Research and Library Services

Northern Ireland Assembly

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# RECLASSIFICATION OF NORTHERN IRELAND WATER

Research and Library Service

The ONS has considered that for Treasury purposes, Northern Ireland Water should be reclassified from a Public Corporation to a Non Departmental Public Body. This paper outlines the background to the reclassification decision and outlines the likely financial and governance implications of the decision.

## SUMMARY OF KEY POINTS

- The Office of National Statistics (ONS) is of the view that Northern Ireland Water (NIW) should be reclassified from having Public Corporation (PC) status as a Government Owned Company to having Central Government status as a Non-Departmental Public Body (NDPB).

- The reason for such a reclassification is that the ONS consider that an insufficient amount of NIW's income is derived from charges for it to be considered self-financing and therefore a PC.

- The financial and governance implications of such a reclassification are complex.

- Financially, consideration will have to be paid to the additional subsidy requirements and the cost of capital charges that will be incurred by the Northern Ireland Department Expenditure Limit (DEL). Implications relating to borrowing capabilities, spending authority, accounting and VAT will also require consideration.

- The implications for governance are less pronounced. DFP states that in terms of governance, NDBPs are most akin to Public Corporations however, NIW's existing legislative framework requires it to be treated as a PC. Appropriate adjustments would therefore be required to avoid confusion.

- This paper considers the background to the reclassification decision, outlines the key players and their role in the classification process and identifies the key financial and governance implications.

## CONTENTS

## SECTION 1: BACKGROUND

The Office of National Statistics (ONS) is of the view that Northern Ireland Water (NIW) should be reclassified from having Self-Financing Public Corporation (PC) status as a Government Owned Company to having Central Government status as a Non-Departmental Public Body (NDPB).

The reason for such a reclassification is that the ONS consider that an insufficient amount of NIW's income is derived from charges for it to be considered self-financing and therefore a Public Corporation.

The Department for Regional Development (DRD) has been advised that this will result in a Treasury requirement that NIW be treated as if it was a central government body rather than a public corporation.

DRD has advised that it, in conjunction with the Department for Finance and Personnel (DFP), is currently trying to establish the detailed implications of the financial consequences of such as reclassification. Limited information from these sources is therefore available at this time.[1]

This paper has therefore been based on generic information gathered from The Assembly, Cabinet Office, HM Treasury, Department for Finance and an industry expert. It outlines the background to the reclassification process and identifies the likely financial and governance implications of such a reclassification.

## SECTION 2: THE CLASSIFICATION PROCESS – KEY PLAYERS AND GENERAL INFORMATION

### THE OFFICE OF NATIONAL STATISTICS

The ONS decides on the classification of all entities and transactions for the purpose of producing national accounts. The ONS states that this role is of particular importance when defining institutions that belong to the public sector as both the UK and EU base their fiscal policy on national accounts. Guidance further states that ONS has established a transparent process for classification decisions.

### ONS PROCESS

The international statistical manuals (mainly ESA95 and the *System of National Accounts 1993)* provide the broad framework and principles for deciding classifications. [2]

A comprehensive set of guidelines exist which focus largely on the boundaries of the general government sector (which comprises central government, state government and local government) and the public corporation sector which together define the public sector.

[1] DRD DALO 164, *Status of Northern Ireland Water – Request for Briefing,* 15th December 2008.
[2] ONS, *UK National Accounts Sector and Transaction Classification: A summary of the classification process.*

Classification decisions are made by the National Accounts Classification Committee (NACC) and ONS guidance[3] outlines the key stages of the classification process which are:

- Stage 1 – Which classifies an entity to the public or private sector; and
- Stage 2 – Which decides whether the entity is a market or non-market producer.

A market producer is described as one where more than 50% of its production costs are covered by the sales of goods and services; similarly, a non-market entity is one where less than 50% of its production costs are covered by the sales of goods and services.[4] It is on this basis that the ONS has taken the view to reclassify NIW**.**

Public Sector market entities are classified as Public Corporations; and public sector non-market entities are classified as the General Government sector.

The ONS has confirmed that it classifies NIW as a Central Government organisation and has done so from its creation in April 2007.[5]

HM TREASURY

The Treasury has responsibility for the control framework used to ensure that the Government successfully pursues its fiscal and monetary policy objectives and is concerned with the correct and proper use of public funds.[6]

The Treasury advises on the budgetary treatment of a given body or transaction. It does this to protect the overall fiscal position of the UK and encourage best practice and value for money in public expenditure.[7]

Guidance on how each type of body should be treated is contained within *Consolidated Budgeting Guidance*[8] and further information on this shall be considered in the next section.

