CABINET

Date of Meeting	Tuesday 15th November 2016
Report Subject	Review of Minimum Revenue Provision
Portfolio Holder	Leader of the Council and Cabinet Member for Finance
Report Author	Corporate Finance Manager
Type of Report	Strategic

EXECUTIVE SUMMARY

Local Authorities are required each year to set aside some of their revenue resources as provision for the repayment of debt.

Regulations require an authority to each year make an amount of Minimum Revenue Provision (MRP) which it considers to be 'prudent'. The Regulations themselves do not define 'prudent' provision. Welsh Government (WG) has provided guidance which makes recommendations to local authorities on the interpretation of the term and authorities are required to prepare an annual statement of their policy on making minimum provision.

As part of the budget strategy for 2017/18 officers have critically reviewed the Council's MRP policy along with our treasury management advisors. The report outlines this review in detail. The review recommends that changes are made to the MRP calculation for past and outstanding capital expenditure which is funded from supported borrowing.

RECOMMENDATIONS	
1	Members approve and recommend to County Council for Council Fund (CF) outstanding debt that:- • Option 3 (Asset Life Method) be used for the calculation of the MRP in financial years 2016/17 and 2017/18 for the balance of outstanding capital expenditure funded from supported borrowing as at 31st March 2016. The calculation will be the 'straight line' method over 50 years. This represents an in year change of the approved and adopted policy for 2016/17 which was previously to use Option 1 (Regulatory Method);- • Option 3 (Asset Life Method) be used for the calculation of the MRP in 2017/18 for all capital expenditure funded from supported borrowing from 1st April 2016 onwards. The calculation will be the 'straight line' method over an appropriate number of years, dependent on the period of time that the capital expenditure is likely to generate benefits. This represents a change of policy which was previously to use Option 1 (Regulatory Method); and- • Option 3 (Asset Life Method) be used for the calculation of the MRP in 2017/18 for all capital expenditure funded from unsupported (prudential) borrowing or credit arrangements. This represents a continuation of the approved and adopted policy for 2016/17.
2	That members approve and recommend to the County Council for Housing Revenue Account (HRA) outstanding debt:- • Option 2 (Capital Financing Requirement Method) be used for the calculation of the HRA's MRP in 2017/18 for all capital expenditure funded by debt. This represents a continuation of the approved and adopted policy for 2016/17.
3	Members approve and recommend to County Council that MRP on loans (which qualify as capital expenditure) from the Council to NEW Homes to build affordable homes be as follows:- • No MRP is made during the construction period. The first loan to NEW Homes to be a short term loan of approximately 18 months which will be refinanced once construction is completed. This represents a continuation of the approved and adopted policy for 2016/17. • MRP is equal to the repayments made by NEW Homes once capital repayments are being made. The second loan to NEW Homes to be a long term loan which will be repaid from rent from the affordable homes. The repayments made by NEW Homes will be classed, in accounting terms, as capital receipts, which can only be used to fund capital expenditure or repay debt which is a form of MRP. It is proposed to set aside the capital receipts (the capital repayments) made by NEW Homes to repay debt, being the Council's MRP policy for repaying the loan. This represents a continuation of the approved and adopted policy for 2016/17.

