Note of Advice by Anderson Strathern LLP for Universities Scotland on the potential impact of the Higher Education Governance (Scotland) Bill on the current classification of Scottish higher education institutions by the Office of National Statistics as Non-Profit Institutions Serving Households

30 September 2015

Introduction

We have been instructed by Universities Scotland (“US”), in light of evidence given to the Finance Committee of the Scottish Parliament on 16 September 2015 on the Financial Memorandum to the Higher Education Governance (Scotland) Bill (“the Bill”), to provide further advice on whether the measures in the Bill, when considered cumulatively with other recent changes in legislation and policy would, if implemented, increase the risk of Scottish higher education institutions (“HEIs”) being reclassified by the Office of National Statistics (“ONS”) as falling within the General Government category (S.13) of the public sector for the purposes of the National Accounts (thus losing their current classification as Non-Profit Institutions Serving Households (NPISHs) within the private sector (S.15)).

In evidence to the Finance Committee, Scottish Government officials accepted that, in the context of a the level of risk of ONS reclassification of HEIs into the public sector, a “modicum of risk” already exists in “certain facets of the structure of university governance – financial and legal arrangements and so on”. However, they also considered that there was no additional risk presented by the Bill to the current ONS classification of HEIs as NPISHs, stating that the Bill’s provisions did not advance the existing risk base. Detailed reasons for this view and the full range of factors that ONS would consider as part of any assessment of the classification of HEIs, were not presented in oral evidence given to the Finance Committee on 16 September.

Summary of advice

Our advice is that the Bill, based on an assessment of the range of factors that ONS would consider as part of an assessment of the classification of HEIs, heightens the risk of HEIs being reclassified by the ONS as being within the General Government category. We think that, when considered cumulatively with other existing government controls over HEIs, the provisions in the Bill would take HEIs into “borderline” territory in terms of their current ONS classification, for the reasons set out in this note of advice.

Context and background

The ONS is the UK’s national statistics institution. It is the executive office of the UK Statistics Authority, which is a non-ministerial department reporting directly to the UK Parliament and the Governments of Scotland, Wales and Northern Ireland. One of ONS’s responsibilities is the collection, compilation, analysis and dissemination of a range of key economic, social and demographic statistics about the UK.
In relation to classifications, ONS will review current sector classifications in various circumstances, including where:

- new legislation, policy decisions or machinery of government changes impact on the operation of an organisation or on the flows of money to, from or within government;
- there are other changes to the operation of a body which impact on the classification decision;
- changes to Eurostat guidance mean that large or specific classification decisions must be reviewed immediately to ensure that they are still compliant;
- decisions which have sizeable impacts (more than £1bn impact on deficit or £10bn impact on debt), but where their cases that have not been reviewed for other reasons, will be reviewed after 5 years;
- for any other reason, there is a need for reassurance that nothing has changed which may impact on the classification decision.

**Forward Workplan of ONS**

ONS’s ‘Classification Update and Forward Workplan’ (September 2015) indicates that ONS will be assessing the current classification of HEIs between January and June 2016. The Workplan makes reference to an assessment to be undertaken of universities between January and June 2016. The reason for the assessment is stated in the Workplan as being a change in policy (significant increases in tuition fee maxima that can be charged by universities in England and Wales), requiring an assessment as to whether universities are ‘market’ or ‘non-market’ producers.

We understand that, although there is no specific reference to Scottish HEIs being included in the overall assessment exercise, nor have they been specifically excluded. We understand that, unless ONS is specifically instructed not to consider Scottish HEIs as part of this exercise, it is possible that Scottish HEIs could form part of the assessment, for example, in relation to rUK tuition fees. If this happens, it is possible that ONS could consider other issues relating to government controls in order to assess what their correct classification should be, or propose a separate review of Scottish HEIs for this purpose. Even if Scottish HEIs are excluded from the 2016 assessment, they could still become the focus of a future ONS assessment, e.g. as a result of how new legislation or policy affects them.


In light of the recent experience of FE colleges having been reclassified into the General Government category *en bloc*, the additional powers that the Scottish Government now seeks through the Bill to control the composition and other factors relating to HEI governing bodies (when taken together
with the existing level of government control over Scottish HEIs and the introduction of a new Eurostat framework for classification of sectors), have caused Scottish HEIs to be apprehensive about the risk of possible reclassification by ONS into the public sector and its consequences.

**Recent experience of FE Colleges**

In 2010, incorporated further education colleges in Scotland were re-classified, *en bloc*, as falling within the General Government category by ONS, having previously been classified since 1993 within the private sector, in the category of NPISHs. We understand that the requirement in section 12(7) of the 1992 Act for an incorporated college’s board of management to obtain prior written consent from the Scottish Ministers to borrow money, give any guarantee or indemnity or create any trust or security over or in respect of any of the college’s property, was a key factor in the reclassification of incorporated colleges to the public sector. We understand that control over borrowing powers was a “show-stopper” for ONS, as far as any claim for retained NPISH status was concerned in relation to FE colleges.

