Report to Policy Committee

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Report of:	*Director of Finance and Commercial Services*
Report to:	*Finance Committee*
Date of Decision:	*23 January 2024*
Subject:	*Local Authority Capital Flexibilities Consultation*

Type of Equality Impact Assessment (EIA) undertaken	Initial		Full	
Insert EIA reference number and attach EIA				
Has appropriate consultation/engagement taken place?	Yes	X	No	
Has a Climate Impact Assessment (CIA) been undertaken?	Yes		No	X
Does the report contain confidential or exempt information?	Yes		No	X

If YES, give details as to whether the exemption applies to the full report / part of the report and/or appendices and complete below:-

*"The (**report/appendix**) is not for publication because it contains exempt information under Paragraph (**insert relevant paragraph number**) of Schedule 12A of the Local Government Act 1972 (as amended)."*

Purpose of Report:

This report provides a draft consultation response to the Department for Levelling Up, Housing and Communities (DLUHC) call for views on new local authority capital flexibilities.

Recommendations:

(i) That Committee approve the proposed response to the call for views on new local authority flexibilities for submission to DLUHC.

Background Papers:
None.

Lead Officer to complete:-		
1	I have consulted the relevant departments in respect of any relevant implications indicated on the Statutory and Council Policy Checklist, and comments have been incorporated / additional forms completed / EIA completed.	Finance: *Matthew Ardern and Phil Moorcroft*
		Legal: *David Holllis*
		Equalities & Consultation: *N/A*
		Climate: *N/A*
	Legal, financial/commercial and equalities implications must be included within the report and the name of the officer consulted must be included above.	
2	**SLB member who approved submission:**	*Philip Gregory*
3	**Committee Chair consulted:**	*Cllr Zahira Naz*
4	I confirm that all necessary approval has been obtained in respect of the implications indicated on the Statutory and Council Policy Checklist and that the report has been approved for submission to the Committee by the SLB member indicated at 2. In addition, any additional forms have been completed and signed off as required at 1.	
	Lead Officer Name: *Philip Gregory*	**Job Title:** *Director of Finance and Commercial Services*
	Date: *19 January 2024*	

1. PROPOSAL

1.1 The Department for Levelling Up, Housing and Communities (DLUHC) launched a call for views on proposed changes to capital finance flexibilities on 21 December 2023 with a closing date for responses of 31 January 2024.

1.2 The Council constitution reserves the following to Policy Committees:

Agreeing the Council's response to consultation by Government or other external agencies where this relates to proposed policy changes which the Chair of the Committee or of the Strategy and Resources Policy Committee consider to be significant.

1.3 The proposed changes to the existing capital finance flexibilities are considered to be significant and the draft consultation response is included in Appendix 1 to the report. The Council is not required to submit a response.

2. HOW DOES THIS DECISION CONTRIBUTE ?

2.1 The proposed changes to capital finance flexibilities would provide the Council greater flexibility on the use of capital receipts and funding for invest-to-save projects which could be incorporated into the Medium Term Financial Strategy of the Council if DLUHC take the proposals forward following consultation.

3. HAS THERE BEEN ANY CONSULTATION?

3.1 This is a technical consultation from DLUHC that does not require public consultation.

4. RISK ANALYSIS AND IMPLICATIONS OF THE DECISION

4.1 <u>Equality Implications</u>

4.1.1 It is the responsibility of DLUHC to ensure that the proposals take into account any equality implications as a result of changes to Government policy.

4.2 <u>Financial and Commercial Implications</u>

4.2.1 Any implication for the Council are included in the report and supporting Appendix.

4.3 <u>Legal Implications</u>

4.3.1 There are no specific legal implications arising from this consultation.

4.4 Climate Implications

4.4.1 There are no specific climate implications arising from this consultation.

5. ALTERNATIVE OPTIONS CONSIDERED

5.1 The Council is not required to submit a response to this consultation. An alternative option to the recommendation would be to not submit a response. The proposal from DLUHC includes significant changes to the capital financing regime that the Council operates within and this alternative option was rejected so that the views of the Council can be submitted to Government.