REPORT DETAILS

1.00	**EXPLAINING THE REVIEW OF MINIMUM REVENUE PROVISION**
	Background to Capital Expenditure and Financing
1.01	Capital expenditure is defined as expenditure to acquire, enhance or prolong the useful life of non-current assets, those which have a useful life of more than one year e.g. buildings or infrastructure improvements. Capital expenditure is funded from a combination of capital receipts, revenue contributions, specific grants and debt in the form of borrowing or other long term financing arrangements such as leasing. Borrowing can be either: • Supported borrowing - funding is provided by Welsh Government through the Revenue Support Grant to cover the revenue debt financing costs of interest and repayment costs; or. • Unsupported borrowing (commonly referred to as prudential borrowing) – Councils have the freedom to determine the level of borrowing considered affordable in revenue debt financing costs with no support from Welsh Government.
1.02	The annual charge to the revenue account for repaying debt is known as the Minimum Revenue Provision (MRP). Local Authorities are required each year, under the Capital Finance and Accounting Wales Amendment Regulations 2008, to set aside some of their revenue resources as provision for the repayment of debt. Regulation 22 of the 2008 Regulations requires an authority to, make an amount of MRP each year which it considers to be 'prudent', though the Regulations themselves do not define 'prudent' provision. Regulation 21(B) of the 2008 Regulations requires local authorities to have regard to guidance issued by Government.
1.03	The Welsh Government has issued guidance for the setting of MRP policy. It states that the broad aim of prudent provision is to ensure that the debt is repaid over a period that is reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by the Welsh Government, reasonably commensurate with the period implicit in the determination of that grant. The WG guidance provides 4 options for making 'prudent provision' outlined below but states in its informal commentary that;- *'The options are those likely to be most relevant for the majority of*

	authorities but other approaches are not meant to be ruled out, provided they are fully consistent with the statutory duty to make prudent revenue provision. Authorities must always have regard to the guidance, but having done so, may in some cases consider that a more individually designed MRP approach is justified. *The decision on what is prudent is for the Authority and it is not for the Welsh Government to say in particular cases whether any proposed arrangement is consistent with the statutory duty.'*
1.04	In a recent letter to all local authorities the Auditor General for Wales concurred that it is for each authority to determine what is a 'prudent' policy.
1.05	**Options for Prudent Provision within WG Guidance** Option 1 - Regulatory Method For capital expenditure funded from supported borrowing which is supported through funding in the Revenue Support Grant (RSG), authorities may continue to use the formula specified in the Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 (the regulations which preceded the 2008 Regulations). Under this method the outstanding capital expenditure (known as the Capital Financing Requirement CFR) funded from supported borrowing less Adjustment A is written down annually by 4% on a reducing balance basis. Adjustment A is a commutation adjustment, a fixed value determined by changes to statutory regulations referred to above (which all Welsh Council's will have). For Flintshire the current 2016/17 calculation is (Council Fund): MRP = (CFR – Adj A) x 4% = (£150m - £1.7m) x 4% = £5.9m
1.06	Option 2 - Capital Financing Requirement Method The same as Option 1 without adjusting for Adjustment A, which results in a higher charge. MRP = CFR x 4% = £150m x 4% = £6.0m
1.07	Option 3 - Asset Life Method Provision is made over the estimated life of the asset for which debt is undertaken. This can be calculated using the 'straight line' method or the 'annuity' method. To illustrate the difference, as an example an asset which is purchased at a cost of £4m which has an estimated useful life of 50 years;- • Straight line method - equal annual MRP charge £4m / 50 years = £0.080m • Annuity or inflation method – annual MRP charge that takes the time

	value of money in the form of inflation into consideration Year 1 = £0.047m Year 2 = £0.048m Year 3 = £0.049m Year 4 = £0.050m Year 5 = £0.051m
1.08	Option 4 - Depreciation Method Alternatively, provision is made in accordance with the standard rules for depreciation accounting. The method is similar to option 3 above
1.09	Welsh Government guidance requires that either option 3 or 4 be used for all capital expenditure which is to be financed by unsupported borrowing or other long term liabilities. Options 1 and 2 are not permitted for this use.
1.10	**Housing Revenue Account (HRA)** Following the introduction of self-financing for the HRA and the voluntary exit from the negative subsidy system on 31st March, 2015, from 1st April 2015 the calculation of the HRA MRP is now similar to the Council Fund as set out in 1.02 above, with the following modifications: • Options 1 and 2 - the percentage is 4% for the Council Fund and 2% for the HRA; and • Options 1 and 2 can be used in relation to capital expenditure incurred before 1st April 2021. After that date only Options 3 and 4 may be used.
1.11	The Council approved loans to its wholly owned subsidiary NEW Homes for the purpose of building affordable homes. The loans qualify as capital expenditure and therefore need to be part of the MRP policy. At its meeting on 14th June 2016 the Council approved the MRP calculation for loans to NEW Homes as outlined in recommendation 3 above.
1.12	The Council's current MRP policy is as follows: • Council Fund capital expenditure funded by supported borrowing on the basis of Option 1 - Regulatory Method calculation. • Council Fund capital expenditure funded by unsupported (prudential) borrowing or credit arrangements on the basis of Option 3 - Asset Life Method calculation. • HRA capital expenditure funded by debt, on the basis of Option 2 - Capital Financing Requirement Method calculation; and • Loans to NEW Homes – as outlined in recommendation 3 above.
1.13	It is important to note the capital financing position on outstanding capital expenditure and the Council's external borrowing. The table below shows the position as at the 31st March 2016:

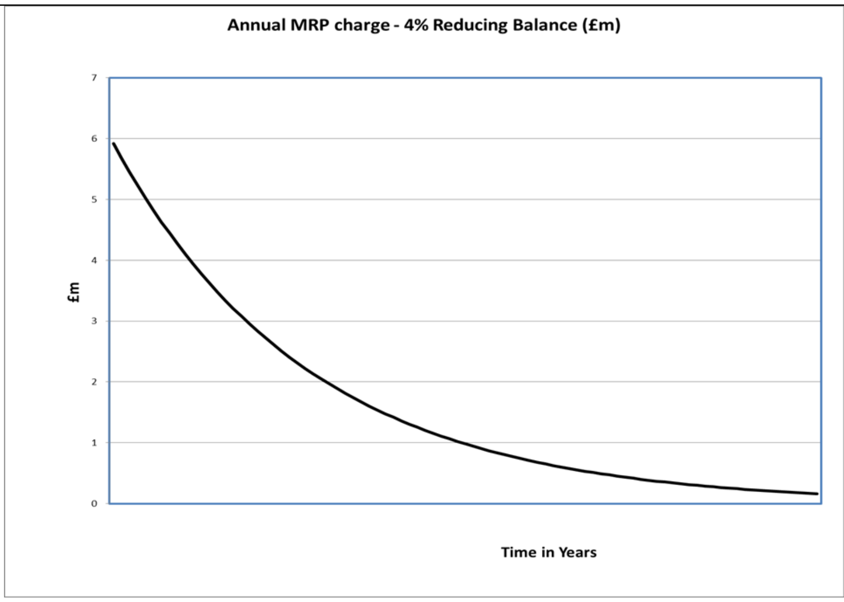
		£m
	Outstanding capital expenditure funded by supported borrowing (Council fund and HRA)*	254.156
	Outstanding capital expenditure funded by unsupported (prudential) borrowing (Council Fund and HRA)	19.637
	Total outstanding capital expenditure – Capital Financing Requirement (Council Fund and HRA)	**273.793**
	Total External Borrowing	251.496
	Capital expenditure funded by internal cash resources	22.297

£22.297m of internal cash is being used to fund capital expenditure. This cash would otherwise have been invested at very low rates of return. External borrowing would also be that much more, at higher borrowing interest rates than any returns on cash invested.

** Council Fund total = £149.650m HRA total = £104.506m*

1.14	The MRP annual charge to the revenue account is based on the Capital Financing Requirement (the outstanding capital expenditure). It is not the same as the cash repayment of external borrowing. The simplified example below illustrates the difference: Assume a 10 year maturity loan of £15m is taken out to fund capital expenditure of £15m on an asset with a life of 20 years. The annual MRP charge to the revenue account on straight line asset life basis is £15m / 20 years = £0.750m. At year 10, the loan is repaid from cash on the balance sheet at £15m, but only £0.750m x 10 = £7.5m has been charged through the Council's revenue account. A decision would need to be made, either to take out another 10 year loan, or fund from internal cash resources for that 10 year period, dependent on the Council's position at that time.
	Review of the Council's MRP Policy
1.15	The review of the Council's MRP Policy has been considered as part of the overall Councils financial context and the Corporate Financial Stewardship part of the three-part budget strategy.
1.16	The Council last reviewed its MRP policy in the autumn of 2014 when setting the 2015/16 budget and adjusted its policy on capital expenditure funded by unsupported (prudential) borrowing by delaying the charge until the asset is in use.
1.17	Up until the last financial year, most local authorities in Wales had adopted a similar MRP policy as Flintshire as set out in 1.12 above. Recently, Welsh local authorities have begun to review and amend their MRP policies following discussions with their treasury management advisors, and their external auditors.
1.18	It was therefore appropriate that Flintshire undertook a more critical review