Other factors resulting in the re-classification of incorporated FE colleges in Scotland included the level of general control that can be exercised by government over the colleges. The re-classification did not turn simply on whether a college was publicly funded. ONS looked mainly at the issue of control, applying the criteria it had developed based on ESA 95. Examples of such control included: the power of Scottish Ministers to merge or close colleges, the power to wind-up and dissolve the board of management of colleges and Ministers’ powers in respect of composition and membership of boards of management.

The Scottish Government took a fundamentally different approach to ONS reclassification of FE colleges, following the reclassification decision in 2010, compared to the approach taken in England and Wales by the respective Governments. The Scottish Government introduced the Post-16 Education (Scotland) Bill, which was enacted in 2013. The 2013 Act increased the level of government control over Scottish FE colleges, as well as Scottish Universities. In contrast, the UK Government passed the Education Act 2011, which changed the relationship between central government and English FE colleges, for example, in relation to borrowing powers. The 2011 Act resulted in English FE colleges being restored to their former classification as NPISHs by ONS. In restoring the classification of NPISH to English FE colleges, the ONS stated:

> “Following the decision to classify Further Education Colleges in the general government sector in 2010, the UK Government has passed new legislation removing public sector controls over the Further Education Colleges in England. The Education Act 2011 received Royal Assent on 15 November 2011. Schedule 12 to the Act entitled ‘Further Education Institutions – Amendments’, is the key section of the legislation. It amends both the Further and Higher Education Act 1992 and the Apprentice, Skills, Children and Learning Act 2009 in respect of the powers held by the public sector in England over Further Education Corporations and Sixth Form College Corporations.

> One of the main changes removes the requirement for Further Education Corporations in England and Sixth Form College Corporations to gain the consent of the relevant government body for any borrowing they wish to undertake. The Act also removed a number of other public sector controls over further education institutions. The Secretary of State’s right to modify, revoke or replace the instruments and articles of Further Education Corporations in England has been removed and the
power to do so given to the colleges themselves. The right of the Secretary of State to dissolve a Further education college has been removed.

The power of the Chief Executive of Skills Funding to appoint up to two additional members of the governing body of a FE corporation has been removed, as have the corresponding powers for the relevant local authority in respect of Sixth Form College Corporations. ...

Having carefully considered the changes in the Act, ONS has concluded that the changes are sufficient to remove the public sector control of general corporate policy of FECs and SFCCs in England, resulting in their reclassification outside of the public sector.”

In light of the ONS reclassification of Welsh FE colleges, the Welsh Assembly Government issued a White Paper in 2012 on a Further and Higher Education Bill to change the relationship between Welsh FE colleges and central government. Four key areas were considered to be indicative of central government control and therefore highlighted as needing to be amended:

- the level of autonomy for colleges, including powers to make changes to their own Instruments and Articles of Government;
- the ability of a college to dissolve itself;
- the requirement for colleges to obtain Government consent to borrow funds;
- the level of operational intervention by central government.

Other issues to be addressed were the composition of governing bodies and areas where Ministerial consent was required in respect of governance.

Following the passage of the Further and Higher Education (Governance and Information) (Wales) Act 2014, which removed a wide range of restrictions and controls on FE colleges, the ONS decided to reclassify Welsh FE colleges as NPISHs within the private sector, with effect from 27 January 2015.

**Current ONS classification framework**

The ONS moved to the new European System of Accounts 2010 in September 2014 and this has now become the basis for the UK’s National Accounts, replacing ESA 95. ESA 2010 provides a framework for the classification of sectors by ONS, by allocating ‘institutional units’ to different sectors. The main sectors are: households, government, corporations (financial and non-financial), non-profit institutions serving households and the “rest of the world”. ESA 2010 is based largely on the concepts set out in SNA 2008, which provides guidelines for national accounts worldwide.

Classifications by ONS are made by assessing “institutional units” against a range of criteria set out in ESA 2010, as supplemented by the ‘Manual on Government Deficit and Debt: Implementation of ESA 2010’ (“MGDD”), (Eurostat, 2014 Edition). HEIs are institutional units for the purposes of ESA 2010 and the public sector consists of all the institutional units that are resident within that economy and controlled by government; whereas the private sector consists of all other resident units (para 1.35, ESA 2010).

ESA 2010 (para 1.36) defines control over an entity as “the ability to determine the general policy or programme of an institutional unit”. MGDD, section 1.2.2, page 12, para 7, states that: “It must be stressed that the ESA 2010 classification criteria are not based on the legal form of an entity. For some entities it may be concluded that they do not have the required autonomy of decision, which is
not automatically evidenced by their legal status”. MGDD I.2.3, page 13, provides that: “10. The
degree of control on an institutional unit by government...would determine whether this
institutional unit is part of the public sector.”

