

## **Accounting Guidance on separating payments under service concession arrangements**

### **Introduction**

This guidance is produced to assist departments and others who are within the scope of the FReM with the application of the estimation technique in situations where the Unitary Payment in a service concession arrangement is not separable. Section 6.2.57 of the FReM requires the grantor to separate out the service, interest and infrastructure elements.

### **Separating the Unitary Payment in a service concession arrangement**

If the payment elements under the service concession arrangement are not readily separable then those elements will need to be estimated. FReM 6.2.58 refers to two methods by which this could be achieved:

- (a) estimate based on fair value of the property
- (b) obtain the information from the operator

For the purpose of this guidance the focus will be on the fair value approach (a). The Unitary Payment specified in the contract should be separated at the inception of the contract on the basis of fair value. The payment should be separated into (a) repayment of the capital element, (b) interest expense on it and (c) the remainder should reflect the service charge.

### **Fair Value Approach**

In situations where it is not possible to separate payments between different elements in service concession arrangements, the grantor should use the guidance provided in IAS 16 Property, Plant and Equipment as a basis for obtaining fair value. IAS 16 Property, Plant and Equipment states that fair value of land and buildings is usually determined from market based evidence normally undertaken by qualified valuers (IAS 16, paragraph 32). Where there is no market-based evidence of fair value because of the specialist nature of the infrastructure, the FReM requires that a depreciated replacement cost approach be used.

The following example illustrates the application of the fair value approach:

### **Illustrative example**

#### **Background**

A government department enters into a 20-year service concession arrangement for office accommodation. Under the arrangement, the operator will design, build, finance and operate (DBFO) the property. It is assumed that the asset will come into use from April 2009. The property reverts to the grantor at the end of the service concession arrangement. The building is expected to have a useful life of 60 years.

The grantor has contractual obligations to make an annual payment of £2 million each year plus a fixed inflation of 4% over the service concession period. The annual payment includes capital, interest and service elements. The fair value of the property is £16 million on 1 April 2009. For the purpose of this example, it has not been revalued.

The property is not a specialist asset and the fair value was obtained using the market-based approach by a professionally qualified valuer.

### Solution

Based on the information provided above, the accounting treatment would result in the entries shown in the table below for the Operating Cost Statement (Statement of Comprehensive Net Expenditure from 2010/11) and Statement of Financial Position for the years 2009-10 and 2010-11. Details of the workings follow the table.

<b>Operating Cost Statement (Statement of Comprehensive Net Expenditure from 2010/11)</b>		
	Mar-11	Mar-10
Depreciation Charge	266,667	266,667
Finance Charge	1,188,227	1,216,000
Service Charge	498,570	418,570
<b>Total Charge</b>	<b>1,953,464</b>	<b>1,901,236</b>
<b>Statement of Financial Position</b>		
	Mar-11	Mar-10
<b>Non Current Assets:</b>		
Property, Plant and Equipment	15,466,667	15,733,333
<b>Amounts falling due after more than one year</b>		
PFI contract	<b>15,241,367</b>	<b>15,634,570</b>
Notes to the accounts		
<b>Commitments under PFI contracts</b>		
<b>Total obligations under on-balance sheet PFI contracts comprises:</b>	Mar-11	Mar-10
Expiry within 16 to 20 years	55,476,157	57,556,157
<i>Less</i> interest element	13,224,380	14,412,608
	<b>42,251,777</b>	<b>43,143,550</b>

## Calculating the capital repayment and finance charge

The combined capital repayment and finance charge is calculated by using the cost of capital rate of 7.6 %, which is calculated as follow:

r cost of capital = 3.5%

r inflation rate = 4% (CPI)

Cost of capital = (cost of capital x inflation rate)

Using the information given above, the rate is calculated as follow:

$$1.0350 \% \times 1.04 = 7.64 \text{ (rounded to 7.6\%)}$$

The inflation rate can be obtained from HM Treasury's Pocket Data Bank, table 16 which is also available on the FReM website. For the purpose of this example it is assumed that the cost of capital on 1 April 2009 is 3.5% and the inflation rate is 4 %.

The interest charge is therefore £1,216,000 (7.6 % x £16,000,000) the capital repayment is £ 365,430.38 (£1,581,430 (total repayment for the year), less £1,216,000 (the imputed interest charge for the year)).

The analysis between the capital repayment and the finance charge will be made each year until the end of the contract. The spreadsheet (PFI example workings) showing the detailed workings shows how the interest charge and the capital repayment will change because the liability will reduce each year.

It is also possible to use the PMT functions in excel to calculate the capital repayment and finance charge. Using this function we can work out the payment amount for a loan based on an interest rate and a constant payment schedule. The syntax for the PMT function is:

PMT (interest\_rate, number\_payments, PV, FV, Type)

Interest\_rate is the interest rate for the loan

Number\_payments is the number of payments for the loan

PV is the present value or principal of the loan

FV optional. It is the future value or the loan amount outstanding after all payments have been made

Type is optional. It indicates when the payments are due (for the purpose of this calculation, it is assumed that the payment is made at the end of the year).

Using the above example, it returns the yearly payment of £1,581,430 on a £16,000,000 loan at an annual interest rate of 7.6%. This calculation is shown on the spreadsheet.

### **Service Charge**

The service charge is the remainder of the total Unitary Payment and the combined annual capital repayment and interest charge. For 2009/10, this is £2,000,000 - £1,581,430 = £418,570.

### **Depreciation**

This is calculated by dividing £16 million into 60 years, which is the useful economic life of the building.