Ministry of Housing, Communities & Local Government

Title:	**Needs & Redistribution Technical Working Group**
Paper:	NR TWG 18-12: Discussion paper on Legacy Capital Finance by the Ministry of Housing, Communities and Local Government
Date:	10 July 2018
Venue:	MHCLG, 2 Marsham Street, London

POLICY DEVELOPMENT: NOT A STATEMENT OF GOVERNMENT POLICY

Introduction

1. The aim of this paper is to summarise the main questions raised in relation to the Capital Financing Formula, taking into account queries raised by the Technical Working group (TWG) in 2016 as well as representations to the recent consultation on relative need.

Technical Working Group

2. In November 2016 MHCLG presented a paper to the TWG on the Capital Finance Relative Needs Formula (RNF)[1], which laid out the rationale and background of the formula and asked for the TWG's views on the existing RNF.

3. The group discussed two areas:
   - Whether current levels of debt (calculations from 2013-14) could be rolled on to 2020 using average rates of interest as a way of mapping 'need' for Capital Financing
   - The overall resource requirements of capital financing.

Consultation on relative needs

4. The major representative bodies of the County Councils Network, District Councils Network, SIGOMA and London Councils agreed with the proposed cost drivers of outstanding debt and interest rates.

5. The LGA broadly agreed with the cost drivers but noted that since the cost related to legacy capital financing is directly measurable for each individual local authority, there may be an argument for funding Legacy Capital debt directly (i.e. outside of the relative needs assessment).

[1] https://www.local.gov.uk/sites/default/files/documents/capital-financing-cost-dr-78b.pdf

6. Similarly across the individual local authority responses we have received, there is broad consensus that these remain the right cost drivers although some respondents expressed a preference for the use of actual outstanding debt and interest rates.

Areas for Discussion

7. The purpose of the Capital Financing relative needs formula is to ensure that local authorities with borrowing commitments that were agreed to be funded through the local government finance settlement have that cost recognised in their relative needs assessment. This remains a pressure on some authorities and the Government still believes that the unringfenced funding distributed by the settlement provides local authorities with the greatest flexibility to service this historical debt.

8. In addition, current statutory guidance on minimum revenue provision[2] makes clear that the Government intends to continue to support historic borrowing via grant income rolled into Revenue Support Grant and that local authorities can continue to plan on that basis.

Overall Approach

9. The assumed end of year legacy capital debt in 2019-20 is currently calculated to be around £25 billion for English Local Authorities. This figure is based on an assumed yearly debt repayment of 4% of the start-of-year debt (representing a 25 year payment period) and an assumed interest charge of 4.4%.

10. Servicing the debt and interest rate under the current relative needs formula in 2019-20 will equate to a figure of around £2.2 billion, down from a figure of £2.7 billion in 2013-14. This yearly figure will continue to reduce in line with payment of the overall debt.

11. The below table illustrates the distribution by authority of the sum of assumed debt repayment and interest charges in 2019-20 calculated with the current formula.

Authority	Sum of Assumed 2019-20 Debt Repayment and Interest Charges
Fire and Rescue	37,328,161
London Borough	277,959,484
Metropolitan District	543,474,240
Shire County	720,411,372
Shire District	76,674,407
Unitary	495,609,339
Grand Total	2,151,457,002

[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/678868/Statutory_guidance_on_minimum_revenue_provision.pdf

Question 1): **Does the group have any comments on the use of historical debt as a basis for overall resourcing calculations for legacy capital finance?**

12. In future the Government is minded to use the output of the existing formula as the basis for a resource total for capital financing. However, this raises questions when put in the context of the other RNFs.

13. Capital finance is unique amongst RNFs as each local authority has a distinct assumed legacy capital debt figure. Unlike other RNFs where expenditure and cost drivers may fluctuate over time, this historical debt is a static figure which is currently reduced by a fixed percentage every year, and will eventually be paid off.

14. Given the unique nature of this RNF there is a question about how it should be treated in relation to the overall settlement resourcing. The output of the capital financing RNF could be top-sliced from the overall settlement resource pool. If the overall Settlement resource envelope changes, this would mean that the capital financing figure remains static whilst other RNFs could be scaled with the remaining resource pool.

15. The alternative to this would mean not top-slicing the capital financing RNF output, meaning it would be affected if there were any scaling. MHCLG welcomes any suggestions for how this scaling might be calculated.

Question 2): **Does the group have any comments on how Capital Financing should be treated in relation to other RNFs? Should it be top-sliced from the overall Settlement resource total? If not, do you have any suggestions for alternative mechanisms?**

Actual vs Assumed debt

16. The overall Legacy Capital Finance debt owed was calculated based on the assumed outstanding debt at 1 April 2013. Assumed outstanding debt at 1 April 2013 is based generally on assumed outstanding debt at 1 April 1990, credit approvals for the financial years 1990-91 to 2003-04, Supported Capital Expenditure (Revenue) amounts for 2004-05 to 2010-11 and assumed capital repayments. In 1990, to avoid perverse incentives and ensure that local authorities aligned with planned levels of government expenditure, the Government used assumed debt figures. The assumed debt figure for the sector was larger than that of actual debt.

17. Both the working group and consultation responses indicated it may be useful to look at current actual rather than assumed debt. However, collection of data on actual debt is not a simple task. Local authority revenue out-turn reports do not make a clear distinction between historical debt serviced by legacy payments and new borrowing undertaken under the prudential code, which is not supported with additional resource by central government. To collect actual historical debt figures would be a significant data collection task.

18. Prudent provision option 1 & 2 of the statutory guidance on minimum revenue provision (MRP) makes clear the recommended behaviour for local authorities in relation to historical debt supported by the Government through the Settlement.

    a. *Option 1: Regulatory Method*
        i. In this option, MRP is equal to the amount determined in accordance with the former regulations 27-29 of the 2003 regulations as if they had not been revoked by the 2008 regulations. In effect, this is 4% of the debt principal outstanding, not including HRA debt. MRP is calculated as 4% of CFR for all borrowings excluding HRA borrowing and less Adjustment A[3].

    b. *Option 2: Capital Financing Requirement*
        i. This is same as in Option 1 above but ignores Adjustment A. Under this option, MRP is equal to 4% of Capital Financing Requirement less HRA borrowings. This is a Prudential Indicator.

19. We expect that the majority of authorities will have serviced their debt using one of these two options. Our modelling for the Capital Finance RNF assumes a 4% reduction of start of year debt. As a result we expect that the majority of authorities overall legacy debt will have changed in a similar fashion.

20. In addition, since the 1990s local authorities have planned to service their historical borrowing based on assumed figures. Changes from assumed to actuals may unfairly affect those authorities who have acted under Government guidance since that time.

Question 3): Does the group have any comments on the use of Actual vs Assumed debt? Are there any suggestions for methods to calculate actual debt?

Interest Rate

21. The current formula uses an average interest rate of 4.4% set in 2013-14. Previous to 2013-14, interest rates were updated yearly.

22. At the technical working group in 2016 it was suggested that MHCLG's modelling should freeze the annual average interest rate at the 2013-14 rate of 4.4% since this formula relates to historical debt only.

23. Given this rationale the Government believes there may be merit to continue freezing the interest rate at 4.4% in the capital financing formula going forward.

Question 4): Does the group have any comments on freezing the interest rate? Are there any suggestions for alternative approaches?

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[3] The main device for achieving the neutrality between old and new MRP systems was "Adjustment A" in the original regulation 28. This was an amount to be calculated at the start of the new system in 2004 and not subsequently varied.