

Meeting	COUNTY COUNCIL	
Date	9 December 2010	Agenda item number 9

REPORT OF THE CABINET MEMBER FOR FINANCE AND PROPERTY

REVIEW OF PRUDENTIAL INDICATORS

1. Purpose of Report

- 1.1 To note the level of capital expenditure and external debt at 2009-10 year end relative to the Prudential Code indicators approved by Council in the Budget Book 2009-10.
- 1.2 To seek approval for adjustments to the Prudential Code indicators originally approved by Council in the Budget Book 2010-11.

2. Background

- 2.1 The Local Government Act 2003 enables local authorities to determine their programmes for capital investment and associated borrowing requirements provided they have regard to the Prudential Code for Capital Finance in Local Authorities developed by CIPFA and also take advice from the Section 151 Officer. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that the treasury management decisions are taken in accordance with good professional practice. To demonstrate that local authorities have fulfilled these objectives, the Prudential Code sets out the indicators that must be used and the factors that must be taken into account. The Prudential Code does not include suggested indicative limits: these are for the local authority to set itself.
- 2.2 Prudential indicators for the forthcoming year and two subsequent years are set within the annual budget and are approved by Council. They may be revised at any time, subject to Council approval.
- 2.3 Prudential indicators are monitored regularly throughout the year and the actual values of some of them are required to be reported at year end.
- 2.4 Under the Local Government Act 2003, a local authority may borrow money for any purpose relevant to its functions or for the prudent management of its financial affairs. Regulation 3(4) of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 states that if the administering authority uses

pension fund money for any purpose for which they may borrow money, then that counts as an investment. Indeed, in recent years, the Council has used pension fund cash to support its Capital Programme. The revised Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 remove the ability of an administering authority to use pension fund cash (effective from 1 April 2010) and, as a result, the Council's arrangements for managing and investing pension fund cash have been amended. Prudential indicators for 2010-11 to 2012-13, set in the Budget Book 2010-11 already take into account these new arrangements. When reporting actual values against the 2009-10 prudential indicators, this report considers the use of this cash to support the Capital Programme, whilst noting that the setting of these 2009-10 indicators in the Budget Book 2009-10 did not incorporate its use.

- 2.5 Local authorities are required each year to set aside a minimum amount as a provision in respect of capital expenditure previously financed by borrowing. The Statement of Recommended Practice (SORP) 2009 includes revised accounting arrangements for Private Finance Initiative (PFI) schemes such that more schemes will be "on Balance Sheet" and therefore subject to this minimum revenue provision (MRP) from 2009-10. The Budget Book 2010-11 stated that the MRP requirement is to be regarded as met by a charge equal to the element of the unitary charge applied to write down the liability. However, since at the time of writing the Budget Book 2010-11, the write down of the liability for PFI contracts had not been identified, it was not possible to take the revised accounting arrangements into account when setting the prudential indicators. The Budget Book 2010-11 stated that these would be reviewed during the year to take into account the changes in accounting practice.
- 2.6 The introduction of International Financial Reporting Standards (IFRS), in particular the International Accounting Standard on leasing (IAS17), has necessitated a review of all leases to determine whether any leases classified as operating leases under previous accounting standards (SSAP21) must be re-classified as finance leases. This change in accounting standards will result in assets held under finance leases being recognised on the Council's balance sheet. The MRP requirement is to be regarded as met by the amount of the repayment of the corresponding finance lease liability and the interest payable is deemed to be the excess of lease rental payments over MRP. The review of leases had not been completed at the time of writing the Budget Book 2010-11 and, hence, these new accounting arrangements were not incorporated into the process of setting the prudential indicators. The indicators need to be adjusted to take into account these changes.
- 2.7 In addition, the International Financial Reporting Interpretations Committee (IFRIC) issued "IFRIC 4: Determining whether an Arrangement contains a Lease". This states that, even if there is no legal agreement for a lease, an arrangement may contain, or be, a lease in substance, as per IAS17. An assessment of the Tram PFI arrangement (which was unaffected by the accounting changes for PFIs outlined in 2.5) has determined that this is, in substance, a lease and, hence, must be accounted for as such. This requires recognition

of the asset on balance sheet. As for other PFI schemes, the MRP requirement is regarded as met by a charge equal to the element of the unitary charge applied to write down the liability. These changes need to be reflected in the revised prudential indicators.

