CORPORATE AND FINANCE REVIEW PANEL - 22nd JANUARY 2004
CABINET - 7TH JANUARY 2004 **PORTFOLIO : FINANCE AND SUPPORT**

CAPITAL FINANCE IN LOCAL AUTHORITIES

1.0 INTRODUCTION

1.1 As part of long-term proposals to modernise and reform the financial and democratic framework for local authorities, the Government are intending to repeal the existing legislation for capital finance (part IV of the Local Government and Housing Act 1989). This legislation imposed strict controls on local authorities in the financing of capital expenditure through credit arrangements.

1.2 These regulations are being replaced by a new system that will rely of powers provided in Part 1 of the Local Government Bill (The Local Authorities [Capital Finance and Accounting] Regulations 2003) The new provisions will be introduced on 1st April 2004.

1.3 The Capital Finance and Accounting Regulations encompass new borrowing powers for capital expenditure, definitions of capital expenditure and receipts, new pooling arrangements for housing capital receipts and some technical capital accounting requirements.

1.4 The CIPFA Prudential Code and subsequent secondary legislation will support the primary legislation for Capital Finance.

2 IMPACT OF THE NEW PRUDENTIAL CODE FOR BORROWING

2.1 In summary, the legislation permits the Council to decide the level of borrowing year on year for capital investment. It will provide a comprehensive framework that will allow the best investment decisions to be made for the replacement of existing or provision of new assets, based on local strategic planning, asset management and options appraisal.

2.2 The basic principle of the new system is that the Council will be free to invest so long as its spending plans are affordable, prudent and sustainable. The new Prudential Code will set out the indicators and factors to be taken into account in making these decisions.

2.3 The new system will apply to all capital expenditure, irrespective of whether the cost of borrowing falls on the General Fund or Housing Revenue Account.

2.4 The primary legislation will contain a provision allowing the Government reserve powers to set borrowing limits for all individual local authorities retrospectively.

2.5 The Council will be required to approve the prudential borrowing limits before the start of a financial year. It is likely this will be included as part of the Treasury Management Policy and Annual Report which forms an integral part of the overall financial strategy for approving the annual budget of the Council. The limits may be revised at any time by approval of the Council.

2.6 The prudential indicators outlined in the Code are mandatory. The Council will need to consider all the resources available, together with its capital programme and revenue forecasts for a minimum of 3 years ahead, identifying the implications for both council tax and housing rent levels of any proposed borrowing for capital expenditure.

2.7 The prudential indicators are designed to support and record local decision making and not to provide comparative performance indicators, they will not associate any part of the authority's external borrowing with specific expenditure.

2.8 The Director of Resources will be responsible for ensuring the Council has taken into account those matters specified in the Prudential Code, for monitoring continued compliance with the agreed borrowing limits and ensuring good corporate governance arrangements are in place.

2.9 A copy of the proposed Prudential Code of Practice for Capital Finance for this Council is attached as Appendix 1.

3 IMPACT OF THE POOLING OF CAPITAL RECEIPTS

3.1 Under the existing capital finance legislation, any receipts from the disposal of housing land or property is subject to 'set-aside' provisions. This means that only 25% of the receipt from the disposal of housing, and 50% of the receipt from disposal of housing land are available as usable receipts to meet new capital expenditure. The remaining proportion of the receipts was set-aside against repayment of outstanding debt.

3.2 These arrangements will be replaced by the new regulations that require all or part of a capital receipt from council housing sales to be paid to the Government. These receipts will be 'pooled' at a national level and redistributed to local authorities for capital expenditure for housing in accordance with the Government's strategic objectives.

3.3 The pooling arrangements only apply to receipts from sales of housing assets and include dwellings under the 'right to buy' scheme (75%) and sales of housing land and shops (50%). Voluntary transfers of housing to registered social landlords (including a share of the receipt from preserved 'right to buy' under a transfer agreement) are exempt.

3.4 It is also proposed to exempt capital receipts from the disposal of mortgage portfolios and shared ownership schemes providing they are used for capital expenditure on affordable housing.

