



Transition model guidance

4 December 2018

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- The Government is currently carrying out a Fair Funding Review which will inform local authorities' funding allocations from 2020/21 onwards.
- A **transition mechanism** will be used to move from the current pattern of funding to the one implied by the results of this review.
- The models presented here illustrate four examples of how a transition mechanism could work in practice.
- In this report, '**settlement funding**' is used to describe the funding that is subject to this transition mechanism. Each authority is will transition from its **starting** share of this settlement funding to its new **target** share.
- For the purposes of modelling, each authority's **starting** share of settlement funding is based on funding provisionally announced for 2019/20.¹ This is the sum of (a) the Settlement Funding Assessment, (b) the Public Health Grant and (c) the Rural Services Delivery Grant.

1. Provisional figures for 2019/20 were published as part of the 2018/19 local government finance settlement.

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- Each authority's **target** settlement funding level is not yet known, as this will be determined by a new formula following the Fair Funding review.
- Instead, the model assumes a **distance to target** for each local authority. This is the assumed percentage change in each authority's starting settlement funding level required to reach its new target share.
- For example, a distance to target of +10% would mean that an authority's target share of funding in 2020/21 (under the new formula) is 10% higher than its actual share of funding in 2019/20.
- The Excel model includes a default distance to target for each authority. This is derived from damping that was applied to 2013/14 Formula Funding allocations. These default figures are not indicative of what each authority's distance to target will be in 2020/21. Rather, they are intended to illustrate a range of plausible values at the England level. The user is able to enter any assumed distance to target for their own authority.

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- The potential transition mechanisms are illustrated by the following four models:
 - **Model 1** – floors and scaling
 - **Model 2** – pace of change
 - **Model 3** – pace of change with floors
 - **Model 4** - pace of change with floors, including other revenue streams
- The following slides provide a brief overview of each of these models. More details on each model are provided in the report that accompanies this guidance.

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- **Model 1 – floors and scaling.**

- This is a simplified version of the status quo. ‘Floors’ guarantee each authority a minimum level of funding, expressed as a percentage change from the previous year. This is financed by ‘scaling back’ funding for authorities who are above this floor. This scaling ensures that the model is revenue neutral.

- **Model 2 – pace of change.**

- Authorities transition to their target shares over a specified number of years. For example, assuming a 5 year transition period, each authority would close 1/5th of its distance to target in the first year, 1/4th of the remaining distance to target in the second year, 1/3rd of the remaining distance in the third year, and so on.
- The shorter (longer) the transition period, the faster (slower) authorities converge with their target funding shares, and the less (more) protection is provided against large annual changes in funding.
- This model is revenue neutral. In any year, the ‘losses’ deferred by authorities who are currently above their targets are exactly offset the ‘gains’ deferred by authorities who are below their targets.

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- **Model 3 – pace of change with floors.**
 - This is a combination of the previous two models.
 - Each authority's transition is determined by a 'pace of change' approach (as in Model 2), in which it converges with its target over a given number of years. By itself, this is revenue neutral.
 - Additional protection is provided in the form of floors. This prevents any authority's funding from falling by more than a certain percentage in any given year (as in Model 1).
 - These floors impose an additional cost on the system. How this is funded depends on whether or not the system is assumed to be revenue neutral.
 - If the model is revenue neutral, then floors are are financed by scaling back the annual change in funding received by other authorities.
 - If the model is not revenue neutral, then it is assumed that the cost of floors is financed by additional funding from central government.

Model overview

- **Model 4 – pace of change with floors, including other revenue.**
 - This is the same as Model 3, but in which floors are calculated with respect to a broader definition of local authority revenue.
 - In Model 3, the floors related to the annual change in an authority’s *settlement funding*. In this model, floors relate to changes in settlement funding *plus other revenue streams*. These could include council tax revenue or other major grants.
 - The floors can also take into account projected *changes* in these other revenue streams.
 - How the floors are funded depends on whether or not the model is revenue neutral (just as in Model 3):
 - If the model is revenue neutral, they are financed by scaling back the annual change in funding received by other authorities.
 - If it is not revenue neutral, they are assumed to be financed by additional central government funding.

