APPENDIX 1

THE PRUDENTIAL SYSTEM AND HOUSING FINANCE - EXECUTIVE SUMMARY

1. The Government has announced major changes to the way that local council fund major spending projects, known as capital spending.

2. They propose to abolish current limits on borrowing and enable local councils to make their own decision on how much money they should borrow **provided that** councils can afford the costs of servicing the extra debt.

3. This will enable councils to borrow large sums of money to fund new projects. At the same time it must be remembered that councils will be incurring the cost of financing those projects for upto 25 years or more, without any extra government support to fund them.

4. The Government is introducing strict rules to ensure that councils can afford any extra borrowing. This is set out in the Prudential Code for Capital Finance. This will require Council's to plan ahead financially to determine whether they can afford any extra borrowing in the next 3 – 5 years.

5. The changes do not stop there. From 2004/5 Council's will have to pay over a large proportion of the proceeds of Council House sales (75%) or other housing land sales (50%) to the government. Currently this money is retained by councils to repay debt.

6. The receipts collected across the country will be pooled by the Government and reallocated to local councils to promote private sector housing projects. However, the Government is relaxing the burden of the "commutation adjustment" for future years.

7. The Government will still provide some direct support for capital spending in addition to any local borrowing. This will be a general allocation that is either in the form of a direct government grant **or** a borrowing approval that is financed from annual government grant.

8. Further into the future Council's will be required to set aside money to maintain council assets. This will be in the form of a depreciation charge. At the same time this will bring council accounts into line with private sector accounts.

9. Major changes to Housing Subsidy are proposed with the Government changing the way that they subsidise existing council borrowing that relates to housing. Due to timing differences these changes could have an adverse impact on this council

10. On a more positive note the Government is also looking at the housing subsidy they provide for managing and maintaining council housing. Their proposals may well move resources away from London and South East to the North and Midlands.

11. These changes could generate an additional £650,000 of subsidy for South Derbyshire over the next 2 years, although this amount could be reduced significantly if the Government seek to reduce the impact on councils who lose out from these proposals.

12. Finally the Government is also looking at removing rent rebates from the HRA. These cost the HRA in South Derbyshire some £120,000. This money would be available for other general HRA spending.

APPENDIX 2

THE PRUDENTIAL SYSTEM & HOUSING FINANCE

1. INTRODUCTION

a) Effectively, the prudential system is a new mechanism for capital expenditure and capital financing, although it has wider implications for medium term service and financial planning and will impact upon housing.

b) The implementation date is 1st April 2004, but work has effectively commenced with budget preparation and setting for 2004/05. Subsequently, for housing, it is likely to affect the financial work around housing stock options.

c) The detailed regulations have recently been approved as part of the Local Government Act 2003.

d) In readiness for this, 4 pieces of information are currently out for consultation from the Government as follows:

- The draft Capital Finance and Accounting Regulations 2003
- Support for Local Authority Capital Investment
- Future Housing Capital Financing Arrangements
- The allocation of Management & Maintenance Allowances in Housing Subsidy

e) In addition, CIPFA has produced a "Prudential Code for Capital Finance in Local Authorities" which provides best practice for the prudential system and has statutory backing in the 2003 Regulations.

f) However, it is likely that the full financial impact on individual authorities of the above will not really be known until the Government produce their draft financial settlement and subsidy determinations for 2004/05 towards the end of November.

2. WHAT IS THE PRUDENTIAL SYSTEM

a) This is considered to be the most significant change in local government finance for many years, in that local authorities will be given the power to make their own borrowing decisions and not be regulated by current borrowing limits imposed by central government.

b) The Government intends the new system to be a boost for local authority capital investment by giving Council's greater freedom to borrow.

c) As long as authorities are able to demonstrate that their borrowing is "affordable, prudent and sustainable," they will be free to borrow. This will be controlled locally within pre-determined limits as contained in CIPFA's code.

d) The government will have reserve powers to set a national limit (intended to protect the national economy) or to impose local limits if the Government feel that an authority is acting irresponsibly.

e) Effectively, it will give rise to a new form of borrowing – "prudential borrowing at the local level." This will not be supported in any form by central government.