As an insufficient amount of NIW's income is derived from charges for it to be considered self-financing, it has been reclassified for Treasury budgeting purposes to a NDPB within the Central Government sector**.**

## SECTION 3: FINANCIAL IMPLICATIONS OF RECLASSIFICATION

BUDGETARY IMPLICATIONS AND TREATMENT

The funds available to the Northern Ireland Executive are those agreed by the Treasury through the Comprehensive Spending Review.

The framework for public expenditure is divided between:

- Departmental Expenditure Limit (DEL) spending, which is planned and controlled on a three year basis in Spending Reviews; and

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[3] ONS, *UK National Accounts Sector and Transaction Classification: A summary of the classification process.*

[4] *Ibid.*

[5] ONS, *Reclassification of Northern Ireland Water – Information Request* – 18th February 2009.

[6] HM Treasury, *Classification Pack,* See: http://www.hm-treasury.gov.uk/d/classification_pack.pdf

[7] HM Treasury, *Consolidated Budgeting Guidance 2009/2010,* http://www.hm-treasury.gov.uk/d/consolidated_budgeting_guidance200910.pdf

[8] *Ibid.*

- Annually Managed Expenditure (AME), which is expenditure which cannot reasonably be subject to firm, multi-year limits in the same way as DEL.

DELs are allocated to each Department by the Executive from the Total Expenditure Limit for Northern Ireland. DEL is split into resource and capital budgets. AME must be approved by the Treasury and is set outside DEL expenditure.

The implication of a reclassification as a NDPB has a number of implications on the Northern Ireland budget.

Using guidance set out in *Consolidated Budgeting Guidance 2009-2010,* other Assembly Sources and industry experts, primary implications are considered below.[9]

<u>SCORING SUBSIDIES AND CAPITAL CHARGES</u>

Public corporations are usually treated on an external finance regime. This means that only the transactions between the department and the public corporation score in public expenditure. These transactions are mainstream capital grants, loans to the public corporation and capital charges on its estate less dividends paid back to the Department. Where dividends are less than the capital charge the department pays the public corporation to cover the difference. Table 1 below outlines the main elements of scoring in the budgets.

Table 1: Public Corporation Scoring Elements

| | ***Resource Budget*** | ***Capital Budget*** |
|---|---|---|
| **External Finance Basis** | Cost of capital charge in respect of public corporations. | Investment grants paid to public corporations. |
| | Subsidies paid to public corporations. | Net lending to public corporations (Voted and NLF) |
| | Less interest and dividends received from public corporations. | Public corporations' market and overseas borrowing (including balance sheet PFI) |
| | | Less equity with drawls from public corporations. |

<u>Source: HM Treasury, Consolidated Budgeting Guidance from 2009-2010</u>.

<u>SUBSIDY REQUIREMENTS</u>

As a public corporation, additional subsidies to NIW score in the Resource Budget of the parent Department, DRD.

It was envisaged that the subsidy would be minimised as receipts would be collected from customers to cover the costs of providing the service.

As a NDPB**,** full resource consumption and capital expenditure of Northern Ireland Water will score in the Department's Resource and Capital DEL in the same way as

[9] HM Treasury, *Consolidated Budgeting Guidance 2009/2010,* http://www.hm-treasury.gov.uk/d/consolidated_budgeting_guidance200910.pdf

the Department's own spending. Therefore, NIW will compete for funding with other Northern Ireland priorities.

As water charges have been postponed, this has resulted in a requirement of a £500m subsidy for 2009/2010 and 2010/2011 period. This £500m competed against other Northern Ireland priorities and will continue to do so if customer charges are further deferred.

### CAPITAL CHARGES

All public bodies must make capital charges on their assets. This is in effect a rate of return that the providers (The Government) of capital receive for the risks that they are facing.

The budgetary treatment of these charges are different for public corporations and NDPBs.

As a self financing public corporation**,** capital charges scored in Annual Managed Expenditure. [10]

This charge was offset by a means of a return from NIW in the form of a shareholder dividend and interest payment.