Model overview

- The following table summarises the key features of the four models.

Key features of the four transition models

	Floors	Pace of change	Includes other revenue streams	Can relax assumption of revenue neutrality
Model 1	✓			
Model 2		✓		
Model 3	✓	✓		✓
Model 4	✓	✓	✓	✓

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Assumptions - overview

- The accompanying Excel spreadsheet allows the user to compare the results of the four models, under varying assumptions.
- The assumptions relate to:
 1. your authority's initial distance to target;
 2. other authorities' initial distance to target;
 3. annual changes in the funding envelope;
 4. the level of the funding floor;
 5. the length of the transition period;
 6. other revenue streams that are taken into account when applying floors; and
 7. whether or not all models are revenue neutral.
- The following slides provide guidance on each of these seven assumptions.

Assumptions - overview

- Note that when entering assumptions, it may be necessary to **update** the models. This can be done using the buttons shown below. The user will need to **enable macros** to do this.
- If the model status is does not say 'up to date', as shown below, then some of the models' outputs will not be valid.

Example where update is needed

Authority name:

Model status: ✘ Update needed

Example where model is up to date

Authority name:

Model status: ✔ Up to date

Assumption 1

- Assumption 1 is the initial **distance to target for the selected authority**.
- The **starting** point is each authority's share of 'settlement funding' in 2019/20. This is defined as the sum of (a) the Settlement Funding Assessment, (b) the Public Health Grant and (c) the Rural Services Delivery Grant, based on provisional figures.¹
- Each authority is assumed to transition from this **starting** share of settlement funding to a **target** share that will be determined by a new funding formula in 2020/21.
- The **distance to target** is the % change in each authority's starting share of settlement funding required to reach its target share. This figure is purely hypothetical, as the new funding allocations are not yet known.
- For example, if an authority's starting share of the settlement funding envelope (in 2019/20) is £10m, and share of the same envelope under the new formula would be £12m, then its distance to target would be +20%.

1. Provisional figures for 2019/20 were published as part of the 2018/19 local government finance settlement.

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Assumption 1

- To exemplify a range of possible values, an illustrative distance to target is provided based on the damping present in 2013/14 Formula Funding allocations.
- This is based on the difference between (a) each authority's undamped formula funding in 2013/14, i.e. its notional funding allocation as determined by a funding assessment formula, and (b) its final funding after damping was applied. The remaining difference is the assumed distance to target.
- We emphasise that this figure is **purely illustrative**, and not indicative of what your authority's actual 'distance to target' is likely to be when the new formula is introduced in 2020/21.

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Assumption 1

- Users can also overwrite this illustrative distance to target for 2013/14 with their own preferred value.
- In the example below, the authority’s illustrative distance to target was +6.9% based on 2013/14 figures. However the user instead specified a distance to target of +5.0%, which was then used in the modelling.

Assumption 1 example

For your authority's distance to target, select one of the following:

<i>Option 1:</i>	Your authority's distance to target in 2013/14, of	6.9%	or
✓ <i>Option 2:</i>	Specify an alternative distance to target	5.0%	
	Selected distance to target:	5.0%	

i Based on the selection above, your authority's settlement funding would need to *increase* by 5.0% to reach its target under the new funding formula (assuming a constant envelope of funding). The transition mechanism will determine how quickly your authority's funding rises over time towards this new level.

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Assumption 2

- Assumption 2 is used to specify the **distance to target of other local authorities**.
- There are two options:
 - 1) Use an illustrative distance to target, based on the damping that was in place in 2013/14; or
 - 2) Apply a random distance to target for all other authorities.
- Under the **second option**, each authority is assigned a random distance to target. The user can specify the 'spread' of these values. By default, it is assumed that 95% of authorities are initially within $\pm 22\%$ of their target (as was the case in 2013/14) but the user can increase or decrease this spread. The maximum spread is $\pm 30\%$.¹
- The distance to target is assumed to follow a normal or 'bell-shaped' distribution.¹ Authorities are more likely to have a distance to target that is closer to the average (of zero) than more extreme values.
- The user can specify one of 20 random scenarios. Selecting a new scenario will assign a new random distance to target to each local authority.

