Leicester
City Council

CABINET **24 NOVEMBER 2003**
COUNCIL

CAPITAL PROGRAMME ISSUES 2004/05 AND THE PRUDENTIAL FRAMEWORK

Report of the Chief Finance Officer

1. Purpose of the report

1.1 The purpose of this report is to recommend a process for setting the 2004/05 corporate capital programme and to inform Cabinet of the new Prudential Framework for capital finance.

2. Summary

2.1 The Council generally approves a 3-year "corporate" capital programme based on the spending priorities set out in its Capital Strategy. The current programme runs from 2002/03 to 2004/05.

2.2 Royal Assent was given to the Local Government Act, including the Prudential Framework on 22nd September. The Prudential Framework will replace the current capital controls from 1 April 2004. Authorities will no longer be told by Government how much they can borrow to fund capital investment, but will be able to set their own borrowing limits based on borrowing being "prudent, affordable and sustainable".

2.3 The new system will require all authorities to radically rethink their approach to capital investment. Final regulations for the new system are not expected until December and CIPFA's Code of Practice, which underpins the operation of the system, has recently been produced.

2.4 Whilst the Prudential Framework will be used to determine local authority borrowing and capital investment decisions from 2004/05, there is a danger that a rush to utilise the additional flexibilities offered by it immediately could result in the Council not making best use of the new system. This could have an adverse impact on future capital programme and revenue budgets. However, the additional flexibilities of the Prudential Framework may offer an early opportunity to fund self-financing schemes or to meet any extremely urgent capital need.

2.5 At this point it is recommended that the Council completes its current 3 year programme, which runs to 2004/05 and that the Council develops a new medium term capital strategy over the autumn/winter 2003/04, which can be used to develop a new 3 year capital programme during 2004 for the period 2005/06 to 2007/08.

2.6 The new strategy will reconsider priorities for spending and also set out the requirements emanating from the Prudential Framework, such as having robust option appraisal in place to justify borrowing. The Chief Finance Officer will have new statutory responsibilities for recommending a "self policing" regime to members whereby proper regard is had for the impact of borrowing.

2.7 The major difference between the Prudential Framework and the current system is that the Council will determine the level of borrowing that can be utilised to support capital investment. The key limiting factor will be the impact and affordability of borrowing on Council Tax (and housing rents, in relation to borrowing for council housing). As such, the affordability of borrowing will need to be considered and approved when the Council approves the general fund and HRA budgets.

3. **Recommendations**

3.1 Cabinet is asked to:-

i. note the implications of the Prudential Framework for the Council, as set out in the supporting information and in particular note that the abolition of capital controls brings with it a responsibility to ensure our capital spending programmes are prudent, affordable and sustainable;
ii. recommend to Council the completion of the current 3 year capital programme, which runs to 2004/05;
iii. agree to develop a new capital strategy over the autumn/winter 2003/4, which will be used as to develop a new 3-year corporate capital programme in 2004 for the period 2005/06 to 2007/08.

4. **Financial and Legal Implications**

4.1 This report discusses the issues related to the Council's capital programme and is thus entirely concerned with financial issues.

4.2 There are no direct legal implications arising from this report.

5. **Author**

Graham Feek
Head of Strategy and Development

DECISION STATUS

Key Decision	**No**
Reason	**Policy & Budget Framework**
Appeared in Forward Plan	**No**
Executive or Council Decision	**Cabinet/Council**

Leicester City Council

CABINET **24 NOVEMBER 2003**

CAPITAL PROGRAMME ISSUES 2004/05 AND THE PRUDENTIAL FRAMEWORK – SUPPORTING INFORMATION

Report of the Chief Finance Officer

1. Current Capital Spending Controls

1.1 At present capital spending by local authorities is tightly constrained by government through the Local Government and Housing Act 1989. The main constraint on local authorities is that they are only allowed to borrow for capital investment if the Government has authorised the borrowing through the issue of a credit approval. Therefore, even where a good business case exists to borrow for investment, unless there is an available credit approval, borrowing can not be undertaken. For example, there are instances where some upfront investment could achieve long term efficiencies that could, effectively, fund the investment. At present it is difficult to fund such schemes.

1.2 Under the current rules, other forms of asset provision, for example, acquiring property or other assets through long leases, is prohibitively expensive. This is because despite such arrangements being paid for as they are used, the current regulations force authorities to, effectively, fund the total value of the arrangement in the year it is entered into (as if it had been funded from borrowing).