	of its MRP policy and engaged its treasury management advisors, Arlingclose, who have completed similar MRP reviews for English and Welsh Councils.
1.19	The options under consideration included: • 4% reducing balance (options 1 and 2 in 1.05 and 1.06 above), • straight line – equal repayment (options 3 and 4 in 1.07 above), and • annuity / inflationary method (options 3 and 4 in 1.07 above), for both supported and unsupported (prudential) borrowing funded capital expenditure. The differences of each option were explored with the concentration being on agreeing which would be the most prudent option.
1.20	Capital expenditure incurred by the HRA was not included in the review. When self-financing was introduced for the HRA and the negative housing subsidy system ended on 31st March 2015 considerable debate took place across Wales on a suitable MRP calculation for HRA assets. As landlord councils were implementing the Welsh Housing Quality Standard (WHQS) and investing in assets a 2% reducing balance method was considered appropriate and affordable and therefore agreed until 2021 when WHQS will be achieved. MRP on any capital expenditure after 2021 must be calculated in relation to asset lives. There is no proposal to amend the MRP policy for the HRA.
1.21	Given that the policy for calculating the MRP on loans made to NEW Homes was set in June 2016 and all options were thoroughly considered at the time, the method is still considered to be the most appropriate and therefore was not included in the review.
1.22	**4% Reducing Balance Method** The method implies that borrowing will be repaid over a 25 year period (in that 100% / 4% = 25), however as the calculation applies the 4% to the reducing balance it takes much more than 25 years to fully repay the borrowing. The table and graph below shows the MRP repayment profile of the £149.7m council fund capital expenditure funded by supported borrowing outstanding as at 31st March 2016:



Year	Annual MRP £m	Outstanding Capital Expenditure £m
2016/17	5.917	142.011
2017/18	5.680	136.331
2018/19	5.453	130.877
2019/20	5.235	125.642
2020/21	5.025	120.616

In 50 years' time from now £19m of capital expenditure will still be outstanding, and in 100 years' time £2.5m is still outstanding. It would take 179 years before the balance is below £0.100m and over 300 years to get to nil.

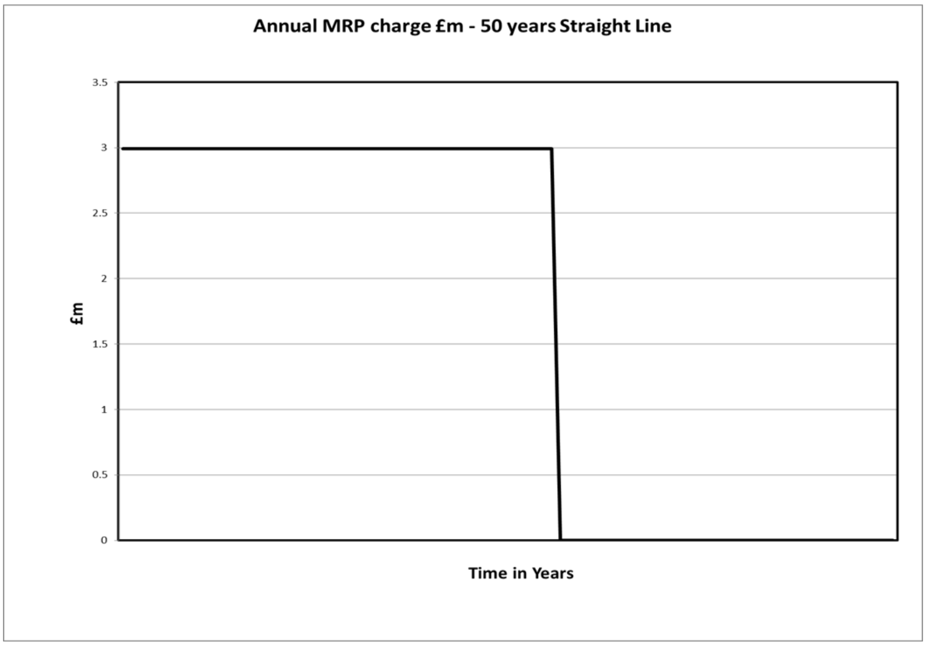
Using option 1, the regulatory method also means that there will always be £1.7m of capital expenditure outstanding, the equivalent of permanent Adjustment A.