NIW earned an allowed return on its Regulatory Capital Value (RCV). The opening allowed real rate of return was set at 5.25%[11], consistent with Treasury and Ofwat requirements. In 2006, the Water Service was valued in the region of 6bn however, this was written down to £1bn which in effect reduced the return that NIW was required to make.

Where a parent Department cannot obtain a return from the public corporation that covers the cost of capital, the Department shall suffer a shortfall in its Resource Budget.

As a non departmental public body the treatment of this capital charge is different.

The capital asset has been retransferred back into the Department for Regional Development's books and the original capital value of £6bn has been restored. The Executive is therefore responsible for a capital charge to the Treasury which, as a NDPB, will not be recovered from NIW.

Whilst this is not a cash payment to the Treasury, it is factored into the overall Northern Ireland DEL. These capital charges amount to £400m per year and this figure will grow as NIW continues to investment in its capital. At least £400m will therefore be squeezed out of the overall NI budget on an annual basis .[12]

The Prime Minister has agreed to waiver this payment for the period 2008/09 and 2009/10 but not thereafter. Therefore, when considering further deferral of water charges both the subsidy requirements and the capital charges need to be considered.

[10] Victor Hewitt, *Correspondence with Research and Library Service, Reclassification of NIW,* 9th March 2009.
[11] Committee for Regional Development, Official Report, Review of Northern Ireland Water Strategic Business Plan, April 28th 2008. http://www.niassembly.gov.uk/regional/2007mandate/moe/080423.htm
[12] Committee for Finance and Personnel, Submission to the Executive's Strategic Stocktake of the Budget Position for 2009/10 and 2010/11, Second Report, Session 2008/09.

### Spending Authority

As a public corporation, the money gathered in from customer receipts would have been used to self finance the operations of NIW. This is not the case with a NDPB.

Where a NDPB obtains income that is not from the DEL, the parent Department may arrange for the NDPB to pass the cash to the Department for surrender to the consolidated fund. Alternatively, the cash may be retained by the NDPB and offset the NDPB's need for cash grant in aid. Either way, income that is not negative DEL does not convey spending authority.[13]

### Borrowing Capabilities

As a Public Corporation, NIW has greater access to borrowing on the open market. Guidance states that only in exceptional circumstances are NDPBs allowed to borrow any expenditure financed by borrowing will count in the Department's DEL.[14]

### Accounting

Central Government Bodies[15] such as NDPBs are required to follow the Government Financial Reporting Manual (FReM). The FReM[16] 2009-10 is the technical accounting guide that complements guidance on the handling of public funds and the preparation of financial statements.

Public Corporations, on the other hand, are not required to follow the Government Financial Reporting Manual. Public Corporations will prepare their accounts in accordance with Generally Accepted Accounting Practice in the UK (UK GAAP).

Parent Department's will agree on what basis the PC will compile its accounts and it is likely, for purposes of transparency, that these will be based on FReM requirements as HM Treasury also require that a certain degree of information is provided to maintain an audit trail for public spending and to input the data into the Whole of Government Accounts (WGA).

### VAT

The reclassification of NIW will undoubtedly impact indirectly on the level of VAT to be paid to HM Revenue & Customs (HMRC).
VAT is a complex issue and the full impact of the reclassification is yet to be determined.

The existing agreement with HMRC allows NIW to recover VAT on the basis that the subsidy currently paid on behalf of domestic customers represents third party consideration with household payments being introduced from 2009/10.[17]

DRD have confirmed that:

[13] Cabinet Office, *Public Bodies: A Guide for Departments,* http://beta.civilservice.gov.uk/about/work/codes/public-bodies.aspx
[14] AASDNI, http://www.aasdni.gov.uk/pubs/DAOs/dao2304attfmv2.doc .
[15] There are a number of exceptions to this rule such as the NHS and Foundation Trusts.
[16] http://www.financial-reporting.gov.uk/
[17] DRD DALO 164, *Status of Northern Ireland Water – Request for Briefing* – 15th December 2009.

> *Additional VAT costs could be up to £60m in 2009/10 if the existing agreement* (with HMRC) *no longer remains in place. Up to £130m would be involved if HMRC sought to recover VAT payments for 2007/08 and 2008/09.*[18]

DRD has also stated that:

> *We cannot predict what view HMRC may take on any given situation. However, we are not yet in a position to engage with HMRC until the Executive has decided on its long term approach.*[19]

## SECTION 4: GOVERNANCE AND ACCOUNTABILITY IMPLICATIONS

DFP states that in terms of governance, *public corporations are in most respects akin to an* ***Executive NDBP.***[20]

The current governance arrangements of NIW are set out below. The reclassification means that governance structures can remain largely in tact, however, the legislation and governing documents for the body would require adjustment. The detailed resource implication of such adjustments would require further consideration.

