DISTRICT COUNCILS' NETWORK
Innovative and collaborative
solutions for people and places

## District Councils' Network response to the proposed changes to the prudential framework of capital finance

**About the District Councils' Network**
The District Councils' Network (DCN) is a cross-party member led network of 200 district councils. We are a Special Interest Group of the Local Government Association (LGA), and provide a single voice for district councils within the Local Government Association.

District councils in England deliver 86 out of 137 essential local government services to over 22 million people - 40% of the population - and cover 68% of the country by area. As the housing and planning authorities, we approve 90% of all planning applications and enabled housing completions in our areas last year. District councils have a proven track record of devising innovative solutions to transform public services, taking a lead role in improving services and outcomes for people and places through better collaboration.

**Summary**
The DCN welcomes the opportunity to respond to this consultation paper. We are supportive of the proposal to ensure that local authorities are prudent and undertake due diligence over their non-financial investments in a transparent way, however DCLG should be careful that the new Guidance does not cause any un-intended consequences which limit innovation from local authorities.

District Councils have a proven track record of devising innovative solutions to transform public services which includes regeneration and investment activity. With the historic and continuing sizeable reduction in funding for District Councils, alternative funding streams need to be found in order for Districts to continue to provide statutory and discretionary services to their residents. These innovative alternatives provide an income stream for local authorities to enable further investment in services. We agree that these should be proportionate to the size of the authority and local authorities should undertake full due diligence and be transparent in the outcomes expected.

Buying a physical capital asset should not be classed as 'borrowing in advance of need' even if the sole reason for purchase is to generate a revenue return for the authority. Authorities with a proper appraisal of financial implications, risk and due diligence and with external specialist advice (where appropriate) can and should be able to borrow to purchase physical capital assets. These can produce a revenue return which more than covers to cost of borrowing and also have a residual value. As long as these investments are proportionate to the size of authority they can be a key way for authorities to raise income and provide secondary results such as economic growth nationally.

Many local authorities have an Audit or Scrutiny Committee to review the Investment Strategy before it is presented to Full Council for approval prior to 31st March. The timing of this consultation may not allow sufficient time for authorities to complete this process for their 2018-19 Investment Strategies, leading to the setting of an initial Investment Strategy and then subsequently having to re-do the process for the new Investment Strategy. Once again we would urge DCLG to allow authorities more time for changes to be implemented.

As a general point it is not clear how the new MRP guidance will be applied in practice, for example in relation to capital investment decisions already taken. These would have been based on existing MRP policies based on the existing guidance. It is not clear in this case whether it will require new calculations and adjustments to what may have already been agreed with local auditors as prudent. This

will impact on how local authorities are approaching decisions they need to make now. In addition, if the changes in rules are applied retrospectively then it will have significant implications for councils that have to change their MRP. This will have a significant impact on revenue budgets and will affect councils' ability to deliver services. Under no circumstances should this change be applied retrospectively and this should be clarified urgently.

We have been informed by the LGA of a potential consequence of this proposal which they have included in their consultation response and are highlighting the issue here as the DCN is also concerned.
*Local Authority investment guidance*
*The consultation says the guidance has to be read in conjunction with the Cipfa Prudential code and the Cipfa Treasury Management code. These have not yet been published or finalised, so it is not possible for local authorities to fully comment on the proposals in the consultation and changes to the Guidance on Local Government Investments and Statutory Guidance on Minimum Revenue Provisions.*

*The LGA would like to draw attention to the combined impact of the following in the draft investment guidance and a recent draft of the Cipfa Prudential code:*
*"Borrowing solely to invest in a yield bearing opportunity is borrowing in advance of need" (Paragraph 40)*
*"Borrowing solely to invest rather than to deliver statutory services or strategic objectives has always been considered to be borrowing in advance of need" (paragraph 21)*
*"Authorities must not borrow in advance of need purely in order to profit from the investment of the extra sums borrowed". (draft Cipfa Prudential code).*
*Taking these together the result is that under the guidance local authorities will not be able to borrow in order to invest in any yield bearing opportunities. The guidance needs to be clear if this interpretation is correct as this would be a significant problem. Under the current (2010) guidance it is clear that "borrowing in advance of need" relates solely to financial investments and financial instruments whereas investments such as commercial property rightly count as capital expenditure as they involve the acquisition of a physical asset and as such are eligible for funding from borrowing.*

