The Chartered Institute of Public Finance & Accountancy

National Assembly for Wales Finance Committee:

Inquiry into Prudential Borrowing and Innovative Approaches to Capital Funding

A Submission by:

The CIPFA Directors of Finance Section

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the people in public finance

CIPFA Local Government Directors of Finance Section is the professional forum which comprises the Section 95 Officers under the Local Government (Scotland) Act 1973 of all 32 local authorities in Scotland. The Section provides opinions on matters concerning the management and operation of Scottish local government finance and also serves as a learning forum for the exchange of experience and information on these issues.

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1. Introduction

1.1 The CIPFA Directors of Finance Section welcomes the opportunity to provide evidence to the Committee's inquiry. We note that the Committee is specifically interested in:

- The lessons learned from local authorities on prudential borrowing; and
- Innovative capital models from elsewhere in the UK

1.2 These two areas will be the principal focus of this submission. We describe the practical operation of prudential borrowing over a period of eight years since its introduction in Scotland.

1.3 Scottish local authorities have been at the forefront within the UK in seeking alternative models for financing large capital projects. One recent model, the Non Profit Distributing Organisation model (NPDO) is set out for the benefit of the Committee as an example of innovation.

1.4 The introduction of prudential borrowing takes place against the background of a wider UK capital control mechanism. That wider mechanism could be exercised at a future point in the form of a national borrowing limit. We therefore set out the agreed proposals which exist in Scotland in the event of the need for the introduction of a national borrowing limit. We contrast this with the draft proposals which are currently proposed for Wales.

1.5 We begin our submission with background information on the statutory framework for prudential borrowing in Scotland.

2 BACKGROUND TO PRUDENTIAL BORROWING IN SCOTLAND

2.1 The enactment of Sections 35 to 37 of The Local Government in Scotland Act 2003[1], introduced a new system of capital controls in Scotland with effect from April 2004. At the same time the previous control mechanism which was based on central government control was abolished[2].

2.2 The equivalent legislation which was introduced in Wales was the Local Government Act 2003[3]. The Committee will wish to note however that in Scotland legislative control is on capital expenditure while in Wales, legislative control is on borrowing.

2.3 Further regulation in Scotland (as in the rest of the UK) prescribed that the application of the new control mechanism by local authorities would be based on the application of the CIPFA Prudential Code for Capital Finance in Local Authorities[4].

2.4 The policy intention as well as the practical effect was to transfer responsibility for decision-making on capital expenditure from central government (in the form of the then Scottish Executive) to local authorities.

2.5 The core objectives of Prudential Code are to provide a framework for local authority capital finance that will ensure for individual local authorities that[5]:

- Capital expenditure plans are affordable;
- All external borrowing and other long-term liabilities are within prudent and sustainable levels
- Treasury management decisions are taken in accordance with professional good practice

2.6 The Code is supplemented by a suite of locally set prudential indicators which operate as a control mechanism to ensure that these core principles are adhered to and reported.

2.7 The Code was fully revised in 2009 following a period of consultation and now incorporates changes as a result of the move towards International Financial Reporting Standards and emphasises the links with strategic planning and asset management and further emphasis is given to the importance of:-

- Service objectives, i.e. strategic planning for the authority
- Stewardship of assets, e.g. asset management planning
- Value for money, e.g. option appraisal
- Prudence and sustainability, e.g. implications for external borrowing and whole life costing
- Affordability, e.g. implications for council tax, rents etc
- Practicality, e.g. achievability of the plan

[1] Local Government in Scotland Act Part 7, Sections 35, 36 and 37.
[2] Local Government (Scotland) Act 1973, Section 94
[3] Local Government Act 2003 Part 1
[4] The Prudential Code for Capital Finance in Local Authorities, 2011 Edition
[5] The Prudential Code for Capital Finance in Local Authorities, 2011 Edition, page 5, para 1

2.8 Since the introduction of prudential borrowing, both the political and wider fiscal backdrop has altered. In 2007, Scotland elected a minority Scottish National Party (SNP) government and in 2011 SNP was elected as Scotland's first post-devolution majority government. One of the key policies adopted by the Scottish Government was a council tax freeze and this has been in place since 2008[1]. Additionally and perhaps most significantly, Scottish Government spending on capital resources reduced by 24.8% in 2011/12 and is forecasted to reduce until 2014/15[2]. It is against that background that this submission is compiled.

