Herefordshire Council

Meeting:	Cabinet
Meeting date:	Thursday 28 September 2017
Title of report:	The rescheduling of debt repayment costs
Report by:	Chief finance officer

Classification

Open

Decision type

Budget and policy framework.

Notice has been served in accordance with Part 3, Section 9 (Publicity in Connection with Key Decisions) of the Local Authorities (Executive Arrangements) (Meetings and Access to Information) (England) Regulations 2012.

Wards affected

(All Wards);

Purpose and summary

To recommend to full Council an amendment to the council's current Minimum Revenue Provision (MRP) policy to change the debt repayment calculation basis to an annuity method.

The recommended approach intends to match the flow of benefits generated by the assets funded from borrowing to the annual MRP charge. Linking MRP to the average useful life of an asset reflects the economic benefit the council receives from using the asset to deliver services over its useful life, representing a fairer cost charge to current and future council tax payers.

The recommended approach ensures that council tax payers are being charged each year in line with asset usage and avoids current council tax payers meeting the cost of future usage or future council tax payers being burdened with charges relating to assets that are no longer in use.

Recommendation(s)

Further information on the subject of this report is available from Josie Rushgrove
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That:

(a) It be recommended to full Council that an amendment be approved to the current MRP policy within the Treasury Management Strategy to be based on the estimated life of the assets, in accordance with regulations, and the method of repayment to be through an annuity calculation (providing a consistent overall annual borrowing charge).

Alternative options

1. Continue using the current MRP policy approach to debt write down, which is a combination of reducing balance and straight line.

   Advantages

   It is a simpler approach to the write down of debt than the annuity method.

   Disadvantages

   The current debt write down approach does not reflect the flow of benefits from the assets funded from borrowing as the charge is higher in earlier years. In addition it does not fully write down the borrowing balance due to the reducing balance method applied to supported borrowing.

2. The revised debt write down approach could be implemented with effect from 1 April 2004. Advice from independent advisors and external auditors is that an implementation date of 1 April 2008 is reasonable.

3. The council is able to devise its own debt write down approach within the MRP policy; no alternative options to those presented in this report have been identified.

Key considerations

4. The rescheduling of debt repayment costs refers to the minimum revenue provision (MRP) which is the method by which councils charge their revenue accounts over time with the cost of their capital expenditure that was originally funded by borrowing.

5. Local government accounting rules require the council to make revenue provision to support the costs of planned capital borrowing regardless of whether that borrowing has actually been taken up; this is referred to as minimum revenue provision and is intended to provide a public demonstration of the costs of capital expenditure.

6. As this is a technical accounting requirement which is specific to local government an example may be helpful to explain this. If the council identified a requirement to buy a new vehicle to grit the roads it would need capital funding to do this. The accounting rules require the council to set aside revenue funding to cover the costs of borrowing that capital. However the council may choose to fund the purchase from reserves, and therefore not need to borrow capital. Before the 2007/08 financial year, the method of calculating debt write down within the MRP was specified in legislation. Since then councils have been able to approve their own MRP policy, in line with guidance available, as long as the amount charged represents a “prudent” cost.

7. To date the council has adopted a MRP policy that charges the cost of debt to the

revenue account on the following basis:

a) For capital expenditure financed through supported borrowing the council has applied a reducing balance method of debt write down at 4% per annum;

b) For capital expenditure finance through unsupported (prudential) borrowing the council has applied a straight line method of debt write down over the life of the asset created.

8. The Department for Communities and Local Government (DCLG) has issued guidance on the calculation of MRP, including a number of methods which it considers to be prudent. The guidance also permits councils to devise other methods they consider prudent. Broadly speaking, the guidance suggests that:

a) MRP on assets acquired through finance leases and Private Finance Initiative (PFI) should be equal to the cash payments that reduce the outstanding liability each year;

b) MRP on all capital expenditure incurred before 1st April 2008, and on expenditure funded by supported borrowing thereafter, is equal to 4% of the opening CFR with some optional adjustments;

c) MRP on expenditure incurred from April 2008 onwards that is funded by unsupported "prudential" borrowing should be calculated by reference to the asset's useful life, using either a straight line or an annuity method, starting in the year after the asset becomes operational.

d) The guidance also suggests that the third method above is an alternative for all other expenditure.

9. The current MRP policy adopted by council on 3 February 2017 (http://councillors.herefordshire.gov.uk/documents/s50043909/Appendix%204%20-%20MTFS%20-%20version%205%20for%20Cabinet.pdf, section 7) recommended a MRP policy using options b and c above. The revised recommended MRP policy will see debt write down move to an annuity basis. This is stated at point d above, is a generally accepted prudent method of calculating MRP and has been reviewed and supported by independent treasury management advisors, Arlingclose.