*Local authorities have invested in property in different ways for many years; if this is to be restricted it could have a major impact on their ability to fund and deliver services to their residents. Furthermore, if this change does go ahead and is applied retrospectively, forcing councils to divest themselves of existing investments, the financial costs and potential losses could be disastrous for some councils. We oppose any restriction that will reduce funding for councils to benefit their local areas and under no circumstances should this be applied retrospectively.*

We have attached at Appendix A some case studies from District Councils to provide an example of a commercial investment approach and the issues faced.

We have set out below our detailed responses to the consultation questions.

**Question 1: Do you agree with the proposed change? If not why not; and what alternative would you propose?**
Yes we support this in principle.

**Question 2: Do you agree that it is important for local authorities to disclose the contribution that investment activities make to their core functions? If not why not; and what alternative would you propose?**
We feel that it would be useful and transparent for local authorities to disclose the financial contribution that the investment makes overall. Many councils have held property investments for many years, the income from which forms a core part of their budget. It will therefore be difficult to define what is 'core' and 'non-core' in a meaningful and helpful way.

**Question 3: Are there any other measures that would increase the transparency of local authority financial and non-financial investments that you would suggest for inclusion in the Investments Guidance to assist scrutiny by the press, local taxpayers and councillors?**
No, local authority information on many areas such as; budgets, investments, treasury management, capital, performance, planning and so on are all publically available on their websites and through committee agendas/meetings for any interested party to review and question as they wish.

We are however concerned that paragraph 19 of the draft guidance requires that indicators should allow comparison of 'a local authority's decisions to a similar authority'. The practicalities of attempting this

preclude it as a possibility. To attempt this would impose a major burden on councils and would require such indicators to be imposed nationally; in addition the 'similar authority' would need to be defined. Such indicators need to be specified locally and the requirement for national comparison in paragraph 19 is not supported. Question 5 below seems to contradict this and appears a more sensible proposal.

**Question 4: Do you agree with the introduction of a requirement to enable Councillors to assess total exposure from borrowing and investment decisions? If not why not; and what alternative would you propose?**
Yes, we agree with this requirement as it would increase transparency and information for decision makers. This should however be flexible to allow local authorities to include indicators which suit their own local circumstances which may have included investments for a primarily regeneration purpose rather than financial returns.

**Question 5: Do you agree with the decision not to specify indicators or thresholds? If not why not; and what alternative would you propose?**
Yes we agree with the decision **not** to specify indicators or thresholds. There are many differences between investments, activity and outcomes for different authorities and any attempt to prescribe indicators or thresholds would result in them being meaningless and not useful for most authorities.

Please also see comments within Question 3 relating to paragraph 19 of the draft guidance, paragraph 19 should be amended accordingly.

**Question 6: Do you agree with the extension of the principles of security and liquidity to non-financial assets? If not why not; and what alternative would you propose?**
No, we do not agree with the extension of these principles.
The balance between security and liquidity will be different for different types of assets. Non-financial assets need to be looked at differently from Treasury assets as they are held for different purposes. It is also not clear from the guidance how regeneration projects would be treated here. A regeneration project will almost never meet the security or liquidity test and should therefore be excluded. Investment properties are already valued in local authorities' accounts under IAS40 and any increases/decreases in value are dealt with in the annual Statement of Accounts. Timing will also play an important part, just because the value of an asset may decrease or increase at a point in time, until the asset is sold this change in valuation is not 'realised' in cash terms. This proposal is therefore un-necessary as it is dealt with by authorities in the Statement of Accounts.

**Question 7: Do you agree with the definitions of liquidity and security for non-financial assets? If not why not; and what alternative would you propose?**
See comments on question 6 above. Financial and non-financial assets are fundamentally different in nature and the same principles cannot be applied to each.

**Question 8: Do you agree with the introduction of a concept of proportionality? If not why not; and what alternative would you propose?**
We agree with the overall concept of proportionality, however do not agree with your proposals fully.