It is considered that the level of government control of Scottish HEIs should be assessed not only in
relation to control by Scottish Ministers, but also control by other government bodies such the
Scottish Funding Council, given the status of SFC and its range of statutory functions. ESA 2010
20.309 provides that “Control of a resident public sector unit .... can be through the direct rights of a
single public sector unit or the collective rights of many”.

ESA 2010 and MGDD contain specific criteria for the assessment of whether a non-profit institution,
such as a University, falls to be classified within the public sector. If ONS assessed the current
classification of Scottish HEIs and whether they should be classified to the public sector, it is
understood that ONS would consider the five indicators of control listed in para. 2.39 of ESA 2010
(for NPIs recognised as independent legal entities – see extract below), together with the relevant
parts of section I.2 of the MGDD (‘Criteria for classifying units to the general government sector’).

“2.39 For non-profit institutions recognised as independent legal entities, the five indicators of
control are:

(a) the appointment of officers;
(b) the provisions of enabling instruments
(c) contractual agreements;
(d) the degree of financing;
(e) the degree of government risk exposure.”

MGDD, section I.2.3, (page 16) contains the following guidance:

“15. The notion of control is also applicable to non-profit institutions which might have different
features and different importance (in terms of size, effect on net lending/borrowing (B.9) and debt,
etc.) among EU Member States and may have an activity to the benefit of different kinds of agents.

16. Similarly to the case of corporates (and equivalent entities), control of an NPI covers the ability to determine the general policy or programme of the NPI. However, here, there is a
significant difference between market and non-market NPIs, determined according to the criteria
below in subjection I.2.4.3 on the quantitative market/non-market test.

17. NPIs controlled by government, and considered market producers (for instance because they
sell services to corporations or to households, at economically significant prices) are classified in the
sector non-financial corporations S.11. On the contrary, ESA 2010 20.13 states that “NPIs that are
non-market producers, and are controlled by government units, are units of the general government sector”. “
Concerning control of NPIs, ESA 2010 20.15 also states that “Control of a NPI is defined as the ability to determine the general policy or programme of the NPI”. It restates the five criteria of control that should be considered in determining whether an NPI is controlled by government:

“(a) the appointment of officers;
(b) other provisions of the enabling instrument, such as the obligations in the statute of the NPI;
(c) contractual agreements;
(d) degree of financing;
(e) risk exposure.”

It states that: “A single indicator can be sufficient to establish control. However, if a NPI that is mainly financed by government remains able to determine its policy or programme to a significant extent along the lines mentioned in other indicators, then it would not be considered as being controlled by government. In most cases, a number of indicators will collectively indicate control. A decision based on these indicators will be judgmental in nature”.

MGDD (2014), pages 16 – 17, provides further commentary on each of these five criteria, as follows:

“a. The appointment of officers

The government may have the right to appoint the officers managing the NPI either under the NPI’s constitution, its articles of association or other enabling instrument.

b. Other provisions of the enabling instrument

On this point, 2008 SNA 4.92 is more explicit than ESA 2010. Notably, if statutorily the functions, objectives and operating provisions are already determined by government, the appointment of officers would become of secondary importance. But control by government would result if government would have the right to revoke staff and to approve budget or financial arrangements. An NPI would be considered to be controlled by government if approval of government would be required to change the statute of the entity (or the type of activity carried out by the entity), or if the entity could not dissolve itself or terminate any relation with government without such approval.

c. Contractual agreements

Some NPIs may enter into contracts with government units in order to perform tasks defined by government, acting as a specialised operator, notably in social areas. When such contracts are the main, if not total, part of the activity of the NPI, it is clear that government would be able to influence the general policy of the NPI. However, control should be assessed if the approval of government would be required for exiting from contracts with government.

d. Degree of financing

Although ESA 2010 20.15 does not specify exactly which should be the degree of financing, 2008 SNA (4.92) indicates that an NPI that is mainly financed by government may be controlled by
government. “Mainly” must be as at least over 50%. The control would be assessed if such financing would be permanent (and not on a temporary basis) and/or it would result in a narrow monitoring of the use of the funds and a strong influence from government on the general policy of the entity.

e. Risk exposure

This indicator is not developed in ESA 2010 but 2008 SNA (4.92) evokes government “exposed to all, or a large proportion of, the financial risks associated with an NPI’s activities”. In this case, the arrangement would constitute government control. Financial risks refers to ex-ante commitments taken by government on some liabilities incurred by the NPI, on possible disruptions of other sources of revenue apart from those received from government, etc.

18. ESA 2010 specifies that, in some cases, one indicator can be sufficient to establish control, but also that it is most frequently necessary to consider collectively a number of indicators and a case-by-case analysis may be frequently needed. In any case, a decisive point is the ability of the NPI to determine by itself or not its general policy.”