1. The spread is limited to $\pm 30\%$ as otherwise the distance to target for some authorities would exceed -100%, i.e. imply negative target funding.

2. We assume that the distribution is skewed, with a distance to target that ranges from 2.5 standard deviations above average to 6.0 standard deviations below average. This is similar to the distribution in 2013/14.

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Assumption 2

- The distance to target for all other authorities (excluding the selected authority) is then scaled up or down so that the distance to target for all authorities in England (in £ terms) sums to zero.
- **Example:** in the example below, the user wishes to use a random distance to target for other authorities, and so selects 'Option 2'. They want to model a situation in which other authorities are initially closer to their targets, so specify that approximately 95% of authorities are within $\pm 15\%$ of their target (rather than $\pm 22\%$).

Assumption 2 example

For other authorities distance to target, select one of these options: **Option 2**

Option 1: Each authority's distance to target in 2013/14; or

✓ *Option 2:* A randomly assigned distance to target, where

(i) approximately 95% of authorities are within \pm **15%** of their target, and

(ii) the following random scenario is used: **Scenario 1**

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Assumption 3

- Assumption 3 determines the **annual change in the settlement funding envelope**.
- Any proposed transition mechanism must be flexible enough to handle scenarios with a growing or shrinking pool of funding for local authorities.
- If the user specifies an annual percentage change in the settlement funding envelope, then annual changes in funding will reflect both (a) the transition of each authority from its starting share of funding towards its target share, and (b) the growth or reduction in the size of the funding envelope over time.
- Assumption 3 could also be used to model scenarios in which local authorities' settlement funding increased in line with inflation each year. For example, this could be the case if 'settlement funding' was delivered in the form of retained business rates. Under the current system, each authority's business rates baseline increases with CPI inflation each year. In this case, the growth rate in Assumption 3 could be set to 2% (the Bank of England's target rate for CPI inflation).

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Assumption 4

- Assumption 4 is used to specify the **level of the floor**.
- The floor guarantees each authority a minimum level of settlement funding, expressed as a percentage change from the previous year. This ensures that each authority receives a minimum annual increase, or maximum annual decrease, in its settlement funding level.
- For Model 4, the floor has a slightly different definition. Here the floor relates to the change in each authority's *total revenue*, rather than just the change in its *settlement funding*. Total revenue includes settlement funding plus other revenue streams, such as council tax revenue.
- Mathematically, the floor must be less than or equal to the annual change in the funding envelope. For example, if the settlement funding envelope changes by 0% each year, then the floor must be set equal to or less than 0%.
- The model does not make assumptions as to what the level of the floor will be. By default, the level of the floor is set to -100%, which is equivalent to there being no floor in place.

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Assumption 4

- **Example:** In the example below, the user sets the floor to -5%. This means that no authority's settlement funding will fall by more than 5% per year (or that no authority's *total revenue* will fall by more than 5% per year, in the case of Model 4).

Assumption 4 example

Floor

Applies to: Models 1, 3 and 4

The **floor** guarantees each authority a minimum level of funding, expressed as a percentage change from the previous year. This ensures that each authority receives a minimum annual increase, or maximum annual decrease, in its funding level. The floor must be less than or equal to the annual change in the funding envelope (see Assumption 3).

Settlement funding floor:

-5.0%

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Assumption 5

- Assumption 5 determines the **transition period**. This is the number of years it would take each authority to reach its target settlement funding allocation.
- Shorter transition periods mean each authority converges more quickly with its target. Longer transition periods provide more protection against large annual changes in funding.
- The model does not make any assumptions about how long the transition period should be. By default it is set to one year, which is equivalent having no transitional protection in place.