3.5 The new regulations also contain a number of adjustments that may be made to reduce the amount of certain types of capital receipt subject to the 'pooling' arrangement (for example the administrative costs associated with the sale or, expenditure incurred on preparing the property for sale). The object of this concession is to allow certain types of capital receipts to be recycled into a local authority's own affordable housing programme.

3.6 The remaining portion of a capital receipt which is not subject to the pooling arrangements (ie 25% for right to buy sales and 50% of other housing assets) may be used at any time for any kind of capital expenditure, or to repay debt.

3.7 The new provisions apply to all local authorities, including those that are debt-free. However, the legislation also includes transitional arrangements for those authorities which are debt free on 31st March 2004. The options for the Council are set out in paragraph 5 below.

3.8 It is not known at this stage, whether the impending secondary legislation will restrict or penalise a local authority that subsequently borrow to finance capital expenditure, having become 'debt-free' on 31st March 2004.

4.0 MINIMUM REVENUE PROVISION AND COMMUTATION

4.1 As part of the reform of the financial framework, the Government are intending to repeal the requirement for local authorities to make an annual revenue provision to offset borrowing for capital expenditure purposes. This is known as the minimum revenue provision (MRP), and currently broadly equates to 4% for non-housing and 2% for housing borrowing.

4.2 The Government is intending to introduce depreciation accounting as a replacement for MRP; as an interim arrangement, a new formula will be introduced, for charges to the General Fund. This will not apply to the Housing Revenue Account where there is no longer a requirement to make such provision following the introduction of the Major Repairs Allowance.

4.3 The commutation provisions will also become discretionary rather than mandatory.

4.4 The impact of the new legislation, assuming its implementation for 2004/05, is as follows:

4.4.1 Although the formula has been amended, because of the Council's overall debt position, no charge needs to be made to the General Fund for MRP. However, because of the changes in the formula, the benefit that would normally be received by the General Fund (£53,000 for 2004/05) will no longer be available.

4.4.2 Under the old regulations, the commutation adjustment would have resulted in a charge to the General Fund from 2007/08 onwards and the Commutation Reserve would have been used to offset this charge. Under the new regulations, when the calculation is to the disadvantage of the General Fund, the adjustment no longer has to be made.

4.4.3 For the period between 2004/05 to 2005/06, the current forecast of adjustments indicate that the General Fund Capital will benefit by around £252,000 for 2004/05, £166,000 for 2005/06 and £52,000 for 2006/07.

4.4.4 The Commutation Reserve may therefore be used to fund other expenditure (subject to the agreement of the District Auditor). The balance on the Reserve, as at 31st March 2003 is £2.3million

5.0 FINANCIAL STRATEGY - OPTIONS FOR 2004/05 ONWARDS

5.1 The Council's current long-term debt profile is as follows:

	Amount Borrowed	Repayment Date	Rate of Interest %
Deutsche Bank	3,000,000	21.9.2004	9.55
Depfa Bank plc	3,000,000	06.4.2010	6.60
PWLB	1,000,000	04.3.2015	10.25
PWLB	250,000	31.3.2017	10.25
Various annuities	356,000	Various to 2021	5.77 average
Total	£ 7.606,000		

5.2 There are three main options available to the Council, which are considered within this report:

- Maintain the existing debt to maturity, with no additional borrowing;
- Premature redemption of debt by 31st March 2004;
- Maintain the existing debt to maturity and incur additional borrowing.

5.3 Option 1 - Status Quo - Maintain existing debt with no additional new borrowing

5.3.1 The cost to the General Fund in maintenance of debt to maturity is £1.143,092 million; the incidence of costs over the period 2004/05 to 2008/09 is shown in Appendix 2. Interest earnings on investments held offset this; but are not reflected in the appendix.

5.4 Option 2 - Premature Redemption of Debt:

5.4.1 Under the new Local Authorities (Capital Finance and Accounting - England) Regulations 2003 the requirement to 'pool' capital receipts are subject to a transitional relief provision for local authorities which are debt free as at 31st March 2004.

5.4.2 In order to achieve 'debt-free status' the Council needs to achieve a negative credit ceiling as at 31st March 2004 and have no long-term debt.

5.4.3 The repayment of debt will be met from funds currently invested and which generate annually investment income. A forecast of the impact from the loss of interest earnings on the General Fund, assuming premature repayment of debt by 31st March 2004 is shown in Appendix 2.

