APPENDIX 1

1. BACKGROUND TO CAPITAL EXPENDITURE AND FINANCING

1.1 Capital expenditure is legally defined as ‘expenditure to acquire, enhance or prolong the useful life of non-current assets’ which is expenditure on assets which have a life expectancy of more than one year e.g. buildings, infrastructure improvements, vehicles, machinery etc. Section 16 of the Local Government Act 2003 provides a definition of capital expenditure and states that any form of capital expenditure must be in accordance with proper practice.

Capital expenditure is funded from a combination of capital receipts, revenue contributions, general capital grant, scheme specific grants, and debt in the form of borrowing or other long term financing arrangements such as leasing.

Borrowing can either be:

- Supported borrowing - funding is provided by Welsh Government (WG) through the Revenue Support Grant (RSG) 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 WG.

1.2 The annual charge to the revenue account for repaying debt is known as the Minimum Revenue Provision (MRP). The following regulations refer to this charge:-

- 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”, although 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.

1.3 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 WG, 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 supporting 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."

1.4 In a recent letter to all local authorities the Auditor General for Wales concurred that it is for each authority to determine what a "prudent" policy is.

1.5 **Options for Prudent Provision within WG Guidance**

1.5.1 Option 1 - Regulatory Method

For capital expenditure funded from supported borrowing which is supported through funding in the 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).

1.5.2 Option 2 - Capital Financing Requirement (CFR) Method

For capital expenditure funded from supported borrowing which is supported through funding in the RSG, the MRP is calculated as 4% of the Capital Financing Requirement at the 1st of April in a year.

1.5.3 Option 3 - Asset Life Method

MRP is calculated using annual instalments over the estimated life of the asset.

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 = £80,000.

- Annuity or inflation method – annual MRP charge that takes the time value of money in the form of inflation into consideration in respect of the above

  Year 1 = £47k
  Year 2 = £48k
  Year 3 = £49k
  Year 4 = £50k
  Year 5 = £51k
  etc.

1.5.4 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.

WG 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.

1.6 Denbighshire's Current MRP Policy

The Council's current MRP policy is as follows:

- Capital expenditure funded by supported borrowing on the basis of Option 1 – Regulatory Method.
- Capital expenditure funded by unsupported (prudential) borrowing on the basis of Option 3 - Asset Life Method.
- MRP on housing assets funded through Prudential Borrowing is charged at 5% of the HRA'S CFR. MRP on all other items such as the buy-out and new builds are charged at 2% of the HRA CFR.

The table below shows the amount of outstanding capital expenditure which needs to be repaid as at the 31 March 2017:

TABLE 1

Item	£m
Outstanding capital expenditure funded by supported borrowing – Council Fund	101.295
Outstanding capital expenditure funded by unsupported (prudential) borrowing – Council Fund	71.542
Outstanding Capital Expenditure - HRA	68.017
Total outstanding capital expenditure – Capital Financing Requirement	**240.854**

1.7 Review of the Council's MRP Policy

1.7.1 WG recommend that before the start of the financial year a statement of the policy on making MRP in that financial year be approved by full council. Each year the policy is reviewed and this year given the current financial position consideration was given as to whether savings could be made on MRP whilst still complying with regulation.

A review of the policy was undertaken by the Council's treasury management advisors, Arlingclose, who have completed similar MRP reviews for other English and Welsh Councils.