3. DRAFT CAPITAL FINANCE & ACCOUNTING REGULATIONS 2003.

a) Provides the statutory basis for CIPFA's Code, and regulations concerning

- Use/treatment of capital receipts
- Provision for Debt Repayment
- Commutation

Capital Receipts

b) Currently, authorities are required to "set-aside for debt repayment" the following proportions of all capital receipts.

- Council house sales (Right to Buys) – 75%
- Other housing land and property – 50%
- All other assets (outside housing) – no requirement for set-aside

c) In practice, authorities may not actually repay debt (especially their longer term fixed rate debt) but hold the money on deposit and to help fund day to day spending.

d) Authorities may not choose to repay debt due to the high premiums imposed on early repayment.

Pooling

e) However, from 2004/05 the Government will require the set aside part of the capital receipt to be paid **direct** to them. The Government will then pool all receipts nationally and redistribute them to local councils to promote specific spending priorities.

f) This redistribution is inherent in the current system via "receipts taken into account" where the Government reduces the amount an authority can borrow if it has significant capital receipts to fund spending.

g) Pooling will see actual cash flowing from local to central government. However, the following should be noted:

- Individual receipts less than £10,000 in value are excluded from pooling.
- Costs of administration can be deducted from the pooling amount before payment to the.
- Stock transfers and sales of vacant dwellings are excluded.
- If receipts are subsequently used for "affordable housing or regeneration" these also escape pooling
- The total amount excluded and not pooled each year is capped to a Capital Allowance (although in practice this is only to prevent offsetting more than has been received).

h) The Government will redistribute all pooled receipts via Regional Housing Pots. However, it is likely that this will be to finance private sector and more strategic initiatives involving housing, rather than directly on council houses.

Provision for Debt Repayment

i) Currently, the authority is required to charge a <u>minimum</u> provision for debt repayment of 4% to its general fund and 2% to its Housing Revenue Account (HRA). This will continue for the general fund <u>but will not be required for the HRA</u>, although voluntary set-aside will continue.

Commutation

j) South Derbyshire, along with many other authorities, currently benefit from a "commutation adjustment" in their accounts. This dates back to1992 and stems from the Government commuting then existing annual revenue grants for outstanding loans associated with slum clearance schemes, to a one-off lump sum payment.

k) As a result of this many authorities found themselves worse off. Consequently, the Government allowed authorities (through the commutation adjustment) to reduce payments for debt in the shorter term, but then to increase the amount in later years.

l) This "commutation adjustment" has been benefiting the Council for a number of years. This has gradually been increasing and peaked at over £400,000 in 2002/03. However, this benefit is now reducing and will become adverse from 2008/09.

m) As the amounts involved are fairly significant and will start appearing as a cost in the Council's accounts in later years, the Council agreed in February 2000 to set-aside the annual benefits into an earmarked reserve. This reserve is designed to meet the cost when the adjustment turns adverse (negative) from 2008/09.

n) A new provision in the 2003 regulations will mean that when the adjustment does become adverse for authorities, no adjustment will be required (i.e. it will be zero, and cannot turn negative).

o) Consequently, the Council can continue to benefit from the adjustment "if it is prudent to do so." Although the Council will need to continue to plan for the continuing reduction in the benefit to 2008/09, it now has the option of reviewing the annual contribution to the earmarked reserve, and indeed the current level of that reserve, as part of the forthcoming budget process.

4. SUPPORT FOR LOCAL AUTHORITY CAPITAL INVESTMENT

a) The Government will continue to provide a general capital allocation to local authorities using the Single Capital Pot. This will provide government support to enable authorities to finance new capital spending upto a certain level.

b) Local authorities will then be able to increase their capital spending through local borrowing that they finance from their own resources. This will not be supported in any form from the Government.

c) In particular, the consultation paper proposes 2 options for support, but also provides detail on the Government's long term aim for dealing with capital accounting and investment.

