READING BOROUGH COUNCIL

REPORT BY HEAD OF FINANCE

TO:	AUDIT & GOVERNANCE COMMITTEE		
DATE:	19 APRIL 2016	AGENDA ITEM:	6
TITLE:	IMPACT OF REVISED MRP POLICY FROM 2017/18		
LEAD COUNCILLOR:	COUNCILLOR LOVELOCK	PORTFOLIO:	LEADERSHIP
SERVICE:	ALL	WARDS:	BOROUGHWIDE
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1. PURPOSE OF REPORT AND EXECUTIVE SUMMARY

When the Council debated the budget in February an amendment (Appendix A) was agreed that referred to the Audit & Governance Committee for review for subsequent years after 2016/17. This report provides some information for the committee to undertake that review and make such observations as it sees fit to inform future financial planning.

2. RECOMMENDED ACTION

2.1 That the Committee considers the information in this report and makes such observations as it wishes for the Administration, working with the Head of Finance to take into account in developing the Council's on-going budget strategy and MRP Policy.

3. POLICY CONTEXT

3.1 The Council is required to set an MRP (minimum revenue provision) policy each year, setting out its approach to debt repayment. As part of the budget strategy for 2016/17 a revised policy was proposed that changed the policy from 2015/16.

3.2 As indicated above there was an agreed amendment that made the change only for 2015/16 and 2016/17, with later years subject to review by the Audit & Governance Committee.

3.3 In particular the Head of Finance was asked to report on the following matters for consideration:

i) the additional overall cost of the revised policy;

ii) the guidance regarding the length of asset lives

iii) a 'prudent' MRP in the light of prevailing interest rates.

4. BACKGROUND

4.1 Local authorities have been able to borrow money to help finance capital expenditure for many years, and have always had in place arrangements for repaying that borrowing. At various times Central Government has sought to control local authority borrowing, as the consequent debt is deemed part if the national debt, and the size of public sector debt can be a concern to Government.

4.2 In 1990 the then Government introduced the concept of a statutory minimum revenue provision, at that time requiring 4% of General Fund Debt and 2% of HRA Debt to be set aside from the revenue budget for repayment. Both these were on a reducing balance basis, so total debt would never be repaid.

4.3 The Local Government Act 2003, which introduced the "Local Authority Prudential Regime" removed the statutory basis of mrp and replaced it with statutory guidance. This was first issued under that Act in 2008 and we are required to take account of the guidance, which is now in its third (2012) edition in setting our MRP Policy. A link to the present guidance, which includes an explanation by DCLG is provided in the Background Papers.

4.4 Setting the MRP Policy and most matters related to borrowing overall are functions that are reserved by legislation to Council, and we do them as part of the budget, as the cost of financing borrowing accounts for roughly 10% of the overall General Fund Budget, so our approach is likely to have a significant impact on the overall budget position in any year. Audit & Governance received the draft Treasury Management Strategy Statement each year at its January meeting. With the Government's move in recent years to issuing the Local Government Finance Settlement (LGFS) about a week before Christmas (rather than at the end of November/first week in December, which was the norm for most years 1990-2010), the Council's timetable for finalising its detailed budget has been shortened.

4.5 As was reported earlier the December 2016 announcement reduced grant by £5m more than we had forecast. This unexpected change led to a need to recast the budget approach in order to set a legal balanced budget. Part of the approach was to change the MRP policy, and unfortunately the revised policy was not available at the time of the January meeting (of A&G). The proposal was published in the Policy Committee Papers on Friday 5 February. The amendment at Council did not change the proposal for the purposes of setting the 2016/17 budget.

4.6 General Effect of the Revised MRP Policy

The revised policy took account of various changes to the local authority finance regime since the DCLG Guidance was published and in overall terms ensures all our debt was eventually paid off (whereas the previous policy had retained for some of the debt the historic practice of paying off using the reducing balance method (described above), but reduced the repayment in the early years by moving to a lower percentage or switching the methodology from EIP (equal instalment of principal) to Annuity (a methodology that looks

at total financing costs and equalises these over time – basically a "repayment mortgage").

4.7 The revised policy was based on the approach adopted by Birmingham CC (where incidentally we understand EY had been involved as advisor to the Council in developing its policy), also incorporating aspects of Southampton CC's Policy (where EY are also auditor). EY, as our auditor were consulted about the revised policy during the latter stages of its development, and did not raise any fundamental objection to the change (in that it was using methods contemplated in the guidance, and developing practice in the sector), making some technical points for us to consider.

