The Chartered Institute of
Public Finance & Accountancy

CIPFA

Local Authority Capital Flexibilities

Call for views

A submission by:
The Chartered Institute of Public Finance and Accountancy

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CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. CIPFA shows the way in public finance globally, standing up for sound public financial management and good governance around the world as the leading commentator on managing and accounting for public money.

Further information about CIPFA can be obtained at www.cipfa.org

Any questions arising from this submission should be directed to:

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1. Purpose

The purpose of the engagement is to seek views on the options set out and invite additional suggestions. The government is not committing to any of these options at this point. To be considered viable, an option must meet at least one of the following objectives:

- encourage and enable local authorities to take forward projects, programmes and initiatives that produce ongoing revenue savings and improve efficiency
- provide additional local levers such that authorities are able to manage pressures without approaching the government as part of a plan to move back to financial sustainability,

and all of the following principles:

- provides demonstrable benefit to the sector or sufficient number of individual authorities that justifies the increased flexibility and outweighs any accepted risk
- the risks of implementing the option must be manageable to an acceptable level while still permitting local decision making
- is consistent with an authority's Best Value duty and the objectives of the Prudential Framework such that all borrowing and investment is prudent, sustainable and affordable.

1.1 While aspects of some of the options set out in this paper may facilitate projects that improve efficiency, we are unconvinced that any of them will satisfy the second objective of moving the sector back to financial sustainability. None of the options would appear to provide a long-term solution to the funding shortfall that many service areas, particularly social care, continue to suffer.

1.2 Option 1 should not be pursued at all. It would not be in-line with an authority's Best Value duty and the principles of the Prudential Framework to apply capital resources to ongoing cost pressures.

1.3 Option 2 is more in-line with the principles since it ascribes capital resources to a one-off project. However it would increase leverage, which would massively increase the downside risk of any invest-to-save project. Is it the right time to allow this when there is concern over current indebtedness within the sector?

1.4 Option 3 would appear to be a solution to a different problem – excessive capital risk and leverage. While the ability to repay PWLB loans at par would be welcomed, it does not solve any long-term funding issues.

1.5 All of the options pre-suppose that all authorities have surplus capital resources and the ability to generate capital receipts. Not all have these, so these proposals would be of little assistance to them and may encourage risk-taking for those least equipped to cover any losses. For more fortunate authorities, the perception could be that they are "selling the family silver" to pay the bills.

1.6 Our key concern about any monitoring regime is the review framework itself. We would support a panel consisting of stakeholders within the sector (CIPFA, LGA, SCT etc) so that plans are reviewed by those best equipped to ask the right questions. We would not support a system whereby an authority would procure a firm or an advisor to review its efficiency plans.

1.7 CIPFA's detailed response does not answer questions 2, 3, 7, 8, 11, 12 and 14 since these apply to a respondent's individual circumstances.

2. Option 1: extend capitalisation flexibilities to include a wider set of eligible costs.

That is, to allow authorities to capitalise general cost pressures and meet these with capital receipts. As a condition, the authority must put in place and commit to delivering an efficiency plan to reduce costs, with a defined payback period on any capitalised spend. The intent is that any use of the flexibility must be part of an overall plan to move back to financial sustainability within the medium-term financial plan.

Q1: Does this option meet the objectives and principles as set in this document? Please provide detailed comments:

2.1 We do not believe this option would satisfy the principles set out for the following reasons:

- Capitalising general costs would not be in line with the Prudential Framework and would increase capital risk and leverage, at a time when it is generally accepted that it is too high.
- It is not consistent with the delivery of best value, since it would be difficult to control in practice.
- It doesn't solve the underlying revenue funding issue and the need for more substantive decisions further down the road.
- This presumes that all authorities have surplus capital resources.

Q4: Should this flexibility be constrained to a specific area or type of expenditure? Or certain types of expenditure be excluded? Please provide detailed comments:

2.2 This option should not be pursued further (see answer to Question 1).

Q5: In your view, are there any risks or unintended consequences that the government should consider?

2.3 Allowing local authorities to capitalise generalised cost pressures could give rise to many issues not discussed in the answer to Question 1:

- This would place current revenue costs on future council taxpayers.
- This could give rise to the misconception that authorities may capitalise "anything and everything".