MGDD, I.2.3, makes special mention in paragraph 19 on page 17 of control of educational units:

“Control of educational units

“19. Many educational units (schools, colleges, vocational training, universities, etc.) are non-profit institutions and are generally largely funded by government. They represent a practical example for applying the ESA 2010 control criteria mentioned in the paragraph above. Most of them are financed by government funds above 50%, since other sources, such as fees paid by parents or students or gifts, appear frequently as a minority source of funding. In some countries, government (at different levels) may take over directly some expenditure, such as teachers’ salaries or building maintenance.

20. As a matter of principle, the mere financing of the educational unit should not be, as such, a determining criterion in classifying government-supported educational units. It is likely that government exerts some influence on the use of its funds. However, if government influence only takes the form of the respect of standards (concerning teaching programmes, the quality of education, material conditions, teachers’ competences, etc.) which are imposed on any educational unit independent of its statute, then it is not control. It is also frequent that different kinds of schools (government units, private NPIs, etc.) are part of the education system. Thus the application of similar standards or norms, to a large number of units, seems to be an important feature in the case of such NPIs.

21. This must be distinguished from direct involvement of government in significant decisions relating to the school. By application of the general rule, if government appoints the managers (or approves their appointment or holds a revocation right) or gives instructions related to the everyday management of the school, thus leaving restricted decision-making capacity to educational unit’s officers, the unit should be classified in the general government sector. Under these conditions, government is deemed to control such a unit if its approval is needed to create new classes or to specialise in some teaching areas, make significant expenditure in gross fixed capital formation
(which could be mainly financed by government), borrow, recruit teachers, or if it can prevent the educational unit from ending its relationship with government."

The guidance produced by HM Treasury in 2013 entitled ‘Class (2013) 1: Sector Classification’ ("HMT Guidance"), although referring to classifications that were made under ESA 95, still contains useful explanatory material in relation to the concept of control by government. The HMT Guidance at Annex B (ONS sector classification criteria), provides a list 14 key areas of secondary controls that were used in previous ONS assessments under ESA 95. These include, amongst other things, a power to determine aspects of how a body delivers its outputs, a power to change the constitution of the body, or veto changes to it, deciding or limiting what financial transactions a body can undertake, exerting numerous minor controls over how a body is run and setting pay rates. Although ESA 2010 will be applied to any assessment of HEIs, it is understood that the concept of control in ESA 2010, compared with ESA 95, has not been substantively redefined. A full list of the 14 criteria referred to in the HMT Guidance is provided in Annex B to this note of advice, for information.

Main areas of risk to current ONS classification of HEIs as NPISHs

The following sections of this note of advice identify key areas of risk in terms of HEIs moving in the direction of meeting criteria contained in ESA 2010 for classification within the General Government sector, although they are not the only mechanisms for government control over HEIs.

Higher Education Governance (Scotland) Bill ("the Bill")

The current Bill, as introduced in Parliament on 16 June 2015, seeks to give Scottish Ministers a number of additional powers over the governance of HEIs:

Section 1 provides a power for the Scottish Ministers to make regulations to govern the process for appointment of a chairing member of a governing body of an HEI, including making provision for periods of appointment and re-appointment, means of selection for appointment, e.g. public advertisement, criteria for selection, interview of candidates, shortlisting of candidates, the holding of an election for candidates and the reimbursement of candidates’ expenses incurred in the process.

Section 2 contains a power for the Scottish Ministers to make regulations for the remuneration and payment of allowances by HEIs to the chairing members of their governing bodies, including specifying or limiting the circumstances in which sums may be offered, requiring “reasonable” sums to be given to the chairing member and delegating to other persons the function of determining sums in particular cases.

Although section 3 requires the Scottish Ministers to consult with HEIs and “such other persons” as Ministers think appropriate before making such regulations under sections 1 and 2, this is merely a duty to consult and there is no requirement on Ministers to follow any particular option put forward in response to such consultations. Although the regulations are to be made under the affirmative procedure in Parliament, this is not necessarily going to act as a particularly strong check on Ministers’ powers, in circumstances where the Scottish Government has an absolute majority in Parliament and can use its ‘whipping’ power to obtain positive approval for secondary legislation.
Section 4 of the Bill prescribes the composition of the governing bodies of all Scottish HEIs, by reference to categories of membership (including numerical representation). Section 8 of the Bill gives the Scottish Ministers a power to use regulations to modify the number of persons in a particular category to be appointed to a governing body. It also gives the Ministers a power to use regulations to modify the actual categories of membership. It would appear possible for Ministers to use this power to delete the current categories specified in section 4(1)(g)(i) or (ii), for example, to exclude existing categories of member from future governing bodies, including those provided for in each HEI’s own Instrument of Government, e.g Order of Council, an Ordinance, an Act of Parliament or a Charter.