It would be transparent and useful information to disclose the overall income on commercial investments, however this could be delivering both statutory and discretionary services in some cases, so our alternative would be:
'to disclose the amount of rental income from commercial property investments and the amount of borrowing that has been committed to generate that income'.
Authorities might wish to consider including a section in their Narrative Report on commercial investments as an alternative.

DCLG should also note that some councils are faced with limited options to raise funding in any other way and are hence turning to these commercial investments as the best alternative available to them due to the funding reductions seen in recent years.
The year-on-year changes in core spending power for district councils has seen huge reductions of £134m (over 5%) from 2016-17 to 2017-18, with further reductions forecast (in the 2017-18 Local Government Finance Settlement) compared to other types of authorities who have seen an increase. In

addition, based on the 2017-18 Settlement data from DCLG, 146 out of the 201 District Councils (72%) will be facing a negative RSG position by 2019-20.

**Question 9: Do you agree that local authorities who borrow solely to invest should disclose additional information? If not why not; and what alternative would you propose?**
Yes, we agree that is would be more informative and transparent to disclose additional information, provided it is useful for the decision makers and does not impair commercial confidentiality. However, borrowing solely to invest may not arise from a deliberate policy but also from changing circumstances, and any disclosures should reflect this. Currently investment in commercial property is classified as capital expenditure and so may be financed by borrowing.

**Question 10: Do you agree with the extension of the disclosure requirement on steps taken to secure sufficient expertise to include all key individuals in the decision making process? If not why not; and what alternative would you propose?**
No, we feel that this is already covered within the existing Member approved Investment Policy/Strategy of a council as is therefore un-necessary.
An alternative is not required as this is already covered through the Member approved Investment Policy/Strategy and the councils own local constitution and job descriptions for key roles. Senior management and members rely upon the professional skill and judgement of operational managers across all areas of local government without themselves having that specific knowledge.

**Question 11: do you agree with the change to the definition of the basis of MRP? If not why not; and what alternative would you propose?**
No, the current application of MRP works appropriately and does not therefore need to be changed.

**Question 12: Do you agree that the Guidance should clarify that a charge to an account cannot be a credit? If not why not; and what alternative would you propose?**
We are broadly in agreement with this as a general principle (and this has been raised previously in an NAO report), however we believe that any negative MRP which arose for a legitimate reason would have been approved by a councils external auditor as part of the audit of the Statement of Accounts.
If approved by the external auditors this suggests that this was prudent and acceptable and therefore Guidance to prevent a negative MRP may not be required.

**Question 13: Do you agree that changing MRP methodology does not generate an overpayment of MRP? If not why not; and what alternative would you propose?**
We agree that flexibility on MRP should be allowed as circumstances will change over time for authorities and assets. It is unreasonable that the adoption of a more suitable methodology should not be capable of being backdated. This would also apply if the change of methodology resulted in there being underpayments in previous years. Revising and re-profiling historical MRP policies to reflect current circumstances may allow a more prudent approach which provides greater fairness to current and future Council Tax payers.

**Question 14: Do you agree that the guidance should set maximum useful economic lives for MRP calculations based on asset life? If not why not; and what alternative would you propose?**
We do not agree that maximum economic useful lives should be set.
Local authorities must set prudent timescales for useful economic lives/MRP and these are audited by external auditors as part of the Statement of Accounts to ensure that they are set prudently. A potential unintended consequence of these proposed limits is that some authorities will simply use them as a proxy rather than properly consider to period over which the expenditure provides benefits. The imposition of a single fixed asset life for different categories is unrealistic. With regular maintenance buildings could well have a life extended well beyond 40 years and it is illogical to assign a useful life to most land, particularly as land may have many alternate uses. It would be more realistic to treat each asset on its own merits and to assign a useful life individually.
An alternative proposal is therefore not required.

**Question 15: Do you agree with the maximum useful economic lives selected? If not why not; and what alternative would you propose?**
Please see response to question 14.

**Question 16: Do you agree that the codes should be implemented in full for 2018-19? If not are there any specific proposals where implementation should be deferred, and what would be the implications of not doing so?**

The timing of this consultation means for many local authorities implementation for a 2018-19 start date would mean producing an interim strategy/policy under the current Guidance and then an updated one later on. This is because the consultation does not end until 22 December 2017, so no feedback to the consultation will be provided by DCLG until the new year. Many local authorities have an Audit or Scrutiny Committee to review the Investment Strategy before it is presented to Full Council for approval prior to 31st March. The timing of this consultation may therefore not allow sufficient time for authorities to complete this process before their Audit/Scrutiny committee, leading to the need for a revised strategy after the DCLG feedback and implementation.