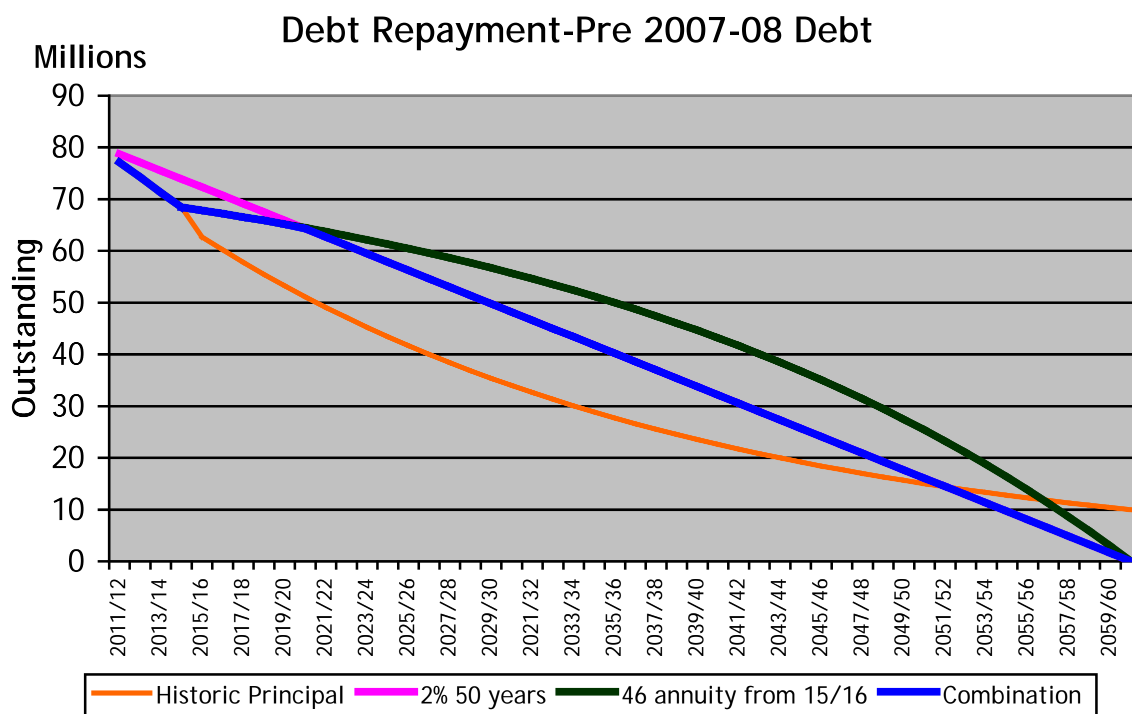
4.8 **Additional overall cost of the revised policy**;

The effect of the revised policy is to reduce the debt repayment in the short term, with the impact that in the medium term the Council will have higher borrowing, and therefore more interest costs.

4.9 For historic reasons the Council's debt is divided into various streams; historic debt prior to 2007/08 (where we do not hold comprehensive records showing which assets were financed by debt, some of which predates Local Government Reorganisation and was inherited from the former Berkshire CC) is treated differently to the debt of each individual year since (where we do know what the assets paid for). The value of the Council's historic assets is however significantly higher than the historic debt.

4.10 Pre 2007/08 Debt.

The graph shows how our MRP plans have changed. Based on the previous policy we were coming down the lower curved (orange) line (but £10m of the debt would still be outstanding in 50 years' time).



4.11 We considered two options;

(i) Moving to an annuity approach over 46 years (the higher curved line)
(ii) Moving to a 2% EIP approach starting in 2011/12

The rationale for the 2011/12 start was that one of the reasons for changing our approach is that historically this debt was paid for in substantial part by RSG, as it had almost all arisen historically from Government borrowing approvals, and since 2011/12 Government has been sharply reducing RSG, effectively reducing its contribution to debt repayment, so the historic repayment pattern was no longer affordable in the context of the budget as a whole.

4.12 It was observed that during the middle period with the annuity approach debt would be well over £20m higher than with the old policy, and this approach had potential inter-generational equity problems. (i.e. it would pass too great a financing burden onto the generation of councillors and residents running the Council in about 30 years' time (taking account of the benefit they might be then receiving from the Council's historic assets)). Council was therefore advised to move to the 2% EIP over 50 years approach, but it was not possible to backdate this, so the proposal was that we have a hybrid approach, using 2% EIP in the long run, but using the annuity methodology until 2022. I.e. overall we plan to make MRP such that debt moves along the "combination" (blue) line.

