it has been judged by the accountants and auditors that the risks and rewards of ownership are mostly borne by London Underground. As a result, these contracts are recorded on the public sector balance sheet. Finance lease payments were made from the public sector (London Underground) to the private sector (the Infracos) once the first parts of the assets became operational.

BCV and SSL were signed off in April 2003 and JNP was signed off on the 31 December 2002.

At the end of March 2006 the London Underground PPP imputed finance lease liability is £0.86 billion, from an estimated total public sector imputed finance lease liability value of £4.95 billion.

ANNEX D - Deviations from resource and company accounts

Department for Transport

The Department for Transport (DfT) are showing a £1bn increase in their balance sheet liabilities in their 2003-04 Resource Accounts, arising as a result of the Channel Tunnel Rail Link (CTRL). The increase relates to the land on which the link is being constructed. The land lease receivables were increased by £1bn due to government changing the discount rate from 6% to 3.5% during the year, and an equal amount was added to the finance lease creditors. A note to their account states:

12.1 The Channel Tunnel Rail Link increase of Land and Buildings (£1,027,100,000) relates to the land on which the link is being constructed. This increase is due entirely to the change in the central government discount rate from 6% to 3.5%. The increase in asset value is matched exactly by an increase in the value of the liability for deferred income, being lease payments due from 2030 to 2086.

A further note in the DfT accounts explains the accounting treatment:

24.6 The Department retains the freehold interest in the land on which the CTRL is being constructed. The freehold land is subject to a 90-year lease. The freehold interest retained by the Department is expected to produce an income of £1,554 million (in March 2005 NPV terms) (March 2004: £1,468 million) from the land rental payable by the owners of Sections 1 and 2. This value has been ascribed to the land and treated as a long-term liability (creditors: amounts falling due after more than one year). The reversionary value of the land and the rail link at the end of the 90-year lease are recorded at market value for existing use. At present, this is deemed to be nil.

In National Accounts finance leases are only shown on produced assets, not land. Leases on land are always operating leases. Therefore, the DfT resource account values for 2003-04, and throughout, which relate to the change in value of leased land, are inappropriate for National Accounts recording as finance lease liabilities.

Home Office

The Home Office resource account for the financial year 1999-2000 does not show finance lease liabilities for PFI projects, judged to be on the public sector balance sheet, which have operational start dates during or before March 2000. Therefore, ONS has estimated the imputed finance lease liability for the Home Office up to and including the financial year 1999-2000.

Ministry of Defence

The Ministry of Defence resource accounts for the financial year 1999-2000 to 2002-03 do not show finance lease liabilities for PFI projects, judged to be on the public sector balance sheet, which have operational start dates during or before March 2003. Therefore, ONS has estimated the imputed finance lease liability for the Ministry of Defence up to and including the financial year 2002-2003.

Government Communications Headquarters (GCHQ)

GCHQ reports to the Foreign Secretary. However, in the absence of available resource account data the imputed finance lease liability for the GCHQ – New Accommodation Project have been estimated based on capital value and other available data.

ANNEX E - PFI project phases

HM Treasury's document "Standardisation of PFI Contracts - Version 3", Chapters 2 and 3, provides details about the length and phases of PFI projects with guidance for authorities and contractors developing PFI contracts. Box 1 below provides a summary.

Box 1: PFI Project Phases	
The Procurement Phase	Advertisement in Official Journal of European Union (OJEU)
	Invitation to Negotiate (ITN)
	Best and Final Offer (BAFO)
	Contract Signature
The Construction Phase	Successful SPV takes on formal structure
	Construction of asset
The Operating Phase	SPV provides support services under long term contract
	SPV maintains the facility
	Public Authority pays SPV For services (to fund operations and to provide a return to investors) To repay debt (if finance lease)
The Termination Phase	The contracted service period ends and the asset either reverts to public or private ownership or becomes redundant. Alternatively a second service phase can be entered into, but this will usually involve new tenders and contracts.

ANNEX F - Worked example of mock hypothetical PFI project

The following mock example shows the profile of payments under a typical PFI project and relates these to the balance sheet recording.