3. Prudential Indicators

The following prudential indicators, whose actual values must be reported at year end, relate to affordability and prudence.

3.1 Estimate of capital expenditure

The level of capital expenditure is likely to deviate from its Budget Book estimate as a result of new additions to the Capital Programme, cancellations of schemes, and slippage, acceleration and changing specifications of projects. The Capital Programme is monitored on a monthly basis and variations to the Capital Programme are reported to Cabinet approximately quarterly.

3.2 Estimate of the capital financing requirement

The capital financing requirement is a measure of the Authority's underlying need to borrow for capital purposes. This relates to capital expenditure which has not yet been financed by capital receipts, capital grants or contributions from revenue income. This is not the same as external debt since the Authority manages its position in terms of borrowings and investments in accordance with its integrated treasury management strategy and practices. For example, rather than borrowing from an external body, the Authority may judge it prudent to make use of cash that it has already invested for long-term purposes, such as reserves, for 'internal borrowing'. This means that there is no immediate link between the need to borrow to pay for capital spending and the level of external borrowing.

In order to ensure that, over the medium term, net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of the capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

3.3 External debt

External debt includes gross borrowing and other long-term liabilities.

3.3.1 Operational boundary for external debt

The operational boundary is the estimated maximum level of external debt in the most likely (i.e. prudent, but not worst-case) scenario. The operational boundary is a key management tool for in-year monitoring. It will probably not be significant if the external debt temporarily breaches the operational boundary on occasions due to variations in cash flow. However, a sustained or regular trend above the operational boundary would be significant.

3.3.2 Authorised limit for external debt

The authorised limit is the intended absolute limit for external debt and exceeds the operational boundary by an amount that provides sufficient headroom for events such as unusual cash movements. If it appears that the authorised limit might be breached, the Service Director – Finance has a duty to report this to the County Council for appropriate action to be taken.

3.4 Financing costs as a percentage of net revenue stream

The Prudential Code requires the Council to be aware of the impact of financing capital expenditure on its overall revenue expenditure position. The relevant indicator is the financing costs of capital expenditure expressed as a percentage of the net revenue stream, where:

- the costs of financing capital expenditure are interest payable to external lenders less interest earned on investments plus amounts set aside for repayments of amounts borrowed; and
- the net revenue stream is the amount of the revenue budget to be met from government grants and local taxpayers.

4. Prudential Indicators: 2009-10 Year-End Monitoring

4.1 Unadjusted figures

The following table shows those indicators that were approved for 2009-10 whose actual values must be reported at year end, together with their actual values, excluding adjustments for the impacts of the SORP 2009 revised accounting arrangements for PFI schemes and the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009.

Indicator	Comments
Estimated capital expenditure (excluding Schools Devolved Formula Capital) Indicator: £149m Actual: £92m (excl. PFI adjustment)	<p>The setting of the 2009-10 estimated capital expenditure did not take into account additional finance liabilities relating to PFI schemes.</p> <p>Capital expenditure was less than anticipated due mainly to slippage in the 2009-10 Capital Programme, much of which was due to schemes being put on hold whilst the Capital Programme was reviewed.</p>
Estimated capital financing requirement Indicator: £562m Actual: £504m (excl. PFI adjustment)	<p>The setting of the 2009-10 indicator (estimated capital financing requirement plus current and two subsequent years' requirements) did not take into account technical adjustments for PFI scheme revised accounting arrangements.</p> <p>The actual level of the capital financing requirement, excluding this adjustment,</p>