5.4.4 The forecast is based on the following assumptions that are subject to a number of variable factors, up to the date of redemption of debt

- The credit ceiling going negative at 31st March 2004;
- The premium for early redemption of debt is £908,000, based on assumptions on repayment dates and current gilt yield forecasts;
- The credit ceilings post 31st March 2004 have been amended to exclude the housing MRP and set aside assuming the new legislation comes into force from1st April 2004;
- The interest rate for investment income and 3 month LIBID rates are projected at 4.8%;
- The costs to the Housing Revenue Account will continue to be matched by equal subsidy
- The Housing Revenue Account will continue to be maintained until 2008/09 assuming any decision to transfer the council's housing stock will not be before 2006/07
- Right to Buy Sales will generate capital receipts of at least £4.2 million per annum to 2006/07.

5.4.5 The forecast shows a cost of £0.932 million, being the loss of interest earnings as a consequence liquidating investments held to repay the debt prematurely. This results overall in an estimated net gain to the General Fund of £210,000.

5.4.6 In addition to this sum, as the Council will be debt-free by 31st March 2004, the General Fund will benefit from the transitional arrangements for the pooling of capital receipts from Right to Buy sales. The transitional arrangements apply for the years 2004/05 to 2006/07 and could generate additional resources of £4.725m for affordable housing.

5.5 **Option 3 - Maintain existing debt with additional borrowing**

5.5.1 For this forecast, an assumption has been made that current debt is extended by £0.5million per annum; the forecast assumes no premature repayment of debt within that period.

5.5.2 The net cost of borrowing over the period of the forecast is £375,000; the incidence of costs per annum is shown in Appendix 3.

5.5.3 Also shown in Appendix 3 is a forecast of net savings to the General Fund over a five-year period if current debt is extended to meet the cost of purchasing replacement vehicles, plant, IT and Leisure equipment. The forecast is based on an assumption that 20% of new debt is charged to the General Fund as depreciation, to enable loans to be repaid after 5 years.

5.5.4 The forecast shows net savings to the General Fund of £676,990 over the period of the forecast.

6.0 FINANCIAL IMPLICATIONS

6.1 Although the forecast in Appendix 2 shows a potential short-term gain for the Council through achieving debt-free status by 31st March 2004, this decision needs to be considered against the longer-term implications for the Council's future housing and other services capital programmes if no further borrowing is permitted.

6.2 With the abolition of the Basic and Supplementary Credit Approvals (BCA/SCA) framework following introduction of the Prudential Code, capital investment will be supported through the 'Supported Capital Finance' element of the Formula Spending Share (FSS) It is not know at this stage whether this system will be replaced with Capital Grants, as previously indicated by the Government.

6.3 In future, the Council will need to consider the level of borrowing for capital expenditure which is supported through the Revenue Support Grant and that which is 'unsupported', the cost of which will be met entirely from the General Fund or Housing Revenue Account.

6.4 Any borrowing to finance capital expenditure will need to be affordable in terms of rent levels within the Housing Revenue Account, and council tax levels within the General Fund. The existing policy of proposed rent increase over the next 8 years and claw-back of housing benefit subsidies will significantly restrict the Council's ability to finance capital expenditure from the Housing Revenue Account.

6.5 With regard to the General Fund, the Government has already indicated 'unofficially' that council tax levels above 5 or 6% may be capped.

6.6 The decision to repay debt prematurely may be influenced by the premiums payable, the forecasts for interest rates and gilt yields over the next 3 years and subsidy proposals.

6.7 A decision to achieve debt-free status by 31st March 2004 will generate additional resources to enable the provision of new homes; there will however, be an additional annual net cost to the Housing

Revenue Account of around £ 304,598 as a result of subsidies available.

6.8 The draft legislation suggests that the Major Repairs Reserve may be used to repay debt prematurely; use of this Reserve however, will impact on the Council's ability to achieve its objective of meeting the decent homes standards set by the Government.

