THE PRUDENTIAL CODE AND ITS IMPACT ON CAPITAL STRATEGY

Report By: County Treasurer

Wards Affected

County-wide

Purpose

1. To note the implications of the new Prudential Code for Capital Finance for the Council with effect from 2004/05 onwards.

Financial Implications

2. As detailed in the report.

Considerations

Background

3. With the recent enactment of the Local Government Bill the Prudential Code for Capital Finance (‘the Code’) will come into force for the new financial year. The Code replaces all current legislation and regulation on capital finance, in particular the system of borrowing approvals which has governed capital expenditure planning over so many years. It is widely accepted that the current system has led to a major under investment in public assets, a statement backed by analysing investment now compared to 40 years’ago.

4. The replacement legislation and regulations will be less prescriptive and offer local authorities more discretion to make local capital investment decisions. This reduced regulation, however, requires a prudential framework which will be embodied in the Code. This framework will need to ensure that capital investment plans are affordable, prudent and sustainable and requires prudential indicators to govern our borrowing. The new regulations within the Code are spilt into two broad areas covering general capital management issues and borrowing strategies. It is important to note that Local Authorities only need to have regard to the Code itself. However, the Bill provides reserve powers for Central Government to set borrowing limits in exceptional circumstances.

5. Many of the ‘best practice’ features of the Council’s current capital strategy have been developed with the likely introduction of the Prudential Code in mind these include:

- The regular meeting of a cross directorate capital strategy and asset management group.
- The formal monitoring of the capital programme through a corporate group and the Cabinet.

- The detailed level of appraisal for individual schemes incorporated within the Scheme Prioritisation Process (SSP).

6. The areas where further development of systems and strategies is required are the progression towards medium term capital programming and the integration with the revenue budget.

Benefits of the New Code

7. The current system of borrowing approvals can significantly restrict the level of capital expenditure undertaken as most local authorities do not have substantial capital reserves and the substantial part of new capital schemes are funded by borrowing. The new Prudential system abolishes these approvals and allows Local Authorities far greater flexibility to meet their corporate objectives by deciding themselves how much they want to borrow.

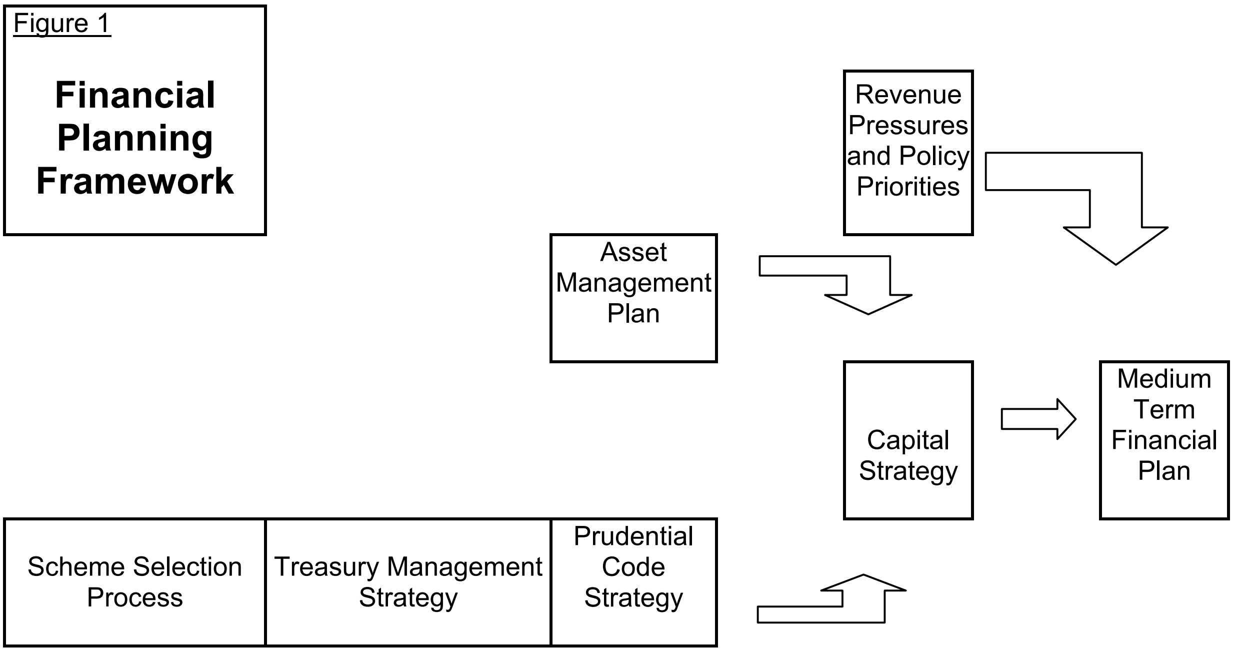
8. The overriding issue, however, is affordability and most local authorities, Herefordshire Council being no exception, are restricted by Council Tax increases within bounds of acceptability. The Code continues to require us to charge to the revenue account each year what is known as the Minimum Revenue Provision (MRP) which reflects the repayment of the debt over time in addition to actual interest charged. This, of course, has a direct impact on the Council Tax levied and for each £1m of capital expenditure funded by borrowing the charge to the revenue account is around £100,000.