Indicator	Comments
	was £58m less than the indicator due mainly to slippage in the 2009-10 Capital Programme.
<p>External debt</p> <p>Authorised limit: £347m Operational boundary: £327m</p> <p>Actual level at 31/03/10: £287m (excl. PFI adjustment and use of pension fund cash)</p>	<p>The setting of the 2009-10 authorised limit for external debt did not take into account technical adjustments for PFI scheme revised accounting arrangements, nor adjustments for changes in pension fund regulations.</p> <p>The actual level of external debt, excluding these adjustments, did not breach the 2009-10 authorised limit for external debt.</p>
<p>Financing costs as a percentage of net revenue stream</p> <p>Indicator: 7.0%</p> <p>Actual: 7.0% (excl. PFI adjustment)</p>	<p>The setting of this indicator for 2009-10 did not take into account interest payable or MRP requirements associated with PFI-related finance liabilities.</p> <p>Actual financing costs as a percentage of net revenue stream, excluding these adjustments, were at the level anticipated in the Budget Book 2010-11 despite the Council using capital receipts to make a voluntary contribution of £2.5 million to repay the principal of amounts borrowed.</p>

4.2 Adjusted Figures

The actual year-end values of prudential indicators have also been recalculated to take into account adjustments relating to revised PFI accounting arrangements and pension fund regulation changes.

4.2.1 Capital expenditure

Taking into account additional PFI finance liabilities of £5 million (relating to the Waste PFI), the actual capital expenditure for 2009-10 (excluding Schools Devolved Formula Capital) was £97 million. This is still less than the estimated capital expenditure indicator value for 2009-10.

4.2.2 Capital financing requirement

Taking into account the adjustment of £147 million for revised accounting arrangements for Private Finance Initiative (PFI) schemes, the actual level of the capital financing requirement at 31 March 2010 was £651 million. Since this exceeds the sum of the estimated capital financing requirement for 2009/10 and the additional estimated capital financing requirements for the following two years, i.e. £562 million, there has been a technical breach of this prudential indicator. However, the actual capital financing requirement is not directly comparable with the estimated capital financing requirement for

2009-10 that was set in the Budget Book 2009-10 since the latter excluded PFI finance liabilities. Since the corresponding MRP requirement is regarded as met by a charge equal to the element of the unitary charge applied to write down the liability, there is no additional revenue budget impact of the adjustment for revised PFI accounting arrangements. If these arrangements had been taken into account in setting the capital financing requirement indicator for 2009-10, this indicator would not have been breached.

4.2.3 External Debt

Taking into account both finance lease liabilities of £144 million relating to PFI schemes and the use of £86 million of pension fund cash to support the Capital Programme, the actual level of external debt at 31 March 2010 was £516 million, which was a technical breach of the authorised limit for external debt, although again the actual value is not directly comparable with this indicator. As in section 4.2.1, the PFI-related adjustment has no additional revenue budget impact. Similarly, the revenue impact of the use of pension fund cash (e.g. interest payments) was already factored into the budget. If both factors had been taken into account in setting the authorised limit for external debt for 2009-10, this indicator would have been set to £561 million and hence would not have been breached.

4.3 Financing costs as a percentage of net revenue stream

Taking into account the interest payable and MRP requirements associated with PFI-related finance liabilities, the actual financing cost was 10.8% of the net revenue stream. Although the indicator was exceeded, this was a consequence of technical accounting adjustments and has no additional revenue impact. Had the new accounting arrangements been taken into account when setting this indicator, it would not have been exceeded.

5. Revision of Prudential Indicators for 2010-11 to 2012-13

To take into account the changes in accounting practice, it is now necessary to revise the prudential indicators for 2010-11 to 2012-13, as anticipated in the Budget Book 2010-11.

5.1 Estimated capital expenditure

The estimated capital expenditure indicator values for 2010-11 to 2012-13 need to be increased to include anticipated additions to PFI liabilities, all of which relate to the Waste PFI scheme, the effect of the Tram PFI coming onto the balance sheet and the impact of reclassification of some operating leases as finance leases under IAS 17.