3. Option 2: extend the flexible use of capital receipts to allow authorities to borrow for the revenue costs of invest-to-save projects.

This would be a simple extension of the current direction to allow authorities to borrow to finance the revenue costs of eligible projects, as well as use capital receipts. The parameters of the direction could otherwise be kept the same (with the same definition of eligible costs and restrictions).

Q6: Does this option meet the objectives and principles as set in this document? Please provide detailed comments.

3.1 This is more in-line with the principles of the Prudential Framework and an authority's Best Value duty. Since it is directly concerned with invest to save projects that may deliver future benefit to taxpayers and as such would be more controllable. However the other issues discussed in our answer to Q1 remain:

- It doesn't solve the funding issue and
- It still would increase leverage and capital risk.
- The presumption that all authorities have surplus capital resource.

Q9: In your view, are there any risks or unintended consequences the government should consider?

3.2 The government should be clear about what kind of costs are eligible for capitalisation and it should be made clear that the costs of borrowing to fund such projects, if deemed appropriate, have to be fully factored into the decision-making process and a prudent view taken of the returns and risks to determine affordability.

3.3 The downside risk of leverage should not be understated. It would be imperative for project financed in this way to deliver the planned savings, since there would be ongoing costs to cover.

4. Option 3: Allow additional flexibilities for the use of the proceeds of selling investment assets.

The proposal is effectively an extension of Option 2, whereby local authorities may use the investment asset proceeds to fund financial pressures, but to also have access to additional flexibilities which may include: increasing reserves where they are demonstrably low; repaying Public Works Loan Board Borrowing without a premium (where one would otherwise be charged).

Q10: Does this option meet the objectives and principles as set in this document? Please provide detailed comments.

4.1 This response pre-supposes that the "investment assets" here referred to are investment property. The definition of *investment assets* in this document would appear to differ to the definitions in the Prudential and Treasury Codes and the Investment Regulations. It is important that these definitions are consistent.

4.2 This option would fit the principles set out in this document, also the selling of the assets in itself would reduce the CFR and therefore capital risk and leverage. The PWLB proposal would make this a more attractive option than it is already, since the premiums are a significant barrier to authorities that would otherwise offload debt. The ability to use the proceeds to fund cost pressures would need careful consideration of the detail (see 4.3 below), but this is certainly more attractive than options 1 or 2, since it wouldn't require additional borrowing and should reduce leverage.

4.3 The government may wish to consider mandating that an authority must set aside capital receipts and repay PWLB borrowing (without a premium) to the level of CFR outstanding for the purchase of the investment assets (or total capital receipt, whichever is greater). This would reduce capital risk and leverage. Any capital receipts remaining after this could be applied to financial pressures/invest to save schemes. This would avoid a potential "double capital" issue whereby the receipt is banked, the cash is used to pay off PWLB debt and then the credit is applied to revenue pressures and not to reduce the CFR. The right controls would need to be in place to ensure this cannot happen.

4.4 Many authorities have invested in investment property through wholly owned companies to which they have provided capital loans. The government may want to consider expanding this option to include capital receipts from loan repayments for commercial loans. This would mean that a wholly owned company could sell investment properties, repay the loan to the authority and the authority could have the same flexibility as if it had sold the investment property itself. This gives authorities who will be starting to make MRP on commercial loans under the proposed revised MRP regulations and guidance an option to unwind the investment to avoid/reduce the increase in MRP.

4.5 The outstanding issue that remains however is that this would be a short-term solution that would not fix the long-term funding issue. This would be a solution to another issue facing the sector: capital Risk and leverage.

Q13: In your view, are there any risks or unintended consequences the government should consider?

4.6 If the option proves very popular, then there could be an issue of flooding an already depressed commercial property market with stock, particularly in areas where an authority owns a large portfolio. There is a risk that these measures create the perception that any authority disposing of investment properties is doing so to manage ongoing financial pressures rather than as part of an overall capital strategy. This might weaken the authority's position in achieving best consideration for the assets in question.

The Government is also interested in understanding whether a reduced interest rate for borrowing from the Public Works Loan Board for invest-to-save projects would further enable invest-to-save projects. The proposal is that this would be to finance the capital costs of expenditure of projects that meet the definitions set out in the flexible use of capital receipts direction.