It would also appear possible for regulations made under section 8 to express categories in very narrow terms. A category with very few people falling within it could, in theory, be added to the section 4 list, to the point of effectively specifying certain persons as members of a governing body. Although it is understood that the current Scottish Government does not intend to use the power in this way, this does not in any way restrict the possible use of this broad power by a future Government, who might not feel bound by a previous Government’s policy commitment in relation to the use of this clearly worded statutory power.

There are no restrictions in the Bill on how these powers to prescribe composition and modify section 4 are to be used, other than making them subject to the affirmative resolution procedure, which is not considered to be a particularly strong check. These are therefore significant powers for Ministers in relation to the control of the composition and membership of the governing bodies of HEIs.

Section 9 of the Bill places a numerical limit on the overall composition of the academic boards of HEIs and section 10 prescribes the composition of the academic board, placing percentage restrictions on certain categories of members. Section 13 gives the Scottish Ministers powers to modify sections 9 and 10, which are to be exercised by regulations. The same issues arise in relation to government control through the exercise of these powers and the lack of effective checks on the powers, as arise in connection with the powers of Ministers under sections 4 and 8.

The Bill makes direct amendments to the constitutional documents of the ancient Universities (see schedule 2 as introduced by section 21 of the Bill). It also gives Scottish Ministers regulation-making powers (sections 1, 2, 8, 13) to impose requirements in relation to appointments, remuneration and composition of governing bodies and composition of academic boards/senates.

The regulation making power in section 8 of the Bill would allow Ministers to remove the current provision in section 4(1)(g)(ii) of the Bill which currently retains as members of the governing body those persons who are appointed in accordance with the governing document of each HEI. Use of the power in this way could result in a governing body being appointed entirely in accordance with the composition set out in section 4(1) of the Bill, with no reference to the constitutional document of each HEI. This would force each HEI to amend their own constitutional documents to reflect this change. The same issue arises in relation to the power in section 13 of the Bill to modify the categories in section 10(1) of the Bill in relation to the academic council/senate.

At paragraph 3.31 of the HMT Guidance of 2013, it is noted that control is evidenced by the ability to control, not just by the action of controlling (with the exception perhaps of ‘step in’ powers in the
event of a failing institution). The HMT Guidance provides that, where a department has a continuing right to exercise overall control but chooses not to do so, that still amounts to control. The power of government to change the constitution of a body, or veto changes to it, is considered to be an indicator of secondary control. In this context, the provisions contained within the HMT Guidance suggest that these regulation-making powers would be considered as indicators of control by ONS.

Although Ministers are currently involved in the Privy Council process for HEIs to change their constitutions in relation to a range of matters and have an existing power to legislate directly to change the constitutional documents of some HEIs, the regulation-making powers in the Bill will mean that, each time they are used, HEIs will be required to consider the contents of their own constitutional documents and amend them to ensure that they are consistent with the Bill and other requirements placed upon them by government. For example, if regulations are made to change numerical requirements for categories on a governing body, in a way that increases the number of prescribed members on a governing body, HEIs may require to revised their own documents to avoid being in breach of the Scottish Code of Good HE Governance’s stipulated maximum membership of 25 persons on a governing body, which is a condition of grant funding.

**Existing areas of government control over Scottish HEIs**

The following paragraphs consider the extent to which HEIs are subject to a range of existing controls by government by reference to a number of sources of control, although not every single power of government over HEIs in considered.

**Further and Higher Education (Scotland) Act 1992**

Section 47 of the 1992 Act gives the Scottish Ministers a power from them to make an order to close any designated institution, to wind-up the governing body of an institution and to dissolve the governing body of the institution. However, if section 47 forms part of the “constitution” of a designated institution (in terms of section 106 of the Charities and Trustee Investment (Scotland) Act 2005), such an order requires the consent of the institution’s governing body. Nonetheless, the power to make the relevant order in relation to the closure, winding up and dissolution, even if some delegation of functions is included in the order, still rests with the Scottish Ministers. Such a power appears to coincide with one of the secondary indicators of control included in the HMT Guidance of 2013 (“power to close a body”).

**Scottish Funding Council (“SFC”) Financial Memorandum**

The SFC is a Non-Departmental Public Body of the Scottish Government performing statutory functions under the Further and Higher Education (Scotland) Act 2005 (“the 2005 Act”). The SFC allocates and pays grant to HEIs in accordance with published policies and procedures.

Under the 2005 Act, the SFC has a power to attach terms and conditions to the payment of grant to HEIs and it is a term and condition of grant payment from the SFC that all HEIs must comply with the requirements set out in the ‘Financial Memorandum with Higher Education Institutions’ (“FM”). If there is any disagreement between any HEI and the SFC about the interpretation of the FM, the decision of the SFC is final. Some examples of the requirements with which HEIs must comply under the FM are given below, although this is not an exhaustive list.
The FM requires HEIs to comply with the principles of good governance set out in the Scottish Code of Good HE Governance and to ensure that public funds are used in accordance with relevant legislation. This is a term and condition of grant payment.