Taking into account slippage from 2009-10, other approved variations and revised capital receipts, the gross Capital Programme for 2010-11 to 2012-13 (including variations approved up to October 2010) is to be funded as follows:

	2010/11 £000	2011/12 £000	2012/13 £000
Gross Capital Programme*	155,766	86,184	67,252
Funded by:			
Government Supported Borrowing	14,756	0	0
Prudential Borrowing	63,668	42,161	18,847
Capital Grants etc.	73,285	20,092	23,449
Capital Receipts	4,057	23,931	24,956
Total Funding	155,766	86,184	67,252

* Excluding Schools Devolved Formula Capital

The revised estimated capital expenditure indicators are therefore given by:

	2010/11 £000	2011/12 £000	2012/13 £000
Gross Capital Programme	155,766	86,184	67,252
Forecast additions to PFI Finance Liability	49,870	63,121	4,424
Estimated additions for Finance Lease Liabilities	1,000	1,000	1,000
Estimated Capital Expenditure	206,636	150,305	72,676

The process of assessing leases to determine whether they meet the accounting criteria for classification as finance leases is ongoing and the estimated adjustments for finance lease liabilities are based on a combination of assessments of leases held prior to 2009/10 and prudent estimates of liabilities corresponding to leases signed subsequently.

5.2 Estimated capital financing requirement

The estimated capital financing requirements for 2010-11 to 2012-13 need to be revised to include all PFI finance liabilities and finance lease liabilities. The actual capital financing requirement at 31 March 2010 was £651 million, including £147 million relating to PFI finance liabilities. The additional capital financing requirements for the next three years are:

	2010/11 £m	2011/12 £m	2012/13 £m
Borrowing supported by Revenue Support Grant	15	0	0
Other Borrowing	64	42	19
Additions to PFI Finance Liabilities (Waste)	50	63	4
Adjustments for new accounting arrangements	41	0	0
Estimated additional Finance Lease Liabilities	1	1	1
Repayment of PFI Finance Liabilities	-5	-3	-3
Other Amounts set aside for Repayment of Debt	-18	-20	-20
Additions (net)	148	83	1

Note: Since the review of finance leases is ongoing and the anticipated level of finance lease liability repayments are not expected to materially affect the indicators, these repayments are not taken into account in setting the indicators.

As such, there will be a requirement to ensure that the actual capital financing requirement at 31 March 2011 does not exceed £883 million, i.e. the revised capital financing requirement at 31 March 2010 of £651 million (see paragraph 4.2.2 above) plus the additional capital financing requirement for 2010/11 and the next two years.

5.3 Operational boundary and authorised limit for external debt

The revised operational boundary for external debt for the next three years can be built up from the existing level of external debt shown in the Balance Sheet at 31 March 2010.

	£m
External borrowing at 31 March 2010 (from balance sheet)	287
Finance lease liability (from balance sheet)	144
Additional borrowing due to pension fund regulation changes	86
Finance liability adjustment for Tram PFI	31
Other finance lease liability adjustments	10
Capital expenditure financed by borrowing 2010/11	79
Additions to PFI finance liabilities in 2010/11	50
Estimated additions to other finance lease liabilities in 2010/11	1
Repayment of PFI finance liabilities	-5
Other amounts set aside for repayment of debt	-18
Contingency for unforeseen borrowing	20
Operational Boundary 2010/11	685
Capital expenditure financed by borrowing 2011/12	42
Additions to PFI finance liabilities in 2011/12	63
Estimated additions to other finance lease liabilities in 2011/12	1
Repayment of PFI finance liabilities	-3
Other amounts set aside for repayment of debt	-20
Operational Boundary 2011/12	768
Capital expenditure financed by borrowing 2012/13	19
Additions to PFI finance liabilities in 2012/13	4
Estimated additions to other finance lease liabilities in 2012/13	1
Repayment of PFI finance liabilities	-3
Other amounts set aside for repayment of debt	-20
Operational Boundary 2012/13	769

Note: As above, finance lease liability repayments are not taken into account in setting these indicators.