Further details would be subject to development of the proposal, however, it is likely the following would apply: local authorities would not be required to apply to the government to use the rate, but would need to include planned borrowing with the discounted rate in their capital plans provided to DLUHC; local authorities would need to submit additional details to DLUHC for transparency; and local authorities would not be able to borrow in advance of need.

The discount offered would not be more than 40 basis points on prevailing rates. This is the discount currently offered for HRA borrowing. The Government is aware that the majority of the cost of interest rates is driven by gilt rates, however, we are looking to understand whether such a discount would support the affordability of invest-to-save projects.

Q15: Would a discount of 40 basis points help make invest-to-save projects more affordable?

4.8 Ordinarily anything that expedites genuine invest-to-save projects would be welcomed, with this proposal however there are significant reservations: the element of the project that is to be financed from borrowing would need to be clearly identified, since authorities generally do not hypothecate individual loans to projects. Any project that is financed by borrowing needs to have a robust business case and a realistic payback period that is not too long. This proposal would still not solve the long-term funding issue and the downside risks cited in pp. 3.3 remain.

5. Additional controls proposed:

Full transparency. Using any additional flexibilities with respect to borrowing for revenue costs must be supported by an efficiency plan detailing how the council will use the capitalisation flexibility, how it will reduce costs and the payback period on this. The plan should be presented to full council or equivalent, and submitted to the government for review. The plan should also be published on the local authority's website. Updates on the efficiency plans must be published at least quarterly.

Mandate a payback period. Efficiency/invest-to-save plans must have a payback period of no more than a fixed number of years eg 10 years. Including the capitalised cost of revenue as part of the investment.

Independent review. Local authorities must commission an independent review of their efficiency plans, share these with the government and publish on their website if they want access to additional capital flexibilities.

Limit flexibilities to specific types of expenditure. Specifically for Options 1 and 3, where capital receipts may be applied to general cost pressures, this could be limited to certain categories of service spend and/or exclude categories of cost spend.

Assurance engagement. The government can commission an independent review of the use of the flexibilities at its discretion.

Q16: Do you agree with these additional controls to apply to any local authority that uses the capital flexibilities or PWLB discount rate? Please provide details.

5.1 Working under the presumption that the efficiency plans are the "invest-to-save" project referred to under Option 2, full transparency is essential. That said, many of these controls you would expect to see on a properly managed and governed project in any case. Almost all aspects of *full transparency* would be part of a robust business case process, certainly in the case of a transformation project. Perhaps the role of central government in reviewing a project should be defined. Would they have the power to intervene and cancel flexibilities? Would a stakeholder panel consisting of the LGA, CIPFA and other interested bodies be a better solution?

5.2 A well-managed transformation project should have a properly defined, achievable and reasonable *payback period.*

5.3 More detail is needed on what constitutes this *independent review*? A peer review regime, with a panel that CIPFA would like to be involved with and other stakeholders, such as the LGA would be preferable to one where an authority procures a firm or advisor to review its plans. Such reviews from external bodies tend to be costly and offer a minimal level of assurance. These may also divert resources from the actual transformation project.

5.4 Although our view it that Option 1 should not be pursued further, limiting the flexibilities to certain types of expenditure appears sensible.

5.5 The government should keep the regime under review and a full review after a certain period of time would seem sensible. Should the review not consider why there is a perceived need for these flexibilities?

Q17: Are there additional controls that the government should require with respect to all or some of the options set out? Please provide details.

5.6 Any new flexibilities should require a robust set of controls. However, the Prudential regulation system and the incoming capital risk framework already provide an extensive system of controls and care should be taken to avoid duplication. The provisions of these frameworks should be reiterated. Any control framework specifically for this regime should focus on:

- The strength and robustness of the business case and business case process of any invest-to-save transformation project.
- A peer-review framework – the onus should not be on the authority concerned to procure their own. Reviews by some parties, such as the large firms, have a track record of being costly and the level of assurance given can be minimal.
- MRP should be limited to a set period for borrowing for invest to save schemes to ensure borrowing costs are not stretched over an unreasonably long period to make a proposed scheme look more effective than it really is.
- Flexibilities should be limited to certain types of expenditure. As per the answer to Q1, CIPFA does not consider capitalising general cost pressures to be appropriate.