Example 2 - Construction and Operation of New Road X under a PFI contract

Main aspects of the example:

In 1997 the government decides a new road (road X) is required and in 1999 it enters a 20 year PFI contract with a private sector entity to build the road.

Construction Phase

The private sector entity constructs the road and it takes 7 years to complete the construction (from 2000 to 2006). Prior to construction, the government department sponsoring the project will provide an estimated total capital value to HM Treasury. This estimate will be the sum of the expected future discounted (i.e. adjusted to take into account the effect of inflation) finance lease payments because the asset will be on the public sector balance sheet. In this example this total capital value is £200m, but this has not been discounted. Note that this value is £200m long before the asset has been constructed and consequently long before there is any finance lease liability for the public sector. When the construction is complete the private sector is the legal owner of an asset (the road) worth £200m.

Operational Phase

The road becomes operational in 2007 and the private sector transfers the risks of economic ownership (e.g. responsibility for repair and maintenance) to the public sector. Consequently the public sector becomes the economic owner of the road, acquired under a finance lease, in 2007. At the same time as the economic ownership transfers, the public sector records positive gross capital formation for the capital value of the asset (£200m). At the same time the public sector will incur an imputed finance lease liability in their balance sheet (i.e. a loan, also for £200m at this point) and the private sector will impute a financial asset. During the operational phase of the contract the public sector will now make regular payments (unitary payments) to the private sector which will include repayments of the finance lease debt. Therefore, the finance lease liability will decrease over time for this road. For this example the regular payments will be £20m per year and only include repayments of the finance lease debt, no interest or service charge payments are included.

The public capital on the balance sheet has been depreciated by a very simple £3m per year.

The private sector retains legal ownership of the road until the end of the contract (2018), when legal ownership transfers to the public sector for a nominal fee.

New Road X Data

		Balance Sheet Entries arising from the project					
		Gross Capital Formation		Assets at end of year		Public Sector Liabilities at end of year	
Phase	Year	(A) Private	(B) Public	(C) Private	(D) Public	(E) Finance Lease Liability	(F) Capital
Procurement	1999	0	0	0	0	0	0
Construction	2000	20	0	20	0	0	0
	2001	20	0	40	0	0	0
	2002	20	0	60	0	0	0
	2003	20	0	80	0	0	0
	2004	30	0	110	0	0	0
	2005	40	0	150	0	0	0
	2006	50	0	200	0	0	0
Operation	2007	-200	200	180	197	180	17
	2008			160	194	160	34
	2009			140	191	140	51
	2010			120	188	120	68
	2011			100	185	100	85
	2012			80	182	80	102
	2013			60	179	60	119
	2014			40	176	40	136
	2015			20	173	20	153
	2016			0	170	0	170
	2017			0	167	0	167

Columns A and B show the private sector gross capital formation from the project in each year during the period of construction and the transfer of the accumulated capital from private sector to public sector in 2007 (when there is no gross capital formation in total from the project).

Column C shows the effect of the accumulation of gross capital formation from 1999 to 2006 on the assets side of the private sector balance sheet, representing the private sector's economic ownership of the new road. After economic ownership transfers to the public sector on 1/1/2007, the physical asset is replaced by a financial asset, corresponding to the public sector's finance lease liability, which diminishes by £20m per annum as payments are made, the first payment being made before 31/12/2007. There are, of course, corresponding entries on the liabilities side, not shown in this table, to represent the capital employed in producing these assets.

Column D shows the effect on the assets side of the public sector balance sheet, representing the public sector's economic ownership with effect from 1/1/2007. This asset diminishes by £3m depreciation per annum, the first depreciation reduction being applied on 31/12/2007. The corresponding entries on the liabilities side are the finance lease liability (column E), which is equal in magnitude to the corresponding asset in the private sector balance sheet, and the capital employed (column F) in producing the asset. The capital employed starts at zero and, from 2007 to 2015, increases by £17m per annum, representing £20m of finance lease payments less £3m depreciation. After the last finance lease payment in 2015, only the depreciation reduction affects the capital employed. The total public sector liability (finance lease liability plus capital employed) is, of course, equal to the value of the corresponding asset.