9. In light of the affordability issue, one of the key flexibilities with the Prudential Code that it can allow us to change low priority revenue budget provision for capital expenditure without having an impact on the Council Tax. The trade-off will have to take account, however, of the full future revenue costs of capital expenditure both in terms of debt repayment but also associated running costs. These are all identified as a matter of course in the current Scheme Selection Process which requires the whole life costing of schemes and detailed option appraisal.

10. A second way of tackling the affordability issue is by using the increased freedoms to borrow for Invest to Save type schemes. Service Directors will agree to reduce their base revenue budgets in future years as savings accrue from initial capital investment. This will require careful programming, however, to minimise the impact on the Council Tax.

Links with other Strategies

11. Integrated financial planning is vital to achieving our objectives as set out within the Corporate Plan. A simple structure of the financial strategies is in Figure 1:



12. Our Capital Strategy last year was assessed as being ‘good’ by the Government Office West Midlands, precluding the need to formally submit a plan at least into the foreseeable future. The advent of the Prudential Code, however, requires the Strategy to be updated and a revised version will be reported early next year. The Asset Management Plan will also have a significant role to play here and this has also now been assessed as being good.

Prudential Indicators

13. An important part of the Code is the approval of the Prudential Indicators by Cabinet. These are then the responsibility of the County Treasurer as Section 151 officer to advise upon and monitor. The key issues involved here are the setting up of financial controls and managing risk. The Council already has a high quality Treasury Management strategy recognised as such by the Audit Commission, and we do not propose making any changes to this. It is our intention to submit a report to Cabinet early in the New Year to agree the detailed Prudential Indicators. These, however, are likely to be developed over the next few years.

14. The indicators required to monitor and control our borrowing are as follows:

- *Council Tax and Affordability*

  The indicator will clearly show the additional impact on Council Tax both as a percentage and a monetary value per Band D property of capital expenditure over and above the Central Government supported expenditure within Comprehensive Spending Reviews.

- *Estimates of Capital Financing Requirement (and similarly External Debt)*

  This is a new concept within the Prudential Code but is simply the requirement for long-term borrowing and associated long-term debt. The current long-term debt stands at £62m.

- *Capital Financing as a Percentage of Revenue Income*

  This measures the ratio of capital financing costs against the net revenue stream, which comprises of Council Tax and Government Grant. This indicator is perhaps the key indicator for measuring prudence as it measures the cost of financing capital expenditure against our annual income. On the whole we will borrow at fixed interest rates over the long-term so we can provide certainty in that respect. However, we cannot provide such certainty over central funding and this, together with competing and significant revenue pressures, are important factors to bear in mind.

15. A key factor here is the extent to which Government funding is maintained particularly for Education; Transport and Housing, i.e. the major recipients of borrowing approvals under the previous system where capital financing costs are reflected in the Council's Formula Spending Shares.

Forward Year Capital Programme

16. As is usual practice at this time of year, we have asked services to provide us with their proposals for new capital schemes which are going through the prioritisation process against set criteria. The process has provided an initial indication, of new schemes and Table 1 shows the aggregated cost of these schemes against current resource forecasts. These have been largely based on the capital financing resources to be made available centrally as reflected in the Comprehensive Spending Review 2002 but also the potential costs associated with Cabinet considerations regarding the new North Herefordshire swimming pool.

Table 1: **2004/05 Capital programme**	**04/05** **£m**	**05/06** **£m**	**06/07** **£m**	**07/08** **£m**
Borrowing Requirement Based on Current SSP Bids	29.0	19.7	30.7	14.9
Assumed 'supported credit approvals' within current system	18.0	18.0	18.0	18.0
Extra Borrowing identified from SSP bids over expected support	11.0	1.7	12.7	-3.0
Current Forecast for Capital Financing Provision	7.3	8.6	10.0	11.4
Cumulative of Extra Borrowing (i.e.: charge to revenue)	0.3	1.0	1.5	2.2
Incremental Council Tax Increase over Current Forecasts	0.5%	1.75%	2.5%	3.75%

17. The potentially significant gap between service aspirations and the capacity to resource projects reinforces the importance to not only consider these capital schemes in conjunction with the revenue budget pressures but also adopt a structured medium term perspective to the process where we can consider the phasing and deferral of capital schemes without discounting them altogether.

18. The revenue pressures have been debated in detail in the recent budget panels and a report will be presented to Cabinet during December where some major financial policy decisions will need to be made. This will include the potential approval of some major capital schemes as at that stage we can assess the impact these may have on the revenue budget and subsequently Council Tax levels following the release of the Local Government Finance Settlement. Examples of some of the major capital pressures are as follows:

- Modernisation of the Crematorium;
- Full funding of the Local Transport Plan;
- Conversion of properties into Information points in line with E Government objectives;
- Rationalisation of the operational property holding;
- Modernisation of existing school premises;
- Continuation of the Housing Renewal programme;
- Construction of new Hereford Library.

The list is merely illustrative at this stage, with members ultimately determining their priorities for capital investment.

19. The Prudential Code for Capital Finance in local authorities will undoubtedly provide the Council with far greater flexibility in how we approach capital spending and is a fundamental change in local authority finance. In particular, the Code will in future provide the opportunity to deliver a range of capital schemes, in support of key policies and public expectations that hitherto could not have been countenanced. Allied to this flexibility, however, is affordability and prudence and these two concepts will heavily influence the approach to the Code within the Council's financial planning processes.

RECOMMENDATION

THAT the Strategic Monitoring Committee note the present position.

BACKGROUND PAPERS

- Report to Cabinet – 20 November 2003.