<u>LEGISLATIVE FRAMEWORK</u>
As a public corporation**:**

- NIW is a company limited by shares and created under the Companies Order (NI). All shares are owned by DRD.
- Water and Sewerage Services (NI) Order 2006 provides for the transfer of DRD assets to the GoCo; issue of a Licence setting out conditions; and defines powers of relevant bodies.
- A Memorandum of Understanding and Articles of Association set out the framework under which NIW will deliver its services.
- A Governance letter sets out principles underpinning the relationships between NIW and DRD as its only shareholder.
- The Licence sets out in considerable detail, the conditions under which NIW will provide its services (charging arrangements, schemes and limits; accounting procedures; procurement procedures; codes of practice; relations with the Regulator and Consumer Council; and asset management and land disposals)
- Legally, DRD is obliged to treat the Company in the way prescribed in the framework.

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18 *Ibid.*
19 *Ibid.*
20 DFP, *Classifying Public Bodies,* http://www.dfpni.gov.uk/classifying-public-bodies.doc

NDPB:

- Primary legislation is usually required and Parliamentary time and resources must be secured in order to implement legislation. Where the Public Body is to be funded by the sponsoring department it is likely that statutory authority will be required for new and continuing expenditure.

- New legislation or revisions to existing legislation would likely be required to avoid confusion.

ACCOUNTABILITY

Public corporation**:**

- The Minister for Regional Development is answerable to the Assembly and has overall political responsibility on the performance of the water and sewerage services and for their regulation.

- DRD and NIW are subject to the same general obligation as any other public bodies to account for themselves to the relevant committee (RD) and the Public Accounts Committee. Similarly the Assembly has the power to review any public funding provided for NIW through the regular appropriations process. NIW's shareholding may not be transferred out of Departmental control without the Assembly's approval.

- Legislation establishes the broad objectives which must be met by the Minister and NIW.

- The Articles of Association lays out a series of rules which NIW must adhere to.

- The NIW board is accountable to the DRD Shareholder Unit for delivering the SBP and efficiency improvements.

NDPB:

- Principle actors are broadly comparable in terms of accountability.

- The Minister for Regional Development would continue to be answerable to the Assembly on the performance of the water and sewerage services.

- The NDPB would be required to publish annual accounts and provide management and financial statements.[21]

- A Code of Practice and A Code of Conduct would be developed for Board Members and Staff.[22]

[21] The Cabinet, *Public Bodies: A Guide for Departments,* Ch 8 Accountability.
[22] *Ibid.*

<u>APPOINTMENTS</u>

Public Corporation

- The Minister is responsible for the appointment of the Chair and non-executive members to the NIW Board. These appointments come under the remit of the Commissioner for Public Appointments for which certain rules and regulations must be applied. The Minister has power to veto the appointments of the Chief Executive and executive directors; Board Members' terms of appointment and renumeration; and Company's Strategic Business Plan.

NDBP

- Appointments to the boards of bodies can be made by Ministers, by officials on behalf of Ministers, by the Prime Minister or the Queen on the advice of the Ministers. As above, these too come under the remit of the Commissioner for Public Appointments and the appropriate rules and regulations must be adhered to.

<u>REGULATION</u>

Public Corporation:

NIWs regulatory structure is set out in the Water and Sewerage Services Order 2006.[23] The following bodies are responsible for regulation:

- Utility regulator – technically a non-ministerial department which has responsibility for protecting the interests of water and sewerage customers with regards to price and quality of service.
- Consumer Council – safeguard interests of the consumer of water and sewerage services.
- DoE, Environment and Heritage Service – safeguard environmental compliance.
- Drinking Water Inspectorate – Quality of drinking water.
- Water Management Unit – protection of water in the environment.

NDPB:

It is unlikely that reclassification would have any impact on the bodies that regulate the existing service. Any changes to regulation would require the necessary changes in legislation.

[23] Water and Sewerage Order (Northern Ireland) 2006. http://www.opsi.gov.uk/si/si2006/20063336.htm