10. A number of councils have moved to a 50 year write-down via a 2% annuity including:

a. Nottinghamshire County Council

b. City of Wolverhampton Council

c. Southampton City Council

d. Telford and Wrekin Council

e. Worcester City Council

f. Lincolnshire County Council

g. Redditch Borough Council

h. Staffordshire County Council

11. CIPFA supports the use of the annuity debt repayment charge method for calculating MRP. Their publication “Practitioners Guide to Capital Finance in Local Government” states that “it is arguably the case that the annuity method provides a fairer charge that equal instalments as it takes account of the time value of money, whereby paying £100 in ten years’ time is less of a burden that paying £100 now. The schedule of charges produced by the annuity method thus results in a consistent charge over an asset’s life, taking into the real value of the amounts when they fall due. The annuity method would then be a prudent basis for providing for assets that provided a steady flow of benefits over their useful life.”

12. An assets useful life is determined as the period which an asset is expected to be available for use by the council, this determines the MRP annuity rate but does not impact on loan interest charges which are at the rate secured when the cash loan is obtained.

13. The change to MRP policy is recommended to take immediate effect with the associated saving to be reflected during 2017/18 and will be reviewed after five years to take account of possible changing economic conditions.

14. Government guidance requires that an annual statement on the council’s policy for its MRP should be submitted to Council for approval before the start of the financial year to which the provision will relate and changes during the year are permitted if approved by full Council.

Community impact

15. The recommendations support achievement of the council’s corporate plan priority to secure better services, quality of life and value for money by ensuring there is robust and proactive management of council resources.

Equality duty

16. Under section 149 of the Equality Act 2010, the ‘general duty’ on public authorities is set out as follows. A public authority must, in the exercise of its functions, have due regard to the need to -

    a) eliminate discrimination, harassment, victimisation and any other conduct that is prohibited by or under this Act;

    b) advance equality of opportunity between persons who share a relevant protected characteristic and persons who do not share it;

    c) foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

17. The public sector equality duty (specific duty) requires us to consider how we can positively contribute to the advancement of equality and good relations, and demonstrate that we are paying ‘due regard’ in our decision making in the design of policies and in the delivery of services. As this is a decision is a finance back office function, we do not believe that it will have an impact on our equality duty.

Resource implications

18. Minimum revenue provision (MRP) is the method by which councils charge their revenue accounts over time with the cost of their capital expenditure that was originally funded by debt. This replaces actual loan repayment cost to recognise that loans may not be secured immediately as the debt financed capital investment is incurred.

19. Loan interest is accounted for when loans are secured, on an accrued actual cost; therefore the MRP policy does not affect the interest charge in the revenue accounts.

20. The MRP review included a useful asset life review and resulted in recommending an annuity rate of 2.28% to recognise the cost of using prudential borrowing. This is based on the council's calculated weighted cost of capital. For supported borrowing a 50 year useful economic asset life, 2% annuity, is recommended. Comparing the two MRP policies, using the same base data, results in the following indicative MRP charge:

	2017/18 £000	**2018/19 £000**	**2019/20 £000**	**2020/21 £000**	**2021/22 £000**
Current total MRP charge	8,696	8,505	8,204	8,008	7,668
Revised total MRP charge	4,626	4,699	4,646	4,693	4,587
Saving	**4,070**	**3,806**	**3,558**	**3,315**	**3,081**

21. The MRP policy change will save £17.8m over the five year period and £32.4m over the period 1st April 2017 to 31st March 2035.

22. The MRP policy change will ensure that supported borrowing is fully repaid by the end of 2066/67 whilst the existing MRP policy will leave a balance of £13.9m to be financed; this is detailed in Appendix 3.

23. Savings against the current prudential borrowing straight line MRP policy will continue until 2027/28, when they become costs.

24. The annuity method is the cheapest MRP option in the early years, and maintains a constant impact on the revenue account over the useful life of the asset being financed, once interest costs are taken into account, with no cost thereafter.

25. The revenue savings identified will not change the amount of cash invested in capital expenditure but will delay the date at which expenditure is charged to the revenue account, which is entirely in line with the official government guidance on MRP.

26. The revised MRP policy will use an annuity approach for all future capital expenditure funded by prudential borrowing and the annuity rate used to calculate the annuity MRP repayments will be linked to the average Public Works Loan Board (PWLB) annuity rate relevant to the assets useful economic life.

27. The MRP policy has no correlation to the asset valuations required to represent the assets held at their fair value in the council's statement of accountants as stated in the Cipfa Code of practice.

Legal implications

28. The council is under a duty to make a revenue provision under regulation 27 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 as amended. The amount to be determined is that which the council considers to be prudent.

29. In determining a prudent level of MRP the Council is under a statutory duty to have regard to statutory guidance on MRP issued by the Secretary of State under s21 of the local Government Act 2003. The Guidance is that referred to above and has been followed in producing this recommendation. The Council however is entitled to depart from the Guidance if it has good reason to do so.

30. The change can be implemented with immediate effect under regulation 27 which allows charges to be made to the revenue account incurred by the council in that year or in any financial year prior to that year.

Risk management

31. The council is required to take a prudent approach when determining the approach to take for the provision of MRP. All approaches detailed in this report can be considered to be prudent.