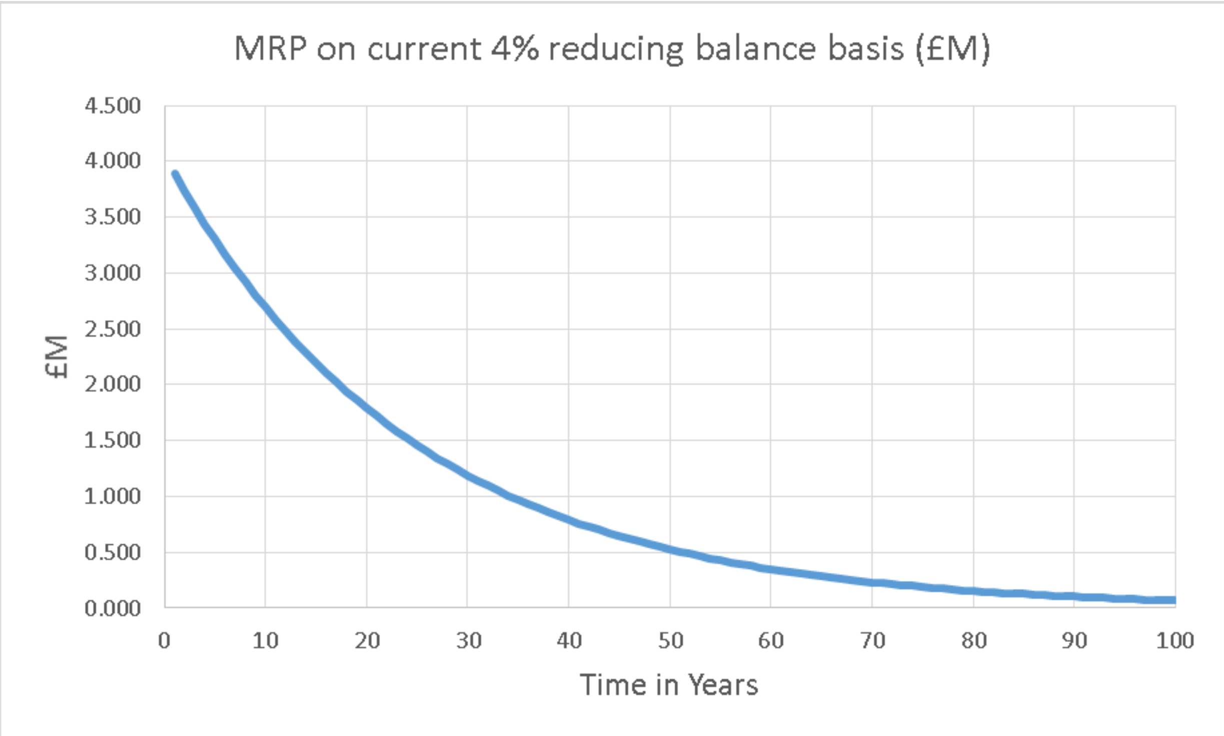
1.7.2 The current policy for unsupported (prudential) borrowing was reviewed and it was considered that the current Asset Life Method was appropriate and provided the most prudent approach so this will remain unchanged.

1.7.3 For supported borrowing a comparison of the options available was undertaken and included:

- 4% reducing balance (option 2),
- straight line – equal repayment (option 3), and
- annuity / inflationary method (option 3),

1.7.4 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 graph and Table 2 below shows the MRP repayment profile of the £101m (including £4m Adjustment A) capital expenditure funded by supported borrowing and outstanding as at 31 March 2017.

Table 2 below provides information relating to the first five years of the full analysis shown in Appendix 2.

TABLE 2

Year	Annual MRP £m	Outstanding Capital Expenditure £m
2017/18	3.887	93.288
2018/19	3.731	89.557
2019/20	3.582	85.975
2020/21	3.439	82.536
2021/22	3.302	79.234

In 50 years' time £13m of capital expenditure will still be outstanding, and in 100 years' time £1.6 will be outstanding. It would take 169 years before the balance is below £0.1m. Using Option 1, the regulatory method also means that there will always be £4.1m of capital expenditure outstanding, the equivalent of permanent Adjustment A. This supports the view that this method is not the most prudent option to take.

The method is commensurate with the methodology used in the RSG to allocate revenue funding from WG for supported borrowing. The 4% reducing balance method is used to allocate funding for the repayment of capital expenditure and it also includes funding to cover the notional interest costs on borrowing equal to the outstanding CFR on supported borrowing. However, Councils are responsible for determining their own levels of expenditure on services and no part of the RSG is earmarked for any particular service.

1.7.5 **Straight Line Method**

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

For all new capital expenditure funded from supported borrowing the charge will be based on the asset life so will be straight forward.