The FM requires HEIs to keep under review and make statutory provision for the list of matters specified in section 7(2) of the 2005 Act which relate to the governance, management and operation of HEIs. There are currently 11 items listed under section 7(2), with some further sub-divisions within each item. The Scottish Ministers have a power under section 7 to modify the list of items in section 7(2) and to issue guidance in relation to listed items. That power is exercisable by way of the annulment procedure for secondary legislation in the Scottish Parliament. It is therefore a term and condition of grant for HEIs to keep under review and make statutory provision for the matters listed in section 7(2), as amended by the Scottish Ministers from time to time.

When making payments to an HEI for strategic, capital or other grant, the SFC can attach additional requirements to the grant and it is a term and condition of grant for the HEI to comply with those additional requirements, as well as complying with the FM.

HEIs must have regard to public sector pay policy set by the Scottish Government. This is a term and condition of grant.

SFC has its own Framework Document with the Scottish Government, which includes requirements placed on SFC by SG in relation to monitoring and control of borrowing by HEIs. To enable it to meet this requirement, the SFC’s FM has placed a threshold for capital finance by HEIs, above which an HEI requires specific SFC consent to undertake any new borrowing. ‘Capital finance’ in this context includes borrowing, finance and operating leases, PFI projects, non-profit distribution projects, loan support projects and revolving credit facilities where borrowing is the substance of the transaction, and other such schemes.

In addition to complying with all the requirements in relation to capital finance in the Scottish Code, each HEI must obtain prior written consent from SFC before it undertakes a level of capital finance where the annualised costs of all capital finance would exceed 4% of either the total income (as per the latest audited financial statements of the HEI) or the estimated amount of total income for the current year, if that is a lower figure. Each HEI must also seek consent from SFC before raising capital finance on the security of assets in which the Scottish Ministers have “an interest”, as defined in the FM.

HEIs must seek the prior written consent of SFC if they intend to offer as security for a loan, any land or property which has been provided, improved or maintained with the aid of SFC grant. HEIs must also seek SFC’s prior written consent if they intend to lend or give a guarantee, indemnity or letter of comfort.

If HEIs do not comply with the FM’s requirements, and with other specific terms and conditions of grant from SFC, they may be required to repay sums to the SFC, with interest. The SFC’s FM is therefore considered to be a secondary indicator of strong government control in some key areas of HEI governance, management and operations. In this context, it is noted that ESA 2010 20.309 (‘Public sector control’) provides that: “(g)... If an entity requires permission from the public sector to borrow, then this is an indicator of control” and “(i) ...An entity that is fully, or close to fully,
financed by the public sector is considered to be controlled if the controls on that funding stream are restrictive enough to dictate the general policy in that area”.

**The Scottish Code of Good HE Governance**

Section 2 of the Post-16 Education (Scotland) Act 2013 (“the 2013 Act”) inserted a new section 9A into the Further and Higher Education (Scotland) Act 2005 (“the 2005 Act”), in the following terms:

“9A Higher education institutions: good governance

The Scottish Ministers may, under section 9(2), impose a condition that the Council must, when making a payment to a higher education institution under section 12(1), require the institution to comply with any principles of governance which appear to the Council to constitute good practice in relation to higher education institutions”.

In this context and, as already noted, the SFC’s FM requires HEIs to comply with the main principles of the Scottish Code of Good HE Governance and to observe the guidelines contained within the Code. The Code itself from July 2013 notes that it has been written so that “exemptions will be rare”. The Code states that “Where universities have a material reason for being unable to comply, they must explain why”.

The 18 main principles of the Code cover requirements in relation to: the discharge of functions and compliance with legal obligations by each HEI’s governing body, the conduct of members of a governing body, the frequency of meetings of the governing body and attendance and active participation at those meetings, the adoption and publication of a Statement of Primary Responsibilities covering a range of duties, a duty on members to exercise their responsibilities in the interests of the HEI as a whole rather than a particular constituency, the responsibilities of the Chair of the governing body of the HEI, the responsibilities of the University Principal, the need for a balance of skills amongst governing body members, a requirement for a lay majority of governing body members, principles in relation to the appointment of the Chair of the governing body including the role of a nominations committee, induction of the Chair and governing body members, the responsibilities of the Secretary of the University, the conduct of meetings, remuneration and review of salaries, effectiveness of governing bodies and their committees, the annual review of long-term strategic objectives and the use of short-term Key Performance Indicators.