32. The risk of adopting this policy change is the increased complexity in calculating the annual MRP charge, this will require monitoring by the council's finance team; this is not considered to require any additional resource. In addition regular reviews of the annuity rate may result in increased MRP costs however when coupled with the loan interest charges total capital financing costs should remain constant leading to improved forecasting.

Consultees

33. All group leaders and our external auditors, Grant Thornton, have been consulted on the proposed MRP policy change.

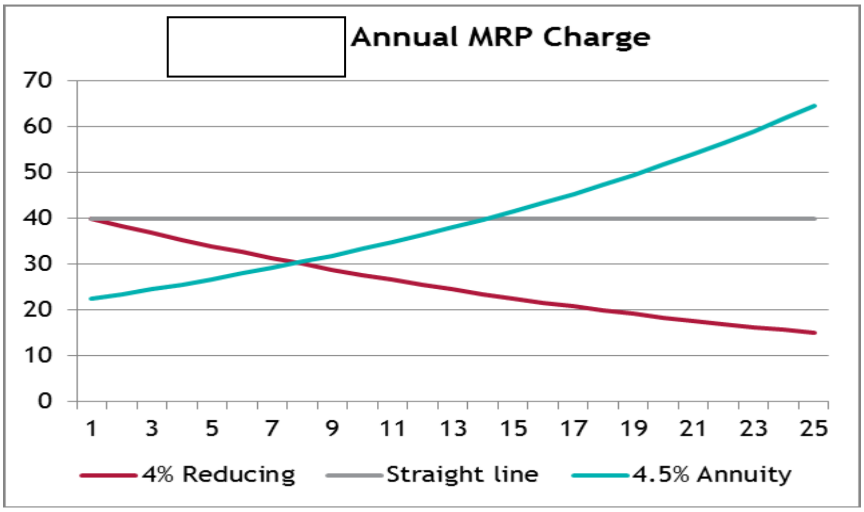
34. Grant Thornton will continue to review if the recommended policy provides a prudent MRP charge; they have stated that the change to an annuity approach is unlikely to be challenged.

35. It's Our County response is attached at appendix 2, the points highlighted in the response have been addressed in this report, in addition further detail requested is provided below.

36. The effect of the different methods of accounting for MRP on capital expenditure financed by borrowing since April 2008, the Council has three MRP options, being:

    a. the 4% reducing balance method (currently used, and only permitted, for supported borrowing)
    b. the straight line asset life method (currently used for prudential borrowing), and
    c. the annuity asset life method (the proposed MRP policy).

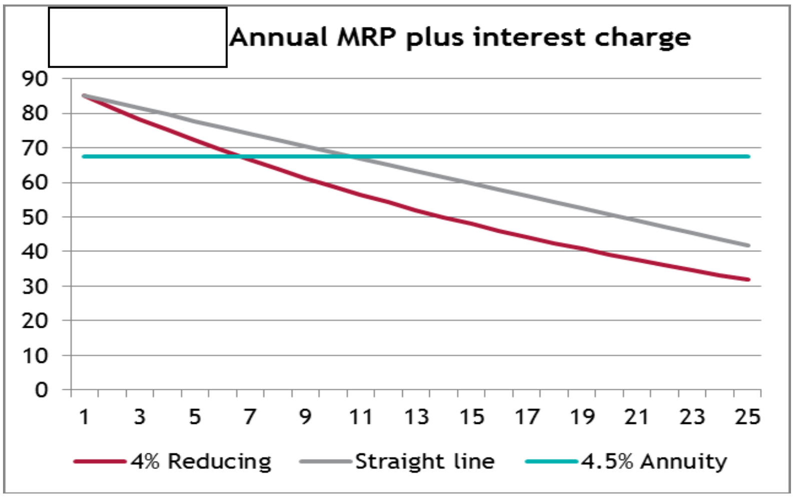
37. These options are shown below graphically.



38. For example an asset with a £1m capital cost financed through borrowing using a 25 year useful life with an interest rate of 4.5% for the annuity method the 4% reducing balance method and the 25 year straight line method both start with the larger annual MRP charges of £40k pa, and could therefore be considered more prudent than the annuity method at first. However, by year eight, annuities MRP rises above the reducing balance method, and by year 14 it rises above the straight line method supporting the recognition of annuity debt write down as a prudent method.

39. Another drawback of the reducing balance method is that after 25 years, when the asset is no longer providing any benefit to the Council, only 64% of its cost will have been charged to revenue, with the effect being that taxpayers in future years will be paying for assets that are no longer in use. The other two methods are designed to ensure that the cost of the asset is charged to revenue over its useful life.

40. Total debt costs include loan interest in addition to the MRP charge. This means that the total cost of borrowing, including MRP and interest at 4.5% for the same example £1m asset, the annuity method would provide a constant total cost, where the other two methods result in a declining total debt cost, as shown in the graph below:



Appendices

41. Appendix 1 – Revised MRP Policy

42. Appendix 2 – It's Our County: response to key decision "the rescheduling of debt repayment costs".

43. Appendix 3 – the impact of the MRP policy change on supported borrowing

Background papers

44. None identified.