BRIEFING PAPER: PFI SCHEMES AND IFRS 16

Merseyside Waste Disposal Authority - June 2025

Introduction

IFRS 16 is the new accounting standard for leases, which local authorities must adopt by 1st April 2024 at the latest. Private Finance Initiative (PFI) schemes involve the authority paying for the use of fixed assets on a long-term contract and these are therefore accounted for as leases. The payments under a PFI contract are a "unitary charge" that typically covers the costs of building, financing, maintaining and operating the assets and increases with inflation each year. The operator's financial model, supplied when bidding for the contract, is used to separate the unitary charge into service, lifecycle maintenance and lease elements.

Under the old accounting standard, local authorities hold a lease liability on their balance sheet reflecting their obligation to pay for the assets, based on the minimum lease payments as calculated when construction has finished the assets and handed over. But under IFRS 16, the lease liability must be updated annually to reflect changes in the lease payments due to inflation.

Upon transition to IFRS 16 in April 2024, accounting for all the inflation since the contract started normally involves a large change in the value of the liability. Since lease liabilities count as external debt, this has implication for the prudential indicators, particularly the authorised limit.

We have reviewed two PFI schemes for Merseyside Waste Disposal Authority: the waste management and recycling contract (WMRC) and the resource recovery contract (RRC). Our findings are as follows:

Methodology

To conduct the work, you have provided us with a copy of the operators' financial models, your current accounting spreadsheet prepared under the old IAS 17 standard, recent unitary charge invoice and a reconciliation of those invoices back to the numbers in the models.

We have then provided you a spreadsheet for each PFI scheme under review, with the following worksheets:

- OpFin – this holds the relevant data from the operator's financial model:
  - Capital cost
  - Inflation indices, based on the inflation assumptions in the model
  - Unitary charge payments, which are partly inflated
  - Operating costs and lifecycle costs, which are fully inflated
  - Third party income
- IRR – calculation of the lease's implicit interest rate from the above data, rebased to inflation on the lease commencement date.
- IAS 17 – this shows the calculations we expect to see in your original accounting model, to see if the lease liability brought forward on 31st March 2024 is materially correct and suitable for use. Actual inflation figures should be entered onto the sheet when known.
- Remeasure – this calculates the new lease liability each year-end, based on the newly inflated lease payments. Until actual inflation figures are known, these are based on assumed rates.
- IFRS 16 – this shows the lease accounting entries under the new standard, including lease interest, principal repayments and annual remeasurements for inflation.
- Disc calcs – this calculates to data needed for the disclosure note table.
- Disclosure – this shows the future unitary charge payments split into its components.

Existing accounting

We believe there are some serious shortcomings in the existing accounting used. In particular:

WMRC

- The initial capital value is far too low, this appears to be an estimated sale value rather than the build cost from the operator's model, and possibly only relates to one asset – the Gilmoss MRF
- The scheme is 35% funded from third-party income, but this is not reflected in the current accounting – a deferred income liability should be created for this
- The implicit interest rate (IRR) has been set at a Green Book discount rate, and has not been calculated from the lease payments that can be derived from the operator's model
- Lease principal repayments have been set on a straight line basis, rather than equal to lease payments minus interest
- The calculated lease payment does not vary with inflation and therefore there is no contingent rent
- Lease calculations have been compounded annually although the payments are monthly
- Lifecycle capital expenditure has been expensed

RRC

- The initial capital value is a little too high compared to the build cost from the operator's model
- The scheme is 36% funded from third-party income, but this is not reflected in the current accounting – a deferred income liability should be created for this
- This leads to an unusually low IRR of 2.97%
- Minimum lease payments are based on the estimated inflation in the model and not actual inflation to the commencement date
- The actual lease payment does not vary with inflation and therefore there is no contingent rent
- Lifecycle capital expenditure has been added to the lease liability – this is only appropriate where a scheme features the regular replacement of components of material value at predefined times rather than as required to replace worn-out asset components, which does not appear to be the case here; and they have been added at estimated not actual prices

We have recalculated the accounting under IAS 17 for the two schemes. The table below shows key differences between the authority's (MWDA) and our (AC) accounting under IAS 17:

	WMRC		RRC	
£'000	MWDA	AC	MWDA	AC
Assets recognised initially	16,950	31,016	297,862	285,901
Lease liability initially	16,950	11,813	297,862	175,767
Deferred income initially	0	6,497	0	99,552
Implicit interest rate p.a.	6.09%	19.54%	2.97%	12.45%
Lease liability 31.03.24	4,964	4,797	187,562	132,135
Interest charge 2023/24	361	804	5,822	15,953
Principal payment 2023/24	961	-626	15,670	5,816
Contingent rent 2023/24	0	702	0	-405

The IRR we have calculated for the WMRC scheme of 19.54% is relatively high. However we note that the model shows £47.4m of operator's profit and lender's interest on £31.0m of capital expenditure over 16.5 years, so this does not appear unreasonable.

The 2023/24 and 2024/25 financial years have relatively high lifecycle costs on the WMRC scheme, leading to negative principal repayments.

The combined decrease in lease liability at 31.03.2024 is £55.594m, offset by the recognition of a £76.699mm deferred income balance. The authority will likely wish to make a **prior period correction** for these amounts and for other errors in the current accounting.

Transition to IFRS 16

Because the inflation applied to the whole unitary charge is smaller than the inflation to be applied to the service and lifecycle costs, the lease payment decreases with increasing inflation. This results in negative contingent rent under IAS 17.

Under the new IFRS 16 standard, that negative contingent rent is converted into a lower lease liability. For the two schemes, we calculate a (further) **combined decrease in the lease liabilities of £5.646m to a balance of £131.326m** on transition to IFRS 16 on 1st April 2024. This should be shown as an adjustment to the opening balance for 01.04.2024, not as an decrease during 2024/25.

The double entry is to the historical cost of the assets; since these have been revalued, the accounting entry on transition will be a credit to the revaluation reserve.

The lease payments for 2024/25 will then be accounted for as follows, in a change to IAS 17 accounting.

	WMRC		RRC	
£'000	IAS 17 AC	IFRS 16	IAS 17 AC	IFRS 16
Lease liability 01.04.2024	4,797	9,871	132,135	121,445
Interest charge 2024/25	892	1,822	15,250	13,950
Principal payment 2024/25	-322	-228	6,157	6,903
Contingent rent 2024/25	1,023	-	-554	-
Total 2024/25	1,666	1,666	20,853	20,853

Further lease remeasurements are required in 2024/25 to reflect latest inflation figures, as follows.

	WMRC	RRC (1)	RRC (2)
Index	October RPIX	January RPIX	DERV Feb-Jan
Affects payment for	April 2025	April 2025	April 2025
2024/25 index	384.8	385.5	966.37
Remeasurement 2024/25 (£)	361,906	-1,755,094	

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