[1] Renewing Scotland: The Government's Programme for Scotland 2011-2012, page 5
[2] Scottish Government & Office of Budget Responsibility (OBR)

3. PRUDENTIAL BORROWING IN SCOTLAND

Practical Operation of Prudential Borrowing

3.1 This section of our submission sets out a practical summary of how prudential borrowing operates in Scotland. As an indicator of scale, local authorities spent more than £2 Billion in Scotland on capital expenditure in 2010/11, of which around half was met from borrowing[1]. The following case study based on a "live" example describes how local authorities take account of asset management and option appraisal best practice as part of an integrated approach to asset management and capital planning.

3.2 In developing a Capital Investment Strategy, a standard business case and scoring process to measure the merits of individual capital projects (a Capital Prioritisation and Options Appraisal Framework) is applied to determine priorities. A dedicated Council-wide group assess business cases against objective criteria.

3.3 Seven separate but specific asset management plans are constructed covering the key asset areas of Corporate Property, School Estate, Roads (including lighting and structures), Greenspace, ICT , Housing, and Vehicle Fleet. These detailed asset appraisals assist in developing the Capital Investment needs thereby strengthening the strategic approach by making recommendations on a long-term Capital Investment Strategy.

3.4 Revenue implications of the Capital Programme are incorporated into future years Revenue Budget, fully integrating Revenue and Capital budget processes. This is reflected in a Corporate Asset Management Plan which sets out how all assets will be managed.

3.5 A significant concern is that of a backlog in investment and maintenance and finite resources with which to address these issues. Property condition surveys and an assessment of the road network indicate nationally across Scottish local authorities this could represent a figure in excess of £2 billion, albeit a significant proportion of this is of low priority. Additionally asset rationalisation programmes are in place to down-size property portfolios.

3.6 Following the collection and analysis of this data on asset useage and conditions recommendations can be presented to elected members on the proposed Capital Investment Programme.

3.7 Up to 2010-11 Scottish Government provided revenue resources within the Financial Settlement to meet the debt costs associated with a notional borrowing value. This allowed local authorities to undertake an element of "supported borrowing". From 2011-12 it was agreed that this arrangement should end with these resources converted into additional Capital Grant. Now, all local authority borrowing is financed from within the local authority.

3.8 Taking a multi-year approach (usually 3 to 5 Years) a resultant Capital Investment Strategy ensures all future Capital Investment plans are developed in the context of improving the linkages to Council priorities and objectives and that account is taken of the proposals in the Corporate Asset Management Plan. The linkage from overall priorities on service delivery to the Prudential Code can be

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[1] An Overview of Local Government in Scotland, Audit Scotland, page 23

further exemplified when the provision and financing of housing services is considered.

Housing

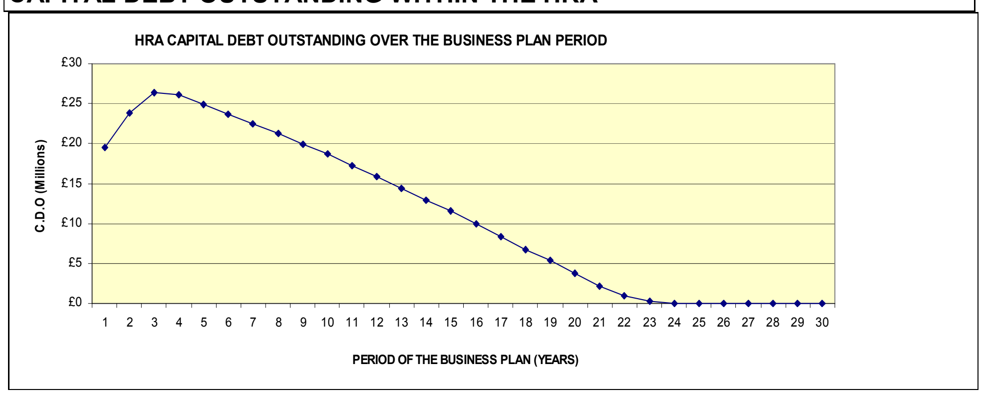
3.9 In Scotland, the Housing Revenue Account (HRA) is a statutory, ring-fenced account. By statute, all tenant rent and costs related to operating the housing service (including debt charges) must be applied to the HRA. However the Prudential Code principles also extend to the HRA.