1.23 The method is commensurate with the methodology used in the Revenue Support Grant to allocate revenue funding from WG to finance debt, as it also uses the 4% reducing balance method on notional outstanding debt. Any change in methodology would therefore break the link between costs charged to revenue (MRP) and the Revenue Support Grant funding received from WG. However, decisions around levels of expenditure on individual services are local decisions for each council to determine, with no part of the Revenue Support Grant being earmarked for particular services.

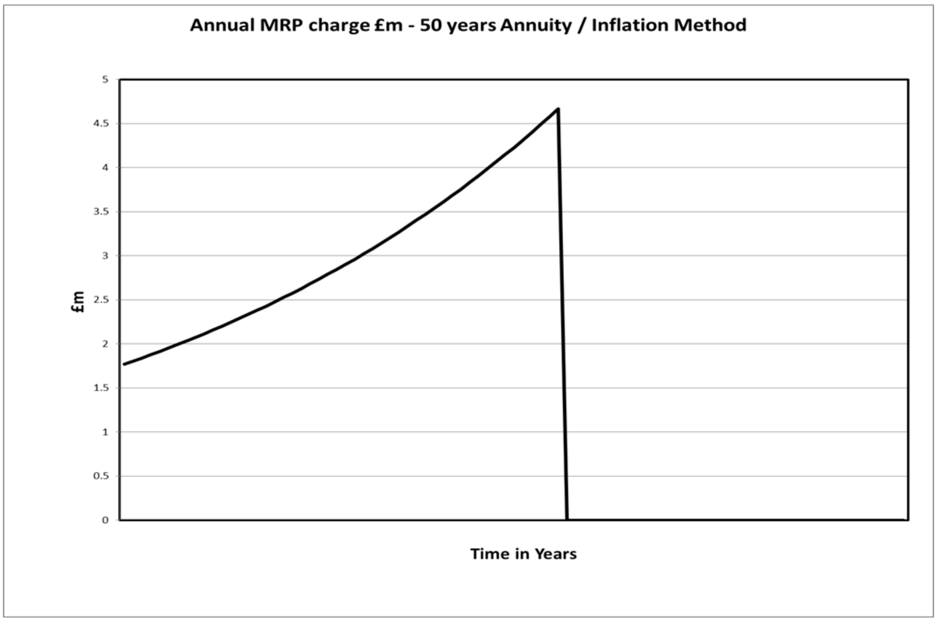
1.24 **Straight Line Method**

The method calculates an equal annual MRP charge to the revenue account over the useful estimated life of an asset.

For individual assets, funded from unsupported (prudential) borrowing, such as a newly built school building, the task of allocating an estimated useful

	is straight forward. For historic capital expenditure funded from supported borrowing, the task of allocating an estimated useful life is not so straight forward. The balance of outstanding capital expenditure has built up over a very long period of time. It will have increased for capital expenditure varying from, short lives for equipment and vehicles, to an infinite life for land, with limited records available of what expenditure was incurred. There will also be expenditure on assets that the Council does not own, for example, works at private properties where there is no asset life. It will have decreased every year for annual MRP charges made, but these would not have been allocated to specific capital expenditure and assets. There will also be a proportion of unfinanced capital expenditure that transferred from Clwyd County Council in 1996 during local government reorganisation, where the Council will simply have taken on a percentage of Clwyd County Council's outstanding capital expenditure based on population. The asset register has been used to calculate, broadly, the useful life of assets as at 31st March 2016 as a proxy for outstanding capital expenditure funded from supported borrowing at the same date. The weighted average life of Council fund assets as at 31st March 2016 was in excess of 50 years, and therefore 50 years has been used and is considered reasonable. The MRP repayment of the £149.7m council fund capital expenditure funded by supported borrowing outstanding as at 31st March 2016 would be £2.993m for the next 50 years. After 50 years the balance will have been fully repaid. The graph below illustrates: 
1.25	**Annuity / Inflation Method**