2. The Prudential Framework

2.1 The Local Government Act received Royal Assent on 22nd September. As a result, the Prudential Framework will replace the current system of capital controls from 1 April 2004. In future local authorities will be free to borrow for capital investment providing the borrowing is "prudent, sustainable and affordable". The system is largely self-regulated and underpinned by regulation and guidance. The main requirement of the regulations will be the need for authorities to follow CIPFA's Code of Practice on Prudential Borrowing. The Government will issue final regulations in December and CIPFA will issue their final Code of Practice in the near future.

2.2 The Code of Practice sets out how authorities should operate the new system. The Code is underpinned by a set of indicators that will help demonstrate that borrowing decisions are "prudent, sustainable and affordable" Authorities are also encouraged to develop their own local indicators, which will provide a fuller guide to borrowing decisions at a local level.

2.3 The Chief Finance Officer will recommend an appropriate level of borrowing each year based upon an assessment of these indicators.

2.4 It is likely that the Secretary of State will have reserve powers to set national borrowing limits if required in the interest of the overall economic position. He also has the power to impose limits on any individual authority he deems to be borrowing more than it can afford. Whilst it is hoped that the powers will not be exercised regularly, they clearly cause a level of uncertainty.

3. Government Supported Borrowing

3.1 At present, the Council receives grant to meet the cost of repaying principal and making interest payments on capital expenditure funded by borrowing. The cost to the Government is limited by the fact that it approves the level of borrowing in the first place.

3.2 The Government will continue to provide support for capital investment. However, the Government is presently consulting on whether actual funding should continue as now, with RSG and Housing subsidy meeting the principal and interest costs, or whether it should issue a capital grant. Leicester has responded to the consultation, stating our preference for a capital grant on the basis of its transparency – i.e. any spending beyond the grant falls directly to the authority to pick up, and meet the costs itself (the Government is not willing to increase the level of support it provides to complement the introduction of the prudential framework).

3.3 It is expected that the majority of local authority investment will continue to be at levels supported by the Government – revenue budgets will not permit a huge increase in borrowing.

4. Unsupported Borrowing

4.1 Any additional borrowing over and above that supported and funded by the Government will fall directly to authorities to fund. There are 2 main ways of funding any additional borrowing. Firstly, by seeking to identify compensating savings or efficiencies to meet the additional principal and interest costs. Secondly, to increase Council Tax or housing rents (in the case of spending on Council housing) to cover additional borrowing costs, subject to affordability.

4.2 The Government considers that the affordability constraint will be the most effective barrier to authorities borrowing excessively.

5. Potential Benefits of the Prudential Framework

5.1 The Prudential Framework is welcome and should offer a number of investment opportunities and choices that are not available under the current system.

5.2 The Council has significant investment backlogs and service aspirations that require substantial capital investment; therefore, any additional options that can be considered to meet these needs are welcome. Realistically the Council will still be heavily reliant upon adequate Government support to meet its needs.

5.3 The Prudential Framework will offer 2 key benefits:

- The potential to carry out “spend to save” type schemes, where upfront capital investment will lead to ongoing revenue savings;
- Enabling previously excluded capital procurement options to be pursued;

These are explored further below.

5.3.1 "Spend to Save" Schemes

5.3.2 At present, if the Council identifies an opportunity to provide pump priming capital investment that will lead to future revenue savings it is constrained by the availability of capital resources. Subject to a robust business case being made, the Council will in future be able to borrow additional money to make the investment and repay principal and interest costs through the revenue savings accruing to the project.

5.3.3 Such an approach could, for example, be used to rationalise property or assets, whereby some upfront investment may be required in order to release a capital receipt, which could subsequently fund the upfront investment as part of their budget planning.

5.3.4 A system of option appraisal is being developed that will test such schemes and ensure that they are robust and will deliver anticipated savings. Corporate Directors are being encouraged to identify such schemes as part of their budget planning.

5.4 Alternative Capital Procurement options

5.4.1 One of the prime reasons for the current capital regulations was to stop the previous practice of authorities acquiring capital assets through "off-balance sheet" finance. This is generally the practice of acquiring the use of a capital asset, and taking many of the benefits that would result from ownership, whilst paying for the asset over the period it is used. Such arrangement included deferred purchase agreements or long leases. The 1989 Act was specifically designed to prevent abuse of such schemes by local authorities; in doing so, however, the good was thrown out with the bad.

5.4.2 A key aspect of the current capital regulations is that such arrangements have to be accounted for as if they were capital acquisition (i.e. at the outset of the contract rather than over its duration). The major drawback to authorities of this requirement is in relation to long leases. In some cases such arrangements can provide good solutions, but cannot be accommodated under present legislation.