3.10 In 2005 a thirty year Business Plan was developed which demonstrated that the Council had sufficient investment resources to bring stock up to the level required in the Scottish Housing Quality Standard by 2015. Subsequent reviews of the Business Plan reflecting material changes have been conducted periodically and continue to demonstrate a viable HRA and SHQS compliance.

3.11 The scope of the Business Plan also importantly demonstrates participation in the Scottish Government's new-build housing programme which provides an element of funding to incentivise local authorities to undertake house-building programmes, with the balance largely financed by additional borrowing utilising the Prudential Code.

3.12 The outcomes of the most recent reassessment of the Business Plan concluded that incorporating changes to Right to Buy, capital receipts and a prudent debt repayment profile, a more flexible and ambitious HRA Business Plan could be adopted. A key positive finding was that not only does the Business Plan still pass all financial tests but there is also further scope for additional borrowing to enhance new-build housing within the HRA. The following table sets out the summary position of the overall Capital Debt outstanding within the HRA as a result of the additional prudential borrowing incurred to finance the new-build programme.

CAPITAL DEBT OUTSTANDING WITHIN THE HRA



3.13 It can be seen from the above table that housing debt will peak in year 3, 2014/15, and will then decline over the future period thereafter, indicating there is further investment capacity within the HRA. At no point does the annual debt charge associated with loan repayment rise above 40% of HRA turnover. The significance of that figure is that 40% is a locally adopted Prudential Indicator of affordability.

Prudential Borrowing and the Role of Elected Members

3.14 Elected members are required to provide appropriate scrutiny and review of their local authority's Treasury Management and Capital Investment Plans, including a review of performance against the Prudential Indicators. Commonly this scrutiny activity is undertaken at an Audit committee, with the findings of that process then reported to a meeting of the Council for final agreement. This ensure that robust governance arrangements are in place and all stakeholders have a full appreciation of the implications of investment decisions. The indicators are an appropriate measurement with a long-term financial perspective, and are therefore complex. Therefore, it is important that Council officers provide appropriate training and briefings to elected members to ensure the key factors and assumptions underpinning these strategies are clear and understood.

The Role of Capital Receipts

3.15 Capital receipts are worthy of specific reference. The focus upon improved asset management which has been a feature of the introduction of the prudential regime has enabled local authorities to be able to identify alternative uses for assets and to identify surplus assets. This has coincided with the general downturn in the market for development.

3.16 The consequence for local authorities in Scotland is that the level of capital receipts has reduced from around £0.5 Billion in 2007/08 to around £100M in 2010/11[1]. This has resulted in greater reliance on prudential borrowing to keep investment plans on track since 2008[2]. In simple terms, local authorities in Scotland have borrowed to compensate for both a timing delay in achieving asset sales and a reduction in overall capital receipts.

[1] Scottish Government Capital Finance Working Group, Paper 49, 20 Sept 2011, para 5
[2] Scottish Government Capital Finance Working Group, Paper 49, 20 Sept 2011, para 10

4. IMPOSITION OF A NATIONAL BORROWING LIMIT

Background

4.1 At the outset of this submission we described the policy intention of the prudential regime to transfer responsibility for capital expenditure to local government. One of the key learning points from the practical operation of the prudential regime is that against that background of local responsibility, government has retained power to impose limits on capital expenditure. Local authorities therefore require to be prepared in the event of any limit being imposed.

4.2 Section 36 of the Local Government in Scotland Act 2003[1], includes a power to enable Scottish Ministers to impose a national limit on capital expenditure. It is understood that such a control would be imposed at a macro level by HM Treasury 'for national economic reasons'. This in turn would trigger use of Section 36 by Scottish Ministers. To date this power has not been utilised.