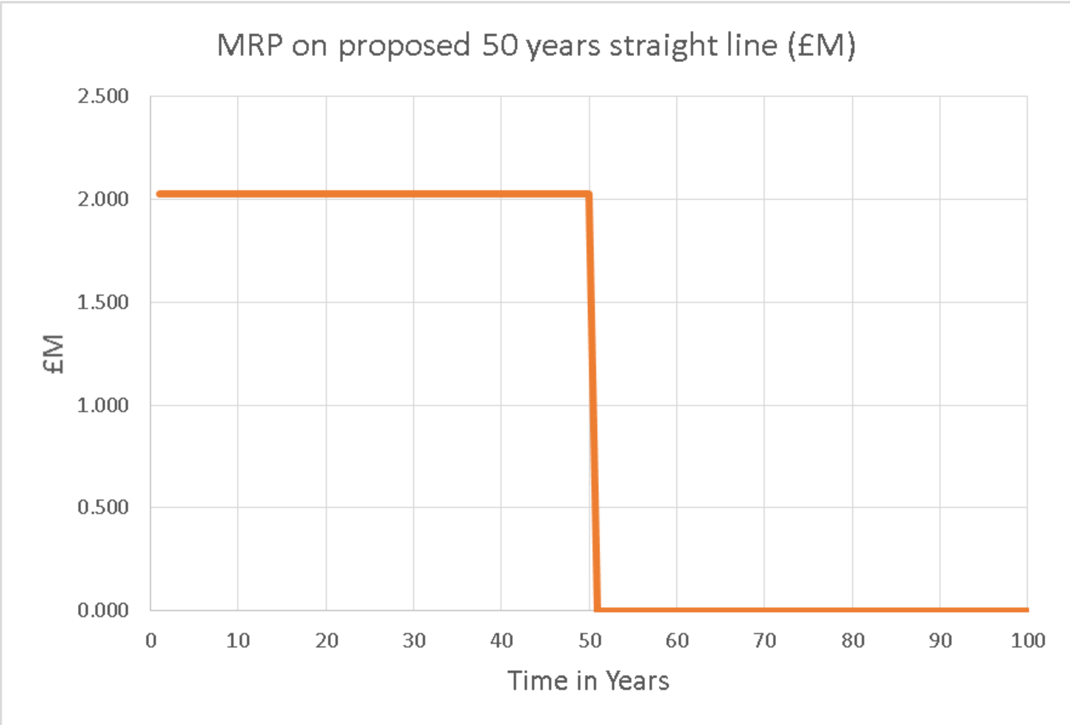
For historic capital expenditure the outstanding balance of £101m has built up over a long period of time and cannot be tied back directly to specific assets.

So for historic debt it has been necessary to identify a proxy for the average life of the assets represented by the outstanding balance.

The closest proxy to determine the average asset life are the assets currently held by the Council which are detailed on the asset register as at 31 March 2017. The category of assets most representative are operational Land and

Buildings and the calculation was based on the weighted average life with land being allocated a useful life of 125 years (land does not depreciate so is not allocated a life on the register). The calculation assessed an asset life of nearly 60 years. However, a prudent approach would be to use a lower asset life and one that is comparable with other Councils which is 50 years.

The repayment of the £101m historical capital expenditure funded by supported borrowing would be over 50 years, annual charge £2.026m. After 50 years the balance will have been fully repaid.



1.7.6 **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 of inflation. With this option the MRP rises over time.

1.8 Conclusions

1.8.2 The annuity/inflation method is not suitable from a budgetary perspective and as costs are weighted towards the latter part of the repayment period future generations will be paying more for assets that are being utilised today which does not meet the requirements of the Well Being of Future Generations Act. Therefore this method has been excluded.

1.8.3 Under the 4% reducing balance method the costs are weighted towards the early part of the repayment period and future generations will still be paying in the year 2186. This method does not represent a fair way to spread the costs for the use of the Council's assets. This method is prudent as more of the asset is repaid earlier but on a cost share basis it is not equitable.

1.8.4 The straight line method is more closely aligned to the life of the Council's assets and costs are spread more evenly among tax payers who will benefit from the assets. This method is prudent and more equitable on a cost share basis.

1.8.5 Based on the conclusions above the preferred method is the straight line method.

1.8.6 The recommendation is to change the repayment profile of the outstanding balance of supported borrowing of £101m as at 31 March 2017 to the straight line method repaid over 50 years.