The Supporting Guidelines in the Code contain more detailed information about how the 18 main principles can be adhered to and contain some prescriptive measures, including specific provisions relating to the composition of governing bodies. On its own, the Code might not appear to be a particularly strong form of government control, particularly given that it was produced by a Steering Group drawn from the HE sector itself. However, when combined with the FM and the condition of grant provisions under section 9A of the 2005 Act, it enables an enhanced level of control to be applied to HEIs in relation to compliance with the adopted Code. It also leaves scope for a significant degree of operational intervention in the affairs of HEIs, beyond the level of current intervention.

**Outcome Agreements and Strategic Plans**

The HMT Guidance of 2013, referred to above, notes that, when providing funding to a body, for example, in the form of a grant, it is good practice for a department to include enough conditions on
the use of the funding to ensure that it is spent as intended. However, the Guidance also notes that, if the conditions on the funding stream are restrictive, to allow the public sector control over the wider policy of the body, then this would form control. The Guidance gives a common example of control as being a requirement for public sector sign off over the grant recipient’s business plan. It considers that ONS would see this as a powerful control, as it allows the public sector to influence the course of the general policy of the body, or potentially how the entity decides to deliver its services or outputs.

Although neither the Scottish Ministers nor the SFC require HEIs to submit their business plans or strategic plans to them for approval, recent changes now require each HEI to agree, and to deliver on, an individual Outcome Agreement with the SFC. Under the SFC’s FM, the requirements placed on HEIs in relation to Outcome Agreements are a term and condition of grant.

Outcome Agreements are understood to have been introduced by the SFC for HEIs in AY 2012-13. The most recent SFC Guidance on Outcome Agreements (‘University Outcome Agreement Guidance for AY 2014-15 to 2016-17: Refresh’, 11 September 2015), issued to HEI Principals, states that Outcome Agreements: “are intended to help Scottish higher education institutions demonstrate their contribution to the Scottish Government’s priorities as set out in the Scottish Economic Strategy and annual Programme for Government. Outcome Agreements have become a powerful tool in demonstrating what universities deliver in return for public investment. They can help:

- Individual universities to show how they are fulfilling Scottish Government priorities.
- The overall university sector to improve its contribution towards Scottish Government priorities.
- SFC to fund the university sector in ways that support the different missions of diverse, autonomous institutions.”

The SFC Guidance on Outcome Agreements also notes that the Guidance will be substantially revised at the end of the current 3 year Outcome Agreement cycle, to: “reflect the SFC’s new Strategic Plan, recommendations from the Commission on Widening Access and any other modifications in Scottish Government and SFC priorities.” This suggests that the Guidance draws heavily on government priorities in terms of its overall content.

Section 3 of the 2013 Act inserted a new section 9C (Widening access to fundable higher education) into the 2005 Act, giving the Scottish Ministers a power to impose terms and conditions for the purposes of enabling, encouraging or increasing participation in fundable higher education. This includes a power to impose a condition that the SFC, when making a payment to a HEI under section 12(1) of the 2005 Act, would require the HEI to comply with a widening access agreement dealing with representation of particular socio-economic groups in fundable higher education.

Although Outcome Agreements (and Widening Access Agreements) are not business plans or strategic plans, they appear to be closely related to these, by linking in to each HEI’s own vision, mission and strategic objectives. Outcome Agreements are to be negotiated between HEIs and the SFC. The recent SFC Guidance of September 2015 notes that an Outcome Agreement “should align with an institution’s strategy so that it enables the institution to negotiate its contribution toward sector level impacts according to its priorities and strengths”. So, just as an HEI’s strategic plan will
inform some of the content of an Outcome Agreement, so consideration of what is to be included in an Outcome Agreement with the SFC could be expected to inform some of the content of an HEI’s strategic plan. This suggests that the public sector influences the course of the general policy of an HEI, as expressed in its Outcome Agreement and Strategic Plan; and also in relation to how each HEI decides to deliver its services or outputs.

**Existing government control over changes to Instruments of Government**

As already stated earlier in this note of advice, ESA 2015 at 20.15 sets out 5 particular criteria to be considered in relation to the classification of NPIs. These criteria include: “(b) other provisions of the enabling instrument, such as the obligations in the statute of the NPI”. MGDD (2014) develops this further, noting that, according to 2008 SNA (4.92), “an NPI would be considered to be controlled by government if approval of government would be required to change the statute of the entity (or the type of activity carried out by the entity)...”.


These Instruments of Government set out the main functions of the governing body of an institution in pursuit of its objects, in setting the overall strategic direction of the institution, managing its finances, setting its estates strategy, managing its human resources (including staff remuneration levels) and ensuring that robust and appropriate management structures and audit processes are in place.