We would therefore recommend that implementation is voluntary for the 2018-19 financial year and implemented in full for the 2019-20 year which would give councils time to plan and implement this properly.

**Ashfield District Council – Case Study**

Facing a budget shortfall of £3.7M over the next three years, Ashfield District Council is committed to finding new income streams to fill the funding gap rather than cutting services to residents. Efforts around Commercialism continue to develop ideas and options; however, commercial property investment is the only option that delivers significant levels of income in acceptable timeframes and with manageable risk. Furthermore, the results of the 17/18 Budget survey indicate broad support amongst residents for this investment activity. As a result, Ashfield DC has moved forward on the investment front, having secured an investment portfolio that delivers at least £430k of new income in 18/19. This level of income would be equivalent to:

- Delivering half of our savings target for 18/19.
- Maintaining the operation of the District's two large Leisure centres; or
- Maintaining the operation of Markets across the District; or
- Maintaining half of Ashfield DC's Community Protection Team.

The location of an investment is one of many important factors considered when making the choice to invest. Whilst the clear choice for Ashfield would be to invest locally, all of the factors considered together must make the investment desirable and must mitigate risk. With all of the investments to date, there were simply no investment opportunities available in the District that were favourable on all evaluation criteria. Should opportunities arise to invest in the District, and the criteria are satisfied, these will be considered and favoured over other opportunities outside of the District. Investment activity notwithstanding, the Council continues to support regeneration in the District and is active in supporting growth usually where there is market failure and not always a case for significant or low risk commercial returns. If Ashfield DC cannot purchase outside of the District then it would be limited in its future options on commercial investment and disadvantaged unfairly, unlike areas with high land values and better commercial yields. Ultimately, this would result in further cuts to services in a District that is already significantly disadvantaged. The Council is confident in meeting the proposed revised CIPFA guidelines and will be reviewing its approach accordingly and updating its Commercial Investment Strategy.

**West Devon Borough Council – Cast Study**

**West Devon Background – Some Facts:**

- Population of over 53,000 covering an area of 1,160 $km^2$
- There are two main market towns – Tavistock and Okehampton
- 45% of West Devon is located within the Dartmoor National Park
- 97% of West Devon is green space – a significant part is designated as an Area of Outstanding Natural Beauty (AONB) and part of Tavistock holds World Heritage Site status
- Annual earnings in the Borough are £17,370
- Number of households billed for Council Tax = 25,500; Current Band D council tax for West Devon is £218.39 (in the highest quartile). West Devon collects £35m in council tax, however only 12% (£4.4m) of this is retained by West Devon.
- The Council's gross expenditure is budgeted to be £26.8m and gross income of £19.4m, resulting in a net budget for 2017/18 of £7.4m.
- The Council has un-earmarked reserves of £1.1m (earmarked reserves of £3.7m) and an asset base of £19.5 million.
- Number of businesses = 2,300 (total RV £31 million); generating £10.7m in Business Rates, of which £1.59m is retained by West Devon (14 pence in the £1 is retained by the Council)
- The largest element of the Council's business rates base is 500 shops, banks and Post Offices which make up £8.2m RV (See Note 1 for a breakdown of the businesses in West Devon)
- The Council is part of a bid by all Devon Authorities to become a 100% business rate retention pilot for 2018/19 (which could generate a one-off amount of £0.5 million for the Council in additional business rates income).
- Work is also underway to complete other income generation activities, reduce discretionary services & spend and where possible, use reserves & new homes bonus to help meet the budget challenge.

- Existing efficiencies & work programmes have helped to generate £2.2m in recurrent annual savings (equivalent to a £109 saving in council tax)
- Despite these initiatives, for 2018/19, the Council still faces a budget gap of £0.17m, rising to £0.7m by 2020/21. Implicit within these forecasts is the proceeds of a commercial property acquisition strategy. £0.2m is forecast to be earned from this strategy in 2018/19 and increased income targets of up to £0.5m will be built into future years' budget projections.