5.4.3 Whilst the Prudential Framework will still require the authority to account for these arrangements as if they were capital acquisitions (they will show as notional borrowing), the fact that the Council can set its own borrowing limit means that as long as we can afford to pay for the annual cost of such arrangements they are feasible.

5.5 The prudential framework also enable departments, as part of their revenue strategies, to identify additional capital investment provided they can find revenue savings to service the debt.

6. Housing Revenue Account

6.1 In the case of HRA spending there is much less scope to fund additional borrowing from increased rents. The Government has introduced "rent restructuring" for the HRA. The aim is for Local Authorities and Registered Social Landlords to set rents over a 10 year period that will result in rent levels in both sectors being comparable (currently local authority rents are considerable below equivalent RSL rents). In order to achieve this, the Government has issued each local authority a guideline rent increase for the 10 year period up to 2010/11. In Leicester's case this is RPI + 0.9%. If Leicester's rent increase exceeds this level the Council would, effectively, not receive housing benefit on the excess. As $^{2}/_{3}$rds of tenants' rents are paid for by housing benefits $^{2}/_{3}$rds of any additional increase would be lost as benefit would not be paid on it. As an example, in order to raise £1m to meet borrowing costs the Council would have to raise additional rents of £3m, which would equate to an additional 5% rent increase.

7. Indicators

7.1 Authorities will be expected to produce a number of indicators that demonstrate that borrowing is "affordable, prudent and sustainable".

7.2 A number of indicators are statutory, with some indicators being historic measures and others being estimates for a 3 year period. For example, % of budget spent on capital financing costs for the next year and 2 following years. Authorities are encouraged to develop their own local indicators, which reflect local circumstances.

The indicators will fall into 3 main areas, which measure:-

- External debt
- Capital expenditure plans
- Treasury management

7.3 Arguably the two most important indicators are the "operational boundary" and the "authorised limit". These limits set out the Council's borrowing ceiling for the next year, with estimates for the following 2 years. The "operational boundary" is the level of borrowing that is normally expected to be operated within. This limit may be breached temporarily without the approval of Council. The "authorised limit" represents the absolute ceiling on all borrowing. If it is exceeded a report must be taken to Council.

7.4 The indicators have to be approved by Council each year. Indicators must be reported periodically to the Council, through Cabinet. It is likely that this will simply result in additional information being provided on regular capital monitoring, which is reported to Cabinet and Scrutiny Committees.

7.5 Officers are seeking to prepare local indicators which measure the Council's unsupported, rather than total, borrowing; and to identify the impact of this on council tax levels. It is felt that this is a better measure of affordability than total debt (after all, any debt is affordable if it is being paid for by the Government).

8. Treasury Management

8.1 At present the Council has £250m of debt (compared to £1bn of assets), which is a legacy from previous capital programmes and spending decisions. The rules for managing the Council's debt and cashflows are complex and are set out in the Treasury Policy, approved by Council, and the Treasury Management Strategy, approved by Cabinet. The Policy, the Strategy and their operation is directed by legislation and professional guidance. The replacement of the existing capital regulations also applies to those aspects of legislation that relates to Treasury Management functions. A key aspect of the new legislation is the requirement for the Council to adopt the latest CIPFA Code of Practice on Treasury Management. There is a separate report on your agenda that asks cabinet to adopt the new Code of Practice.

9. Summary

9.1 In summary, the Prudential Framework offers some opportunities for the Council to address its investment needs. However, the self regulated nature of the system means that the Council must have robust systems and controls in place to ensure that the framework is used well and results in good schemes being conceived and delivered.

10. Proposed Approach and Timetable

10.1 Preparations for the Prudential Framework

10.1.1 There are a number of preparations that the Council needs to make for the prudential framework. These fall into technical issues, which can be left to officers to develop, such as a robust system of option appraisal and the calculation of statutory indicators, and policy issues such as the extent the Council wishes to utilise any additional borrowing discretion.

10.1.2 Some of the necessary changes will be encapsulated in a revised capital strategy, such as new capital priorities; others such as formally setting indicators, will be approved when the Council agrees the 2004/05 capital programme.

10.1.3 There is an opportunity to utilise the new freedoms from 2004/05. There are 2 main circumstances where the Council might seek to utilise addition borrowing at an early stage:-

i. To provide headroom to fund demonstrable “spend to save” type schemes as they arise and can be fully justified;
ii. To meet an urgent capital need.