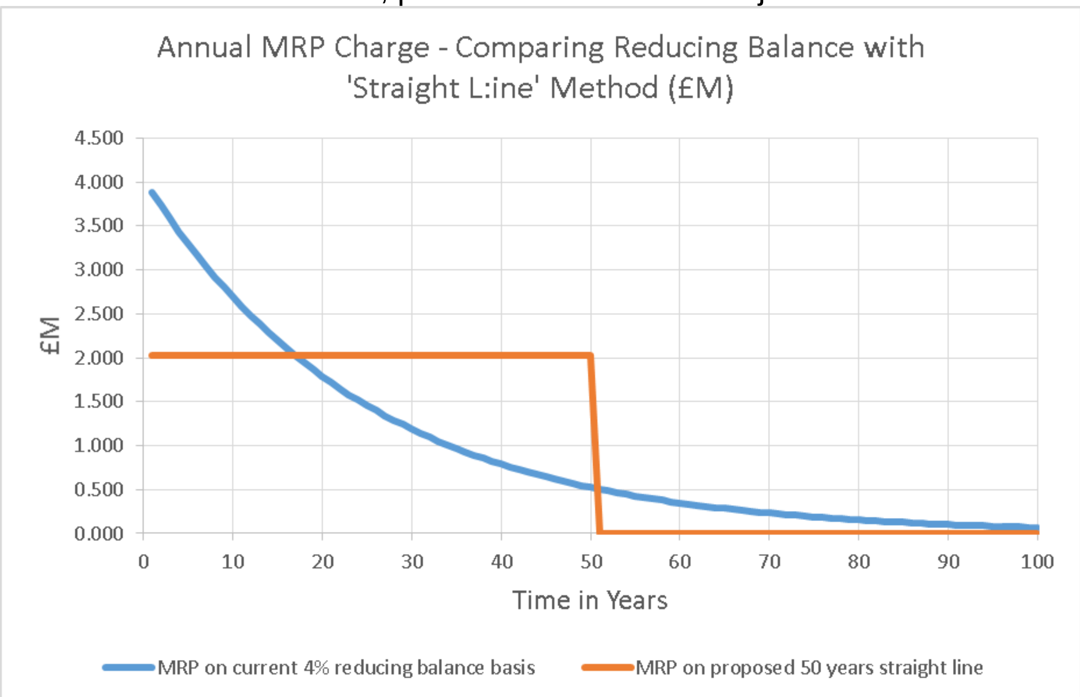
1.8.7 New capital expenditure funded by supported borrowing incurred from 2017/18 onwards be repaid over the life of the asset.

1.8.8 This represents an in year change to the MRP policy from option 1 - Regulatory method to option 3 asset life method.

2. RESOURCE IMPLICATIONS

2.1 The base budget can reduce if Members support the recommendation, this would produce a recurring saving of £1.861m.

2.2 A full 100 year analysis comparing the 2 methods is shown in Appendix 2 and summarised in the Chart below. This shows that by changing to the straight line method there are savings compared to the existing method in years 1 – 16, additional costs in years 17 - 50 and further savings in years 51 – 100. It also shows that there would still be an outstanding balance of £1.6m by 2116/17 under the current method, plus £4m in relation to Adjustment A.



2.3 For capital expenditure incurred from 1 April 2016 onwards which is funded from supported borrowing, the MRP calculation will be based on asset life so could vary from 5 years to 50 years. The table below shows the differences in MRP charges for both methods and shows examples of varying asset lives, based on the 2017/18 supported borrowing allocation of £3.025m from WG:

TABLE 3

MRP Charge	4% Reducing Balance (£'000)	Straight Line - 25 year life (£'000)	Straight Line - 35 year life (£'000)	Straight Line - 50 year life (£'000)
2017/18	121	121	86	61
2018/19	116	121	86	61
2019/20	112	121	86	61
2020/21	107	121	86	61

Going forward an assessment will be made of the additional MRP pressure for the following financial years based on our capital spend and the allocated supported borrowing from Welsh Government. An appropriate revenue business case will therefore be submitted annually to reflect capital financing pressures arising from the capital programme.

2.4 There are no resource implications other than financial.

3. LIST OF ACCESSIBLE BACKGROUND DOCUMENTS

3.1 Various Welsh Government papers, including:

- Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003.
- Capital Finance and Accounting Wales Amendment Regulations 2008.
- Guidance on Minimum Revenue Provision.
- The Well-being of Future Generations (Wales) Act 2015.

4. GLOSSARY OF TERMS

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 that has yet to be financed from capital receipts, capital grants or revenue financing.

Minimum Revenue Provision (MRP): A charge made to revenue to repay outstanding 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 from the Welsh Government as a contribution towards the cost of providing services.

Unhypothecated Supported Borrowing (USB), commonly referred to as Supported Borrowing: Each year WG provides Councils with a Supported Borrowing allocation. WG then includes funding to cover the revenue costs associated with the supported borrowing for future years within the RSG. The Council decides how this funding is spent.

Prudential Borrowing and the Prudential Code. Authorities set their own policies on acceptable levels and types of borrowing with regard to the approved level of capital expenditure. The main objectives of the code are to ensure the strategy approved is prudent, affordable and sustainable.