The contingency for unforeseen borrowing is available to cover any temporary cash flow issues that might arise, and also for increases in the Capital Programme that require financing by borrowing.

It is proposed to add a further £20 million to the operational boundaries to provide cover for unusual cash movements. The proposed authorised limits are:

2010/11	£705 million
2011/12	£788 million
2012/13	£789 million

Both the authorised limits and operational boundaries are less than the capital financing requirement because best practice in treasury management means that actual borrowing is below the notional underlying borrowing requirement.

5.4 Financing costs as a percentage of net revenue stream

The revised indicator for 2010/11 is set by including, within financing costs, PFI-related interest payable and MRP equal to the elements of the unitary charges applied to write down PFI liabilities (again assuming non-materiality of the part of non-PFI finance lease repayments deemed to be interest payable), yielding a revised indicator of 11.9% of net revenue stream for 2010/11.

Net revenue stream includes the Revenue Support Grant (RSG) and, since the level of RSG receivable is uncertain from 2011/12, it is not practical to set revised indicators for 2011/12 and 2012/13 at this stage. These will be set in the Budget Book 2011-12, taking into account prudence, affordability and sustainability.

5.5 Impact of capital investment on Council Tax

The impact of new borrowing for additions to the Capital Programme will continue to be considered within decisions regarding individual capital schemes and will continue to be reported in the relevant Budget Book for the totality of changes proposed to the Capital Programme.

5.6 Summary of Revised Prudential Indicators

The following table shows the revised prudential indicators for the years 2010/11 to 2012/13 alongside those set in the Budget Book 2010-11.

Prudential Indicator	2010/11 £m	2011/12 £m	2012/13 £m
<u>Estimated Capital Expenditure</u>			
As set in Budget Book 2010-11	145	82	66
Revised	207	150	73
<u>Estimated Capital Financing Requirement</u>			
As set in Budget Book 2010-11	564	580	573
Revised	799	882	883
<u>Authorised Limit for External Debt</u>			
As set in Budget Book 2010-11	453	469	463
Revised	705	788	789
<u>Operational Boundary for External Debt</u>			
As set in Budget Book 2010-11	433	449	443
Revised	685	768	769
<u>Financing Costs as a Percentage of Net Revenue Stream</u>			
As set in Budget Book 2010-11	7.6%		
Revised	11.9%		

6. Financial Implications

- 6.1 The factors leading to the technical breaches of the 2009/10 prudential indicators have not affected the revenue budget, nor the level of Council borrowing and its financing costs.
- 6.2 Although the prudential indicators have been revised upwards, this is not intended to allow for any additional Capital Programme borrowing other than that incorporated into the indicators originally set in the Budget Book 2010-11.

7. Statutory and Policy Implications

This report has been compiled after consideration of implications in respect of finance, equal opportunities, personnel, Crime and Disorder, Human Rights and those using the relevant services. No specific issues arise out of the proposals in the report.

8. RECOMMENDATIONS

- 8.1 To note that, had technical amendments not been made to accounting arrangements, the 2009/10 prudential indicators would not have been breached.
- 8.2 To note that factors resulting in technical breaches of the 2009/10 prudential indicators have had no practical impact on the revenue budget or on the borrowing levels of the Council.
- 8.3 To approve the revised prudential indicators for 2010/11 to 2012/13 set in section 5.

**CLLR REG ADAIR
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Background papers available for inspection

Accounting Tabulations, Internal Management Reports

Electoral Divisions affected

Nottinghamshire

Legal Services' Comments (CEH 02/11/10)

Two recommendations are for noting only and the full Council has the power to make a decision in respect of recommendation 8.3.

Financial Comments of the Service Director - Finance (SB 04/10/10)

The financial implications are set out within the report.