Without going into detail here about the different procedures for amending Instruments of Government, which has been the subject of previous advice, each of the different procedures for changing the Instruments of Government for the Ancient, Chartered and Post-92 universities/HEIs entail some element of approval by government, with government in some form (e.g. the Privy Council, Her Majesty in Council, the Scottish Ministers and, for ancient universities, the Scottish Universities Committee) having a key “say”. It is understood that, when the Privy Council is considering proposed changes to the Instruments of Government of Scottish HEIs, it will not do anything that its advisers do not agree with and its “advisers” in this context are the Scottish Ministers and/or their officials.

On some occasions, the changes being made are actually a direct or indirect result of a requirement by government for HEIs to change their Instruments of Government. For example, in the last couple of years, some HEIs have been required to go through the Privy Council process to amend governance documents to meet the requirements of the Scottish Code concerning the recruitment of governing body chairs. They may need to go back to the Privy Council shortly to change their governing documents again, if the Bill is enacted. The current arrangements appear to correspond with the terms of category (b) of ESA 2015 at 20.15 as an indicator of government control.
Conclusion

Having considered the impact of the increased government control that the Bill will bring in relation to Scottish HEIs, and in the context of the other sources of government control that currently exist in relation to Scottish HEIs, we consider that the Bill brings HEIs closer to a possible reclassification by ONS into the public sector as NPIs.

We note that the HMT Guidance from 2013 states that, when considering the classification of a body, ONS will look at all controls, major and minor, and decide whether they add up to control.

The cumulative effect in relation to the elements of government control over Scottish HEIs includes the effect of a proposed increase in government control over HEIs’ Instruments of Government and the composition of their governing bodies through the current Bill, control through existing legislation governing HEIs and the processes for changing their Instruments of Government, regulation and control through the SFC’s Financial Memorandum, control through Outcome Agreements and the level of operational control through the Scottish Code of Good HE Governance.

As a result of this cumulative effect, Scottish HEIs appear to be moving into “borderline” territory in terms of whether they can retain their private sector categorisation as NPISHs for the purposes of the National Accounts. It is understood that this “borderline” territory is an uncomfortable place for HEIs, because of the major ramifications that would follow any ONS reclassification of HEIs to the public sector.

It is considered that, if the ONS carried out an assessment in the near future to ascertain whether HEIs are still correctly classified as NPISHs, or whether they should now to be classified as NPIs within the public sector, the challenges posed to HEIs by such an assessment exercise should appear at the level of ‘significant risk’ on their risk registers.

Anderson Strathern LLP
30 September 2015
Annex A

MGDD I.2 – Current criteria to determine public sector control (not specific to NPIs)

For information, the MGDD at section I.2, in addition to specifying criteria for classification of NPIs with the public sector, highlights the following criteria as being sufficient, individually, to determine government control of an institutional unit:

1. Rights to appoint, remove, approve or veto a majority of officers, board of directors, etc.
2. Rights to appoint, veto or remove a majority of appointments for key committees (or sub-committees) of the entity having a decisive role on key factors of its general policy
3. Ownership of the majority of the voting interest.

Where the criteria of control listed above are inconclusive, further criteria are to be considered, on a case-by-case basis. ESA 2010 (para. 20.310) specifies that a “number of separate indicators may collectively indicate control” and that each classification case needs to be judged on its own merits by the ONS.

MGDD I.2.3 (page 14 at para. 14) notes that: “there may be cases where one single and important criterion is sufficient in this regard. As a result, a unit which does not meet the above-mentioned criteria of control (even if in majority privately-owned) could still be included in the public sector”.

The “separate indicators” cited in ESA 2010 are:

4. Rights to appoint, veto or remove key personnel
5. Rights under special shares and options
6. Rights to control via contractual agreements
7. Rights to control from agreements/permission to borrow
8. Control via excessive regulation
9. Others, e.g. approval for some important decisions, e.g. mergers, dissolution, changing statute.
Annex B

ONS sector classification criteria (extracted from HMT Guidance of 2013, Annex B)

The following criteria were previously used by the ONS to decide whether or not an entity should be classified to the public sector.

**Governance controls – primary indicators of control**

Does the public sector:

- have the right to appoint the majority of the board or has veto rights; or
- own the majority of the voting shares of the organisation?

**14 key areas indicating secondary control**

Can the public sector:

1. determine aspects of how the body delivers its outputs;
2. have a final say in sale/acquisition of fixed assets;
3. take a share of proceeds of asset disposals that goes beyond the repayment of previous government support for capital formation;
4. close the body;
5. prevent the body from ending its relationship with the public sector;
6. veto any takeover (except in the case of a conventional share);
7. change the constitution of the body, or veto changes to it;
8. decide what sort of financial transactions the body can undertake, or limit them;
9. prevent the body from receiving certain types of income from other sources;
10. exert numerous minor controls over how the body is run;
11. exert financial control (N.B. this is different from funding) as part of a general system of controlling public expenditure;
12. control dividend policy;
13. set pay rates; or
14. approve acquisitions.