**The financial challenge which the Council faces**
From 2018/19, the Council will receive no core Government funding (Revenue Support Grant) and the Council will need to be self-sufficient. The Council is facing a significant budget challenge, which the Council is planning to cover through a combination of generating income, ensuring maximum use of its assets, and further reduction in costs / non-statutory services.
To ensure that valued, local public services can continue to be delivered in the future, like many Councils, West Devon is looking at a range of solutions for addressing its budget gap, from outsourcing of services, establishing companies to deliver services and reducing grants and funding to third parties.

West Devon already has a strong history of making innovative decisions to drive efficiencies. Together with South Hams District Council, West Devon has (since 2007) achieved a 30% reduction in its workforce, with a shared delivery model – this model, alongside the shared working with South Hams, has saved the two Councils £6m per year (£2.2m for WDBC). As a result of sharing their workforce, the Councils are financially interdependent on each other; this means that if either Council were to fail to balance their budget, there would be a significant negative impact on the finances of the other Council.

**Commercial Property Acquisition**
One method to derive income is the implementation of a commercial property acquisition strategy. In July 2017, the Council adopted a commercial property acquisition strategy, with an initial tranche of £25m of borrowing approved. The strategy suggests a total acquisition budget of £75m. In December 2017, the Council resolved to increase this initial budget to £35m.

The strategy is predicated on acquiring commercial properties which are already let to strong covenants for a minimum unexpired lease length of 4 years, with lot sizes ranging upwards from £2m. Properties can be located anywhere within the UK. A diversified and balanced portfolio will be built, mixing asset classes, geographies and tenants according to market availability with a target to generate a net initial yield of 5.85%. As at December 2017, no properties have yet been acquired but the Council is actively pursuing this strategy.

The Council will undertake prudential borrowing to meet any gap in its Capital Financing Requirement generated as a result of these capital acquisitions. The Council's treasury management strategy allows for such borrowing to be taken over a maximum 50 year period and for Minimum Revenue Provision (MRP) to be made on an annuity basis.

Surpluses generated from this strategy will contribute to the financial sustainability of the Council, enabling it to continue to deliver and/or improve frontline services in line with the adopted strategy & objectives.

**Summary**
Government Local Authority funding policies appear at the moment to heavily favour those areas that have positive economic growth opportunities and are completely biased against rural and sparsely populated authorities such as West Devon.

If Government were to limit the ability of rural councils to acquire properties outside of their area and boundary, it would severely limit the ability of such authorities to meet their budget challenges and financial stability. The Council has limited opportunities to increase its income streams from business rates growth (the Council is at the baseline) or to increase its households and achieve more council tax income and new homes bonus funding.

Opportunities to invest locally in commercial opportunities are limited due to the rurality of the area. If restrictions are to be put in place over where assets can be acquired, the Council's strategy to diversify its assets in order to spread risk via a balanced portfolio would be unachievable.

There are few opportunities to build a balanced £75m property portfolio within West Devon due to the fact there are few large businesses located in the Borough and the population catchment is small when compared with more densely populated areas of the Country.
Subsequently, few high value retail, logistic, office and large manufacturing investment opportunities are located within the Borough.

Whilst the Council is keen to deliver its joint local plan and assist businesses with the provision of high quality accommodation, such initiatives are long in gestation and cannot return the level of surplus required in the same timescale as the adopted acquisition strategy.

If the Government were to restrict asset acquisitions to local authority areas, then we would want to see some allowance in our funding formulae to compensate for restricting our revenue generating opportunities OR dispensation allowed for rural authorities to continue to pursue well defined acquisition strategies which are implicit in those authorities achieving a balanced budget.

**Note 1**
A breakdown of the main areas of the Council's 2,300 businesses is below (Total RV £31 million):
500 – Shops, banks and Post Offices – Total RV £8.2 million
273 – Factories, Workshops – Total RV £2.7 million
257 – Offices – Total RV £1.6 million
252 – Warehouses – Total RV £3.3 million
240 – Hotels, Boarding Houses etc. - Total RV £3 million
54 – Schools and Colleges – Total RV £2 million

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