4.13 The impact of this is that between now and about 2052 we will have more debt, initially by about £2m pa rising to £11.6m in 2028 but subsequently falling. During the period when there is more debt, on average it is £8m extra debt pa, at an average interest cost of £290k pa (just over £400k at the peak). Taking account of the later years when debt is lower, over 50 years the estimated additional net interest costs are about £6.2m (so the 50 year average is £124k) and with the additional debt repayment the average additional annual cost is just under £400k

4.14 Overall we therefore have £6.2m additional cost over the next 40 years to reduce by about £9m debt repayment between 2015 & 2020 on this aspect of the proposal. To put this in context, borrowing of £9m for 40 years would incur financing costs of £8.1m, so the financing cost of the MRP change is less than that of an equivalent amount of new borrowing.

4.15 Post 2007/08 Debt to 2011/12

Since 2007/08 we have repaid this debt using the EIP method. The change to the MRP switched this to the annuity method for the remaining debt. New debt after 2012/13 (though there was no new debt in that year) had already been changed to the annuity method a couple of years ago.

4.16 The impact of this is quite complex, because the assets have varying lives, and the amount borrowed varied significantly from year to year, but to illustrate the short term impact the change reduces MRP on these asset streams across these years from the £4.7m made in 2014/15 to £3.2m in 2015/16, £3.4m in 2016/17, £3.5m in 2017/18.

4.17 In overall terms the change reduces the debt repayment costs for about a decade up to 2027/28, with higher annual repayments being made after that time to compensate. Over the decade, about £9.2m less debt will be repaid (£5.2m of it by 2019/20), and overall debt will be higher up to around 2037 by £6.1m pa on average at a total interest cost over that period of £4.6m; about £220k pa on average.

4.18 Overall Additional Cost

On the basis of these estimates the changes to historic debt repayment therefore will add £12.3m mainly interest costs over a 40 year period at an average of £510k pa until the mid 2030s and a reduced amount after that. In terms of the benefit, we will repay less debt of about £14.1m by 2019/20 (the period of the present parliament for which the government has set the spending in the grant settlement).

4.19 **Guidance regarding the length of asset lives**;

The DCLG's Guidance is available on the link provided in the Background Papers. The Guidance sets out 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 that they are fully consistent with the statutory duty to make prudent revenue provision." The key issue is therefore what the Council considers to be prudent.

4.20 In relation to repayment periods, the Guidance recommends that debt is repaid "over a period bearing some relation to that over which the asset continues to provide a service". We fix the life at the time of the capital expenditure and we have developed classes of assets, so for example most Transport Infrastructure is assumed to have a 20 year life.

4.21 Particular difficulty arises with some assets, such as freehold property (where the freehold has a "permanent" life) or major assets where we expect a very lengthy life. For example we anticipate being in the (new) Civic Offices for many decades and have arrangements to keep the building in good repair, and equally we would expect the new school buildings being built for the Primary Capital Programme to last many decades (albeit no doubt with some need for refurbishment programmes in 20/30/40 years' time (depending upon component). In the case of Freehold land, the guidance provides for a maximum period of 50 years unless the building is estimated to have a longer life. There are other circumstances where the guidance provides a suggested life, though ultimately it is for authorities to decide what is prudent. The guidance also recognises that sometimes we incur capital expenditure for the benefit of the town on assets that are not in our ownership, and recognises that in these circumstances it is reasonable to pay that offer over the asset lives.

4.22 Finally, the guidance comments that "if it is ever proposed to vary the terms of the original MRP statement during the year, a revised statement should be put to the Council at that time". The statement adopted in February is intended to apply from 2015/16. Overall the revised statement remains broadly consistent with the approaches provided for in the guidance.

4.23 **A 'prudent' MRP in the light of prevailing interest rates.**

MRP is not necessarily directly linked to prevailing interest rates. However, by moving to an annuity method, we have introduced a link to the average rate we pay on all borrowing which is currently fairly stable at around 3.6%. The Policy as set fixes MRP for the life of the asset based on the average rate we are paying at 31 March in the year it is completed (with MRP normally starting in the following year).