4.3 The Scottish Government, as advised by HM Treasury, and in anticipation of the possibility that a limit may be imposed at some point in the future determined that a protocol should be developed to set out how such a limit would operate in practice. A protocol between the Scottish Government and local government was finalised in June 2008 and it detailed the administrative arrangements which would be put in place in the event of a need for a national limit[2].

4.4 The protocol was developed with input from key stakeholders in Scotland and was finalised in June 2008. The protocol is both transparent and understandable in that the level of detail enables clarity on the administrative arrangements to be put in place in the event of a national limit being required.

Comparison of National Limit Protocols

4.5 We note that while there is a finalised protocol in Scotland, no such protocol exists in England and in Wales, only a brief protocol exists in draft form[3]. The protocols contain similar wording with the same broad intention although the respective levels of detail, as well as status differs. The committee will wish to examine these differing arrangements further.

[1] Local Government in Scotland Act 2003, Section 36

[2] National Limit on Local Authority Borrowing, Protocol Between Scottish Government and Scottish Local Authorities, 27 June 2008

[3] Draft National Limit on Local Authority Borrowing, Protocol Between the Welsh Government and the Welsh Local Authorities (undated)

4.6 The CIPFA Directors of Finance Section provided professional input into the development of the protocol in Scotland. Based on that knowledge we have compared the Scottish protocol with the draft Welsh protocol as follows:

Observation	**Scotland**	**Wales**	**Comment**
Status of Protocol	Final (since June 2008)	Draft	-
Parties to the Protocol	Scottish Government, Directors of Finance, COSLA, CIPFA, Audit Scotland	Welsh Government, WLGA	Key stakeholders in Scotland have contributed to the protocol. There is a 'buy-in' to any resulting process.
Transparency of Protocol	Available on Scottish Government website	Not yet publicly available	-
Timing of Imposition of Limits	Specified that "..any limit ..would be set in advance and apply to the following financial year only."	(Welsh Government) "…would expect advance notification" Noted that WLGA will be required to comment on proposals within 5 working days.	Clarity in Scottish protocol that the limit would be set in advance. Less certainty in the draft Welsh protocol.
Level of Detail included within the protocol	Detailed paper including definitions and parties to whom applicable	Short paper only.	Level of detail in Scotland has enabled advance debate and subsequent clarity on issues which may yet have to be addressed in Wales.
Clarity and Specification of Allocation Methodology	Detailed methodology described including data required and calculation methodology for individual authority allocations.	Proposed methodology yet to be determined per para 10 of the draft protocol.	

4.7 The key issues which emerged from the comparison was that devolved administrations and local authorities are in differing states of readiness for any national limit imposition. Although devolved administrations are entitled to take their own decisions, any imposed limit will of course be UK-wide.

4.8 A further implication for the Committee to consider, in the event of additional borrowing powers being granted, will be whether a detailed and transparent protocol for national government is desirable and whether it should be developed. The Scottish local government protocol provides a useful benchmark against which a national protocol could be developed.

5. INNOVATIVE FUNDING MODELS: NON-PROFIT DISTRIBUTING ORGANISATION MODEL (NPDO)

Introduction

5.1 Whilst the main focus for this submission has been prudential borrowing, we note that the Committee also intend to address alternative funding models from elsewhere in the UK. Over the last four years local authorities in Scotland have contributed to the development of a new model, referred to as a non-profit distribution model (NPDO). In this submission we briefly set out the underlying features and, on a case study basis, we describe how this has operated in one Scottish local authority. This NPDO model was developed over 7 years ago and the core principles are still used through the national HUB development initiative and Scottish Futures Trust and there have been some developments since then.

5.2 The model which is a derivative of early private finance schemes has the following identifiable features:

- Profits earned by the Special Purpose Vehicle company (SPV) are paid to a charity
- Achievement of similar or Improved value for money as a standard PPP
- A more transparent governance structure to ensure NPDO principles are adhered to by the SPV

NPDO – A Practical Case Study

5.3 When options were being appraised to deal with the backlog in maintenance of a local authority's school estate, traditional PPP was seen to have a number of drawbacks particularly relating to the expense and the possibility of windfall surpluses accruing to the private rather than the public sector.