	The method is similar to straight line in that MRP is charged to revenue over the assets useful life and fully repaid at the end of the useful life. An annuity rate is set for the period to reflect that over time the value of money decreases due to inflation. This produces a consistent and 'real' charge to the tax payer of using the asset over its life, however, at today's prices it is an increasing charge. 2% is the rate commonly used being the Bank of England's target rate for inflation. The table and graph below shows the MRP repayment profile of the £149.7m council fund capital expenditure funded by supported borrowing outstanding as at 31st March 2016:



Year	Annual MRP £m
2016/17	1.769
2017/18	1.805
2018/19	1.841
2019/20	1.878
2020/21	1.915

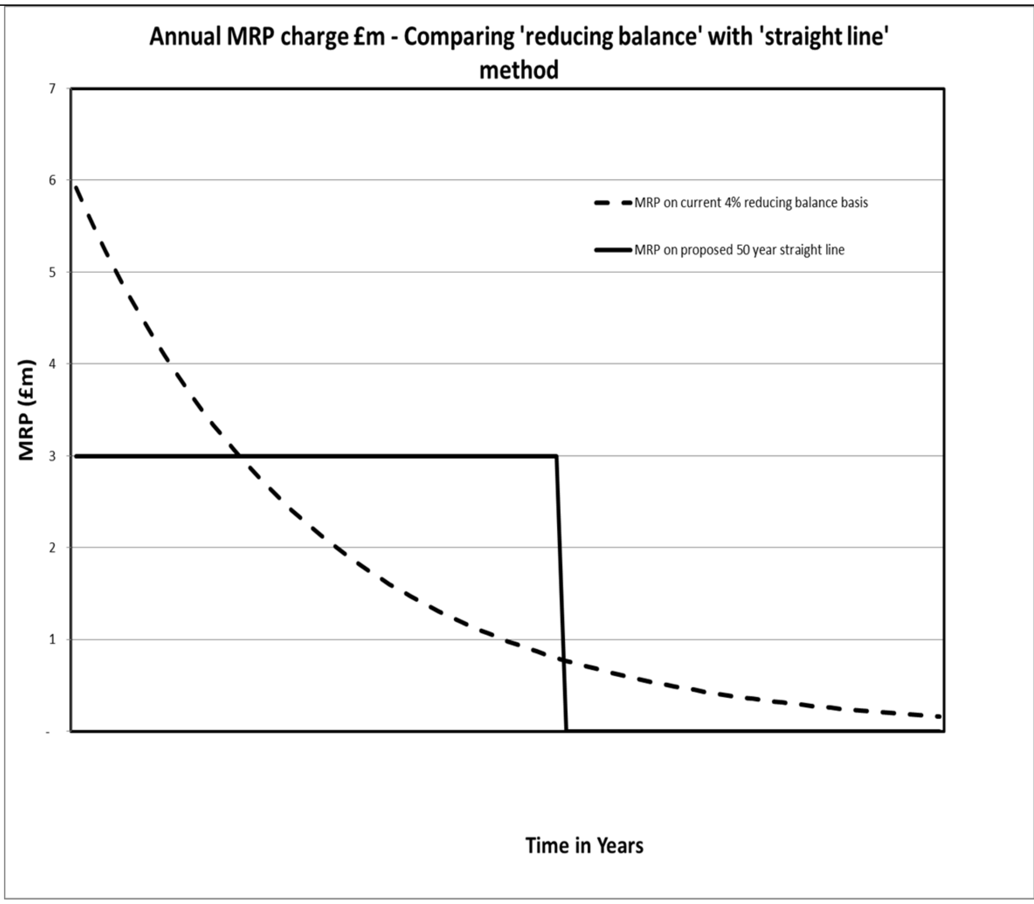
1.26	**Conclusions** 'Prudence' is a subjective judgement. None of the options or methods described can be assessed as being the absolute correct method – this is a matter of judgement. Rather all options must be considered with the Council's particular circumstances borne in mind and a preferred option selected. The option must be first and foremost prudent but also sustainable and affordable over the long term.
1.27	As the MRP charge rises over time using the annuity / inflation method, from a budgetary perspective this isn't desirable and is therefore ruled out for this practical reason.