7.0 RECOMMENDATIONS

It is recommended that the Cabinet:

7.1 Note the introduction of the proposed Capital Finance and Accounting Regulations;

7.2 Note the potential impact on the future resources available to the Council to finance capital expenditure,

7.3 Adopt the Prudential Code for Capital Finance, as outlined in Appendix 1 to this report

7.4 Agree in principle to pursue becoming debt-free by 31st March 2004 but this be subject to a further report in February when the final Regulations have been published.

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Background papers

Part 1 Local Govt. Bill
Prudential Code (CIPFA)

APPENDIX 1

NEW FOREST DISTRICT COUNCIL
PRUDENTIAL CODE FOR CAPITAL FINANCE

OBJECTIVES

1. In adopting this Code of Practice the Council wishes to ensure that:

   - All capital expenditure plans are **affordable**;
   - All external borrowing and other long-term liabilities are within **prudential** and **sustainable** levels authorised by the Council
   - Treasury management decisions are taken in accordance with good practice

2. In setting the prudential indicators, the Council will have regard to whether:

   - The level of borrowing can be sustained over the period in which it will have a financial impact, having regard to the implications for the council tax and housing rent, and other future spending priorities;
   - proposals for capital investment provide value for money and meet service objectives
   - Proposals for capital investment form an intrinsic part of the capital strategy and plans for the management of the Council's assets;
   - The forward plans for capital investment can actually be achieved.

PROCESS

1. Cabinet will consider the prudential indicators for treasury management for the forthcoming year, as part of the budget setting process, for approval by the Council no later than February of the preceding financial year.

2. Any revisions to the indicators during the relevant financial year will be considered initially by Cabinet before being referred to Council for decision.

3. The Director of Resources will be authorised to vary individual categories of external debt between borrowing and other long-term debts without reference to the Council, provided the total authorised limit for the financial year is not extended.

4. All such variations will be subject to a report to the next appropriate meeting of the Council.

5. Any proposals for new capital expenditure, will be considered within the context of forecasts for both the General Fund and Housing Revenue Account for the next and subsequent 2 years, which reflect servicing costs for existing

debt, all resources actually and estimated to be available, and revenue income and expenditure.

<u>RESPONSIBILITIES OF THE DIRECTOR OF RESOURCES (S151 OFFICER</u>)

Director of Resources will be responsible for:

1. Ensuring that the Council has regard to the following factors upon setting or revising the agreed prudential indicators.

    - Proposals for new capital investment will be considered against existing borrowing to ensure the overall debt remains within sustainable limits;

    - The implications for the level of council tax within the General Fund, and the rent level within the Housing Revenue Account for any proposals for new borrowing are identified;

    - The flexibility the current proposed capital expenditure plans will leave for future capital or revenue spending or changes to revenue income or expenditure;

    - The resources available and the extent to which financing costs are supported by government grants or contributions from other bodies;

2. Implementing procedures to monitor on a regular basis, performance against all prudential indicators;

3. Report to the Cabinet and Council any action that may, or has, breached the authorised limit for external debt.

<u>PRUDENTIAL INDICATORS</u>

1. The following prudential indicators will be adopted by the Council and will be applied to the following and two subsequent financial years and for the General Account and Housing Revenue Account where appropriate:

    - Estimated ratio of financing costs to net revenue stream

    - Actual ratio of financing costs to net revenue stream

    - Estimate of the incremental impact of capital investment decisions on the Council Tax and/or weekly housing rent

    - Net Borrowing and capital finance requirement

    - Estimates of capital expenditure

    - Actual capital expenditure at the financial year end

    - Estimate of capital financing requirement

    - Actual Capital financing requirement at the financial year end

- Authorised limit for total external debt
- Operational boundary for external debt
- Actual external debt at the financial year end

2. The Council will also maintain a Code of Practice for Treasury Management the basis of which is the professional practices recommended by the Chartered Institute of Public Finance Accountants (CIPFA) and will include:

   - Upper limits on exposure to the effect of changes in interest rates for both fixed and variable interest rates, expressed as both an absolute amount and as a percentage
   - Upper and lower limits in respect of the maturity structure of external borrowing, within defined periods of under 12 months, 12-24 months, 24 months to 5 years, 5 to 10 years and above 10 years
   - Total principle sums invested for periods of longer than 354 days