Supported Capital Investment

d) This will exist in the short term whilst the prudential system develops and until longer term arrangements are made (see below). Support will still in theory come from the Single Capital Pot so some flexibility for authorities will remain.

e) Two options for support have been put forward – a direct capital (cash) grant or via a "value of new investment" supported through the annual revenue support grant. The Government favours direct grants as they are certain, stable and can be more easily directed to specific areas.

f) It should be noted that any prudential borrowing at the local level would not be supported in any form by central government.

The Future

g) In accordance with the Government's long term aim of providing a set of accounts for the whole of the public sector, they intend to introduce "true depreciation accounting" into local government. This will be a fundamental change in that depreciation will be a direct charge against local authority resources.

h) This form of accounting is already widely used in central government and is seen by the Government as a good tool for ensuring assets are properly maintained. The theory is that if assets are poorly maintained or not used efficiently, this reduces their useful life and hence increases depreciation.

i) This is probably 3 to 4 years away, although the Government could have "dry runs" for 2004/05 and 2005/06. It is likely to be phased in to minimise any impact on council tax, rent levels, central government grant support and to ensure that details regarding local authority assets are robust.

j) There are also indications that once depreciation accounting is fully implemented, central government support for capital will be via capital grants for new investment, and revenue support grant (via the annual financial settlement) for depreciation/maintenance.

5. FUTURE HOUSING CAPITAL FINANCING ARRANGEMENTS

a) This is the technical accounting document for how the prudential system will impact on the HRA. In particular, it considers the mechanism for transferring housing's share of the Council's debt charges to the HRA (the current Item 8 calculation) and how this will be supported by the Government through housing subsidy.

b) On the face of it, the major change is that there will be no requirement to charge a minimum provision for debt repayment to the HRA (which is substantially funded via housing subsidy). The Government is redistributing this money towards funding future investment in Arms Length Management Companies.

c) Other than this, the interest charges to the HRA for debt repayment will broadly be the same as now but based on a Capital Financing Requirement (CFR) as opposed to the current "credit ceiling" which will be abolished. The CFR will be a measure of indebtedness on the HRA, but will be based on the current credit ceilings rolled forward (currently the Government's preferred option).

Change in the Base Subsidy Level

d) Reimbursement via housing subsidy will effectively equal the same amount year on year (eventually).

e) However, there is an anomaly in the current system in that there is a timing difference between actual capital charges to the HRA and when subsidy on these charges is received.

f) This difference is 2 years, and relates to set-aside capital receipts in the formula. This was done for administrative purposes when the current system was introduced in 1990 - the Government use figures 2 years in arrears in calculating the current year's subsidy.

g) On 1st April 2004, the effect of the new system will produce a one-off "hit" on subsidy receivable for authorities with debt. This is because the charge to the HRA will no longer include set-aside (receipts will be pooled and paid to the Government) whilst the Government will still be taking into account an authorities set-aside receipts from the last 2 years in the 2004/05 and 2005/06 settlements.

h) Like most housing authorities across the country, South Derbyshire has seen substantial increases in council house sales over the past 2 years. The set-aside element included in the subsidy calculation will be around £6m for the past 2 years. This will amount to a loss of subsidy of approximately £240,000 in 2004/05 and a further £20,000 in 2005/06.

i) A specific response has been made to the Government on this particular issue stressing the apparent unfairness of what is basically a "legacy" of the old system.

j) It is interesting to note that the calculation of the CFR as one of the prudential indicators under the new system is different to that being used for housing subsidy. This seems inconsistent and could be confusing for users of the Council's accounts. If the prudential CFR were used to calculate subsidy, this would eliminate the above loss to the Council.

6. THE PRUDENTIAL CODE FOR CAPITAL FINANCE IN LOCAL AUTHORITIES (THE CODE)

a) The code sets out best practice for the prudential system. In particular, the prudential indicators (PI's) that need to be calculated each year around borrowing and treasury management to comply with the legislation, and provides the guidance to determine the local borrowing limits. Basically, in setting its annual budget and local tax levels, the Council will need to set and report the following.