1.28	This then leaves 2 options under consideration – 'reducing balance' and 'straight line'. For outstanding capital expenditure funded from unsupported (prudential) borrowing the regulations require a method based on the asset's life and therefore using the straight line method represents a continuance of the existing policy.
1.29	For outstanding capital expenditure funded from supported borrowing under the reducing balance method it takes a considerably longer period of time to repay the debt in full than the straight line method, where the debt is fully repaid in 50 years' time. The straight line method is more closely aligned to the life of the Council's assets and the costs are spread more evenly among tax payers who will benefit from the capital expenditure / assets. All things considered the straight line method is viewed as more prudent when compared with the reducing balance method. The straight line method is not without its flaws as outlined in para 1.23. The recommendation therefore is to transfer the balance of outstanding council fund capital expenditure funded from supported borrowing of £149.7m as at 31st March 2016 to an MRP repayment profile of straight line over 50 years. To address the issues outlined in paragraph 1.23 any new capital expenditure funded from supported borrowing incurred from 2016/17 onwards would be grouped appropriately into assets with similar useful lives and the MRP calculation built up from each separate group of asset. This represents an in year change to the MRP policy from option 1 regulatory method to option 3 asset life method.

2.00	**RESOURCE IMPLICATIONS**
2.01	The table below shows the difference in the MRP charge for outstanding council fund capital expenditure funded from supported borrowing as at 31st March 2016 using the current reducing balance method and the recommended revised straight line method for the next 5 years.

Year	MRP - 4% Reducing Balance (£m)	MRP – Straight Line 50 years (£m)	Variance – Cost / (Savings) (£m)
2016/17	5.917	2.993	(2.924)
2017/18	5.680	2.993	(2.687)
2018/19	5.453	2.993	(2.460)
2019/20	5.235	2.993	(2.242)
2020/21	5.025	2.993	(2.032)
			(12.345)

The table shows the significant savings that result from changing the MRP method in the earlier years, and the graph below plots the differences in MRP charges between the 2 methods over time.



A full 100 year analysis of the implications is shown at appendix 1. This demonstrates that there are savings in years 1 – 17, additional costs in years 18 - 50 and further savings in years 51 – 100. It also takes into account that £4.217m of debt which would still remain outstanding under the current method at year 100. When all of these savings and costs are discounted to allow for the time value of money it results in a positive Net Present Value of £5.019m.

2.02 The savings in the earlier years will result in lower cash balances than currently forecast in the MTFS and therefore there will be an additional interest cost pressure to be considered. Conversely in later years, the higher MRP results in interest savings. The implications of which will be factored into future cash-flow and interest cost computations within the central loans and investment account.

The estimated additional interest costs for the next 3 years are shown in the table below:

Year	Estimated additional interest costs (£m)
2016/17	0.018
2017/18	0.106
2018/19	0.170

2.03 For future capital expenditure incurred from 1st April 2016 onwards which is funded from supported borrowing, the MRP calculation will involve splitting into groups with similar useful lives which are then used to calculate the MRP charge on a straight line basis. This means that the MRP charge for each year will vary dependent on what the useful life of the expenditure is.