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- Assumption 6 is used to specify the **other income streams** that are taken into account when applying floors.
- This assumption applies to Model 4 only. In Model 1 and Model 3, the floors applied to annual changes in each authority’s *settlement funding* level. In Model 4, floors apply to annual changes in each authority’s *total revenue*.¹
- Total revenue is made up of settlement funding plus other revenue streams. Here, the user specifies what is to be included under ‘other revenue streams’. The user has the option of choosing up to three other revenue streams: (a) council tax revenue, (b) the Better Care Fund, and (c) the New Homes Bonus.²
- All else being equal, the more revenue an authority receives from these other revenue streams the less transitional protection will be applied to changes in its settlement funding level.
- Please note that **this assumption is only valid when floors are negative** (see Assumption 4). In this Excel workbook, it is not possible to guarantee that Model 4 will be revenue neutral when the floor is greater than 0%. Please see the accompanying report for more details.

1. Model 2 is not listed here as it does not include floors.

2. These three revenue sources were all part of MHCLG’s definition of Core Spending Power (CSP) in 2019/20, based on provisional figures. The other components of CSP – the Settlement Funding Assessment and Rural Services Delivery Grant – are included in the definition of ‘settlement funding’ for the purpose of this modelling (along with Public Health Grant).

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Assumption 6

- Users can also specify any assumed *growth* in these revenue streams. Any assumed growth in these revenue streams will further reduce the level of transitional protection applied to each authority’s settlement funding level.
- The assumed value of these other revenue streams is based on provisional figures for 2019/20, as announced by MHCLG as part of the 2018/19 local government finance settlement.
- **Example:** in the example below, the user includes council tax revenue and the Better Care Fund in the definition of total revenue. Note that settlement funding is always included in this definition. The user has not opted to include the any assumed growth in these revenue streams (this is kept at 0.0%).

Assumption 6 example

The floor is calculated with reference to the following revenue sources:

Total revenue		Include?	Annual growth
Settlement funding levels	✓	Yes	
Council tax revenue	✓	Yes	0.0%
Better Care Fund	✓	Yes	0.0%
New Homes Bonus		No	0.0%

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Assumption 7

- Assumption 7 allows the user to toggle **revenue neutrality** for certain models.
- By default, all four models are assumed to be revenue neutral. Any transitional protection provided to some local authorities is offset by a reduction in the funding received by others.
- It is possible to disable this assumption for Model 3 and Model 4.
- Under these models, authorities move towards their target funding levels over a fixed number of years. By itself, this is revenue neutral.
- These models also have additional protection in the form of floors. This prevents any authority's revenue from falling by more than a certain percentage in any year. These floors impose additional costs on the system.
- If the models are revenue neutral, then this cost is financed through a downward adjustment in the annual change in funding received by other authorities.
- If the models are not revenue neutral, then the cost of floors is assumed to be met by extra funding from central government. This means a downward adjustment to other authorities' funding is not necessary.

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- In the example below, the user disables the assumption of revenue neutrality. The cost of additional floor protection in Model 3 and Model 4 is then assumed to be met by additional funding from central government.
- The additional funding required from central government is shown in Table 5 of the 'Outputs' tab.

Assumption 6 example

Assume that all models are revenue neutral?

No

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Outputs

- The 'Outputs' tab compares the results of each transition model based on the specified assumptions.
- It is divided into two parts: the first part summarises the impact of each model on all local authorities on England. The second part shows the impact on the specified local authority.
- An explanation of each table and chart is provided in the Excel workbook itself.

Outputs

- The header of the 'Outputs' sheet provides key information on the models, as shown below.

Model Outputs

Selected Authority: Adur

Model up to date? ✓

Update

Plot results for:

Model 1	Yes
Model 2	Yes
Model 3	Yes
Model 4	No

Major assumptions:

Distance to target for selected LA	6.9%
Floor	-100.0%
Years to transition	1
Annual change in envelope	0.0%
All models are revenue neutral?	Yes

A duplicate of the model status and 'Update' button. The model is only valid if a green check mark appears.

Different models can produce similar results, depending on the assumptions entered. These buttons allow the user to toggle the visibility of each model in the charts below, which can help in cases where there is significant overlap.

A summary of the major assumptions that were entered on the 'Inputs' tab.