- Prudential Indicators (PI's) to back-up its capital expenditure plans
- The "affordable" local borrowing limit
- The cost and affordability of its overall financial plans over the next 3 years
- Indicators for its treasury management activities (borrowing limits, etc)
- How planned capital investment meets the Council's strategic priorities
- The full impact on its revenue accounts of capital expenditure.

Procedures

b) As the prudential system will be relevant from 1st April 2004, the above factors will need to be taken into account in setting next year's budget. The Council will also need to keep under review the above factors, which can only be changed by the body setting them (Finance & Management Committee under terms of reference FM08). The responsibility for ensuring compliance with the Code and reporting lies with the Council's Chief Finance Officer.

c) The indicators will be calculated from figures contained on the Council's Balance Sheet (as published in its annual statement of accounts). The figures are not intended for comparative purposes or as an indication of an authority's credit rating.

What is Required

d) The new system has been piloted in some authorities, and experience here has shown that Council's with the following are well placed in meeting the requirements of the code.

- Adoption of CIPFA's Treasury Management Code
- Medium term financial projections
- 3-year rolling capital programmes
- A Capital Strategy
- Consultation on priorities and budgets
- Prioritisation of spending (use of scoring mechanisms, etc).
- Option appraisal techniques for capital spending

e) Looking at this list, the Council has a good basis to work from. Besides using option appraisals more than we currently do, refining current procedures and reporting, generally the Council is well on the way to meeting the requirements of the code.

The Council's Local Borrowing Limit

f) This is based on a measure of the Council's overall indebtedness (net value of its fixed assets, less debt and other long-term liabilities). It is likely to be around £18.8m (based on figures contained in the 2002/03 statement of accounts).

g) <u>However, it is not the limit in itself that is critical, but rather the affordability of the resultant debt charges – effectively the cost and their financing</u>. For instance, the cost of borrowing upto £18.8m would be around £3/4m per year in interest charges (a 25-year PWLB loan at current rates of 4%).

Will there be greater flexibility for South Derbyshire

h) Yes in theory, as borrowing will not be controlled by central government. However, the Council will need to demonstrate

- that any spending meets their strategic priorities,
- the cost of borrowing is the most cost-effective method,
- interest charges are affordable,
- a burden is not placed upon future tax levels, and that
- any other resources readily available have been considered.

7. THE ALLOCATION OF MANAGEMENT & MAINTENANCE ALLOWANCES IN HOUSING SUBSIDY

a) Currently, the formula for allocating these funds across authorities is over 10 years old, and crucially is based on expenditure dating back to 1987. Therefore, the Government commissioned an independent review of the allocation of these allowances in order to implement a fairer distribution of the national available pot.

b) The review has recommended formulae, which takes account more of local authorities' relative need to spend, building in factors around local deprivation and anti-social behaviour. In addition, a fixed cost element has been built into the management allowance to help smaller authorities that do not easily benefit from economies of scale.

c) The proposals would result in radical redistribution of resources (mainly from London and the South to the North and Midlands). It is likely that the Government will agree them, although some form of phasing may be implemented to protect "losing" authorities.

d) The impact of the proposals would mean increases for the Council **(if approved in full)** as follows:

Indicative Increases	**2004/05**	**2005/06**
Management Allowance	11%	19%
Maintenance Allowance	20%	10%

e) Based on stock levels used for subsidy purposes, this would generate approximately £650,000 additional subsidy over the next 2 years.

8. THE REMOVAL OF RENT REBATES FROM THE HRA

a) The Government previously consulted on this issue back in March 2000 (and was reported to the Housing and Environment Committee at that time). The legislation enacting this is contained in the Local Government Act 2003.

b) The legislation would see the cost of rent rebates and the Government grants to reimburse it, being accounted for in an authority's General Fund. This will in theory benefit the HRA as it subsidises approximately 2.5% of rent rebates (around £120,000 per year).

c) The Government has indicated that this residual cost will not fall on the General Fund (i.e. by an increase in Government grant) although this is not yet clear.