The table below shows the differences in MRP charges for both methods and varying useful lives, based on the 2016/17 supported borrowing allocation of £4.183m from Welsh Government:

MRP Charge	4% Reducing Balance (£m)	Straight Line 25 year life (£m)	Straight Line 35 year life (£m)	Straight Line 50 year life (£m)
2017/18	0.167	0.167	0.120	0.084
2018/19	0.161	0.167	0.120	0.084
2019/20	0.154	0.167	0.120	0.084
2020/21	0.148	0.167	0.120	0.084

Going forward for each financial year a recurring pressure for MRP will be built into the MTFS dependent on; the supported borrowing allocation from Welsh Government for the previous year and the useful life of that capital expenditure.

2.04 There are no resource implications other than financial.

3.00 CONSULTATIONS REQUIRED / CARRIED OUT

3.01 The proposed changes have been recommended following detailed discussions with the Council's treasury management advisors, senior internal officers and key Cabinet members.

Wales Audit Office is also being consulted as external auditors.

3.02 The proposed changes will be referred to the Corporate Resources Overview and Scrutiny Committee for comment before being discussed at County Council as part of Stage 2 of the budget in December.

4.00 RISK MANAGEMENT

4.01 The impacts of a change in MRP policy has long term effects that cannot be readily undone and therefore carries a significant amount of associated risk for future generations.

The Well-being of Future Generations (Wales) Act 2015, when fully enacted, will put in place a requirement to;

"act in a manner which seeks to ensure that the needs of the present are met without compromising the ability of future generations to meet their own needs".

It also requires that authorities take account of, amongst other things;

"the importance of balancing short term needs with the need to safeguard the ability to meet long term needs".

	The recommendation to change the MRP policy for supported capital expenditure from reducing balance to straight line ensures that the costs are spread more evenly amongst the taxpayers benefiting from the capital expenditure. This is not considered as compromising the ability of future generations to meet their own needs merely that future generations pay for assets from which they benefit from using.

5.00	**APPENDICES**
5.01	Appendix 1 – MRP 100 year analysis

6.00	**LIST OF ACCESSIBLE BACKGROUND DOCUMENTS**
6.01	Various Welsh Government papers. **Contact Officer:** Liz Thomas – Finance Manager, Technical Accountancy **Telephone:** (01352) 702289 **E-mail:** liz.thomas@flintshire.gov.uk

7.00	**GLOSSARY OF TERMS**
7.01	**Capital Expenditure:** Expenditure on the acquisition of non-current assets or expenditure that extends the life or value of an existing asset **Capital Financing Requirement (CFR):** A measure of the capital expenditure incurred historically by an authority that has yet to be financed from capital receipts, capital grants or revenue financing. **Council Fund (CF):** The fund to which all the Council's revenue and capital expenditure is charged. **Housing Revenue Account (HRA):** The fund to which all the Council's revenue and capital expenditure relating to its housing stock is charged. **Minimum Revenue Provision (MRP):** A charge made to the Council Fund to repay borrowing taken out for capital expenditure. Authorities must determine their own prudent MRP charge each year, taking into consideration statutory guidance issued by the Government. **Prudential Code:** The code of practice drawn up by the Chartered Institute of Public Finance and Accountancy (CIPFA) to underpin the requirements of the Local Government Act 2003 in respect of an authority's duty to determine the affordability, prudence and sustainability of its capital investment needs. **Revenue Expenditure:** All expenditure incurred by an authority that cannot be classified as capital expenditure **Revenue Support Grant (RSG):** Is paid to each authority to cover the cost of providing standard services less the Council Tax income at the standard

	level. **Unhypothecated Supported Borrowing (USB), commonly referred to as Supported Borrowing:** Each year Welsh Government provide Council's with a Supported Borrowing allocation. Council's borrow to fund capital expenditure equivalent to that annual allocation, Welsh Government then include funding to cover the revenue costs associated with the borrowing for future years within the Revenue Support Grant. The Council decides how this funding is spent. **Unsupported Prudential Borrowing**: Borrowing administered under the **Prudential Code**, whereby authorities can set their own policies on acceptable levels and types of borrowing. The Prudential Framework allows authorities to take out loans in response to overall cash flow forecasts and other factors provided they can show that the borrowing is to meet planned capital expenditure in the current year or the next three years.