4.24 To illustrate the impact, it is easiest to provide an illustration. Our current average borrowing rate is about 3.6%, so based on the annuity methodology if we had a new 10 year life asset total annual repayments (principal and interest) would be around £120.85m. In a scenario that our average borrowing rate increased to 5% annual repayments would increase to around £129.5m. The MRP in each year of the life of the asset would be as per the following table

Year	MRP @ 3.6%	MRP @ 5%	Difference
1	84,848	79,505	5,344
2	87,903	83,480	4,423
3	91,067	87,654	3,413
4	94,346	92,036	2,309
5	97,742	96,638	1,104
6	101,261	101,470	- 209
7	104,906	106,544	- 1,638
8	108,683	111,871	- 3,188
9	112,595	117,464	- 4,869
10	116,649	123,338	- 6,689

4.25 The table shows that as interest rates rise, in the early years the MRP would tend to fall (and vice versa should interest rates fall), with the difference pattern being reversed. However, the table also illustrates that the changes are not great for what would be a huge change in our average interest rate. Given the large amount of long term fixed rate borrowing we have there is no prospect of our average interest rate rising anywhere near 5% within the next decade, and probably much longer; indeed in the short term the average rate may fall slightly. Clearly the overall annuity repayment tends to fall as interest rates fall.

4.26 In our context, it is therefore reasonable to assume that MRP will not be materially impacted by realistic to anticipate changes to interest rates. i.e. this factor is not likely to be significant,

5. CONTRIBUTION TO STRATEGIC AIMS

The changes made to the MRP approach were done to support the overall budget, and ensure resources were available to meet the Council's strategic aims.

6. COMMUNITY ENGAGEMENT AND INFORMATION

The Council does not normally consult with the community on this particular issue.

7. EQUALITY IMPACT ASSESSMENT

An EIA is not directly relevant.

8. LEGAL IMPLICATIONS

None at this stage. The revised MRP approach meets legislative requirements.

9. FINANCIAL IMPLICATIONS

As above, noting that all calculation in this report have assumed (unless indicated otherwise) that the Council can maintain a long term average interest cost around 3.6%, the present rate (which has been stable in recent years

10. BACKGROUND PAPERS

TMSS
DCLG Guidance
https://www.gov.uk/government/publications/capital-finance-guidance-on-minimum-revenue-provision-third-edition

Appendix A – Amendment to the Budget Resolution – February 2016

"Delete the wording in recommendation 2.6 on page B5 of the Building a Better Reading: Corporate Plan and Budget 2016-19 report and replace with the following:

'This Council notes that:

i) paragraph 2.6 of the recommended actions asks the Council to approve a revised Minimum Revenue Provision (MRP) statement to apply from 2015/16; (Annex D, page B153);

ii) the MRP is the rate at which loans are repaid annually in addition to the interest charge. Currently loans are repaid at 4% per annum of the balance. Most loans are repaid within 25 years. The revised policy will reduce the rate to 2% per annum and the repayment period will be fixed at 50 years; (paragraph 7, page B155);

iii) the new policy will apply to non-HRA existing borrowings of approximately £230 million and the additional £50 million to be borrowed over the next 3 years;

iv) the extension of the borrowing period will reduce the annual financing cost but increase the total cost over the lifetime of the loans;

v) we are currently experiencing a period of historically abnormally low interest rates and that these are forecast to increase over the next decade;

vi) the statutory Guidance issued by DCLG does not prescribe the annual repayment profile but suggests four options for making MRP that it considers 'prudent'; (paragraph 3, page B154)

vii) as per paragraph 4 of the revised policy 'the Council considers that 'prudent' in this context does not mean the quickest possible repayment period' (paragraph 4, page B154);

viii) a draft of the Treasury Management Strategy was presented to the Audit & Governance Committee on 28 January 2016 but that this did not include the revised MRP policy (paragraph 7.3, page B23); and

ix) paragraph 10 of the statutory Guidance states that elected Members should be given the opportunity to scrutinise any changes to the MRP policy before they are adopted.

Accordingly, the Council resolves that the Treasury Management and Investment Strategy and Prudential Indicators set out in Appendix 8, and the revised MRP Statement be approved, subject to Paragraph 2 of Annex D (under the sub-heading 'Statement of MRP Approach' on page B153), being revised to say:

This policy applies to the financial years 2015/16 and 2016/17 only. The revised policy is referred to the Audit & Governance Committee for review for subsequent years. In particular the committee is instructed to ask the Head of Finance to report on the following matters for consideration:

i) the additional overall cost of the revised policy;

ii) the guidance regarding the length of asset lives at paragraph 6 of Annex D;

iii) a ‘prudent’ MRP in the light of prevailing interest rates.

Any interpretation of the Statutory Guidance or this policy will be determined by the Head of Finance, taking advice as necessary from the Head of Legal & Democratic Services, the Council’s treasury advisor, Arlingclose and consulting the external auditor, EY.’”