5.4 The NPDO approach maximises the opportunity for the local community to benefit from SPV profits by removing the need for equity shareholders and diverting all surpluses generated during the concession period to a charity devoted to educational aims. In all other regards this is similar to a traditional PPP which is important in terms of marketability of the scheme. The local authority has a contractual relationship with a SPV. This contractual relationship is based upon the standard PPP contract.

5.5 In the case of this particular authority, the release of funding was dependent upon the contract being compliant with the Scottish Schools Standard Contract (SSSC). The adoption of a contract consistent with standard PPP contracts was seen as a key element of ensuring there was a market for the project especially given the volume of schools PPP contracts brought to the market at around the same time.

Financing

5.6 The project is entirely financed by borrowing. None of the shareholders have a return in the SPV that will yield them an investment return beyond that earned as interest on monies lent to the SPV. Around 90% of the funding is referred to as senior debt and this has been borrowed at a rate similar to other more traditional PPP projects.

5.7 The remaining 10% is referred to as junior or subordinated debt. This has less security than the senior debt and has a higher rate of interest. This is because it exposes the lender to a greater risk. Lenders of senior debt get their interest and principal repaid before the lenders of junior debt.

Governance

5.8 The board of the SPV comprises up to 5 directors appointed by the providers of the subordinated debt. Each of the private sector partners in the project has a minimal shareholding. This allows them to appoint directors to the board. In addition to the directors appointed by the subordinated lenders there is an independent director (ID) appointed by Partnerships UK and a stakeholder director (SD), appointed by the Authority in the first instance, but who will be appointed by the charity when this is established.

5.9 The ID's role is to ensure that the SPV conforms to the NPDO principles enshrined in the Memorandum and Articles of Association and the Project Agreement. The ID is also responsible for initiating any refinancing of the project. The SD is responsible for ensuring the charity's interests are protected at SPV board level and that surpluses are passed to the charity in line with the Project Agreement.

5.10 The board of directors do not manage the SPV directly but appoint a management company to manage the contract and various sub contractors on behalf of the SPV. As part of the project the private sector partners had to agree to a resolution agreeing not to take a dividend or return based on their shareholding but to transfer any profits beyond a certain level to charity. The amount of profit that can be retained by the SPV is set at a level to provide an incentive to management and to provide for operational stability of the SPV.

The Charity

5.11 It is envisaged that a charity, separate to the SPV, will be set up to receive monies when any surplus funds are generated, although the exact charity is not specified in the SPV's company documents. The charity's probable objectives have been drafted and are expected to cover the following:

- for the public benefit to advance education and social welfare through the provision and/or finance of educational facilities, equipment and/or services;
- to provide and/or finance the provision of facilities, equipment and services to advance the education of people who have any disability or infirmity or who suffer from ill health;
- to promote community participation in healthy recreation by providing and/or financing facilities, equipment and services for playing sport;
- to promote community participation in the arts and culture by providing and/or financing facilities, equipment and services in relation to arts and culture;
- to advance the physical education of young people by providing and/or financing facilities, equipment and services for playing sport;
- to promote access for and inclusion of disadvantaged groups and individuals to educational facilities, equipment and services; and
- generally to provide, participate in and/or finance the provision of educational facilities, equipment and services for the benefit of the public.

Comparison with Standard PPP Contract

5.12 The following table summarises both the differences and the similarities in comparison to a standard PPP contract.

Similarities to Standard PPP	**Differences with Standard PPP**
Based around a DBFO contract between the public sector and a SPV.	100% debt funded
Consistent with SSSC for local NPDO	No equity return to SPV shareholders
High level of debt finance for SPV	SPV profits transferred to charity
Same risk / reward profile as PPP for accounting treatment	Independent and stakeholder directors on SPV board
VFM advantage of NPDO over public sector model comparable to traditional PPP scenario.	Sharing of refinancing gains extends to junior debt (not available in standard PPP because equity cannot be refinanced)

5.13 Going forward there are likely to be developing consequences which have yet to emerge including likely lengthy negotiations with funders on security and the practical consequences with no efficiency savings passed on to shareholders.