10.2 3 Year Corporate Capital Programme

10.2.1 In January 2003, the Council agreed not to roll forward the 3 year programme because of the significant uncertainty associated with the introduction of the Prudential Framework. It is further proposed that the Council does not roll forward the current programme beyond 2004/05, which is the final year of the 3 year programme. This is for several reasons.

10.2.3 Whilst the new system might, subject to “affordability, sustainability and prudence” enable the Council to address some of its capital aspirations and needs from 2004/05 there are risks attached to this approach. If the Council wishes to utilise any of the additional freedoms offered by the Prudential Framework it needs to be sure that it does so in respect of its highest priority schemes and needs. Whilst the use of additional flexibilities, such as unsupported borrowing, is not a one-off opportunity, clearly it is not an option which can be used with impunity and if it used early on to fund schemes without adequate consideration of all spending needs and priorities the wrong schemes may be funded. The Council’s capital priorities are 2 years old and now need to be reconsidered.

10.2.4 The Council is currently in the process of bidding to the Government’s Building Schools for the Future programme. If successful, the bid could attract around £150m funding for Leicester’s schools. The Council has also commenced an “Options Appraisal” on its housing stock, which will identify the most effective way of managing and funding the Council’s housing stock in the future. These key pieces of work could have a significant impact on the Council’s capital priorities in the future and, therefore, represent a further reason to complete the current 3 year capital programme and consider afresh the Council’s capital programme, including the use of the prudential framework, from 2005/06 onwards.

10.2.5 It is therefore recommended that the Council develops a new medium term capital strategy over autumn/winter 2003/04, which can then be used as the basis of developing a new 3 year capital programme during 2004 for the period 2005/06 to 2007/08.

10.2.6 Members will be formally invited to consider some limited use of the Prudential Framework for the property maintenance backlog and ICT infrastructure as part of the budget process. It is likely that members may wish to utilise the prudential framework in 2004/05 to address high priority property maintenance schemes.

10.3 Capital Strategy

10.3.1 In the past 2 years the Council has achieved a "good" rating for its capital strategy and therefore has not had to submit a capital strategy to government this year. Whilst not a government requirement, it is still good practice to have a capital strategy, especially in the context of the prudential framework, when a clear set of priorities and rules are essential for ensuring the Council makes proper decisions on capital. However, the format and content will no longer be steered by government, which means the Council has a free hand to determine a strategy that only contains those elements that are genuinely useful.

10.3.2 In order to develop a new capital programme in 2004 for the period 2005/06 to 2007/08 the Council should determine a new set of capital priorities based upon current priorities. Directors have started the process of considering their main service capital priorities.

10.4 Capital Stocktake

10.4.1 The prudential framework reinforces the importance of taking account of the capital needs of services, as well as financial considerations, when determining capital spending programmes. As part of the preparations for the prudential framework, departments have carried out a "stocktake" exercise to identify known and anticipated capital needs.

10.4.2 The stocktake considered the position over a number of timeframes, up to maximum of 10 years. As expected, the exercise has proved difficult in some areas; clearly having clarity up to 10 years ahead is difficult and things will change. However, for the first time the Council has some idea of the cost of its capital aspirations and needs.

10.4.3 The aim of the exercise was to identify the demand for corporate resources, after consideration of capital resources that are hypothecated to services or specific schemes (generally by the government), which are likely to continue in some form. Clearly the results in terms of spending needs and estimated resources require some qualification. However, the summary does give a reasonable indication of the overall position.

10.4.4 The total outstanding capital "need" (general fund and the HRA) over the 10 year period, over and above expected hypothecated capital, is around £300m. This can be contrasted with estimated corporate resources of approximately £30m over the same period (these being resources supported by the Government). It should be noted that many authorities could come up with a similar figure.

10.5 Timetable

Below is a draft timetable setting out the key dates for the preparations needed for the Prudential Framework.

November	Cabinet Adopt new Treasury Management Code of Practice
January	FREOPS – draft 2004/05 "corporate" capital programme
February	Cabinet & Council - 2004/05 "corporate" capital programme Cabinet & Council – Prudential Indicators, including borrowing limits (integrated into the general fund budget)
Spring to Autumn 2004	Develop new 3 year programme 2005/06 to 2007/08

11. Other Implications

OTHER IMPLICATIONS	YES/NO	Paragraph References Within Supporting information
Equal Opportunities	No	
Policy	No	
Sustainable and Environmental	No	
Crime and Disorder	No	
Human Rights Act	No	
Elderly/People on Low Income	No	

12. Background Papers – Local Government Act 1972

None

13. Author

Graham Feek
Head of Strategy and Development