6. REASONS FOR RECOMMENDATIONS

6.1 The content of this consultation represents a significant change in Government policy and, in accordance with the Council Constitution, members are asked to approve the consultation response.

Call for views on new local authority capital flexibilities

Summary

The Government is inviting local authorities, sector representatives and other stakeholders to provide views on a set of options with respect to capital flexibilities and borrowing, to be managed locally, that could be used to encourage and enable local authorities to invest in ways that reduce the cost of service delivery and provide more local levers to manage financial resources. Our intention is to also invite other ideas to be put forward, to ensure we have adequately considered all viable options.

It is not the intent to replace the Exception Financial Support process: this process will remain and the Government will take action where there is local failure. The Government does, however, recognise where local authorities face cost pressures that are not a consequence of local failure, then further freedoms to use capital resources could allow local management of budget pressures, and facilitate investment that reduces future costs and supports continued sustainability over the long-term.

The options are set out in detail in this document. At high level these can be categorised as:

Supporting invest-to-save activity. Increasing the flexibilities to use capital receipts and borrowing to finance the costs of transformation and efficiency projects.

Local management of budget pressures. Providing greater flexibilities on the use of capital receipts, including the scope to meet general budget pressures, and potential additional flexibilities where the proceeds relate to the sale of investment properties.

The options are not intended to be mutually exclusive, and local authorities that use any new flexibilities provided by the Government will be expected to put in place plans to reduce costs and improve efficiency in a way that reduces future risk. The Government is considering these flexibilities as a means to help local authorities help themselves so local authorities must play their role in making this work effectively.

There is a clear balance between providing greater freedoms to use capital resources to alleviate local revenue pressures and incentivise efficiency, while avoiding creating unsustainable financial practices through misuse of flexibilities. The Government is mindful that any additional flexibilities must have safeguards that are proportionate and effective at preventing misuse, while still placing decision-making at local level. This document sets out a range of options to mitigate risk while still devolving decision-making locally and respondents are invited to provide views on these and put forward any other risk mitigation measures that may be appropriate.

The Government does not commit to any of the options set out in this document. To be taken forward, the measures must have material benefit to the sector; not significantly increase risk to the sector or public finances; and be consistent with the Best Value duty and the Prudential Framework. The evidence collected through this call for views will inform Government policy.

Background

Central to the local government finance system is the concept of capital expenditure. The term is defined in section 16(1) of the Local Government Act 2003 ("the 2003 Act") as expenditure of the authority which falls to be capitalised in accordance with proper practices. Normally, only capital expenditure may be funded out of capital resources or financed by borrowing, whereas revenue expenditure must be charged to the revenue account and forms part of the 'balanced budget' requirement, whereby council tax must be set each year to balance net expenditure plus or minus movements in reserves.

Under normal practices, local authorities cannot use capital resources or borrowing to finance revenue costs. The Government, however, can by regulations or directions allow local authorities to treat revenue costs as capital, allowing the costs to be met through the proceeds of asset sales (capital receipts) or through borrowing. Referred to as 'capitalisation', this mechanism is used by the Government as the principal means to support local authorities that require financial support. There is also a general direction, which has been in place since 2016, that allows local authorities to use certain capital receipts to fund the revenue costs of activity that reduces ongoing revenue costs or improves efficiency. This '*flexible use of capital receipts*' may be used by local authorities without approval from the Government and is intended to allow authorities to take forward transformation and cost-saving projects that are otherwise unaffordable.

It is not generally considered prudent or sustainable for local authorities to rely on capital or borrowing for revenue costs. This is because capital receipts are one-off and unpredictable, while borrowing creates a liability. However, there are circumstances where using capital or borrowing to meet revenue pressures is necessary and appropriate and the ability to use capital resources and borrowing for revenue costs is a powerful additional flexibility. It can be used to address financial pressures or remove affordability barriers to projects that may increase costs in the short-term but lead to savings overall.

Capital flexibilities are used to support investment that produces ongoing revenue savings. Local authorities have considerable flexibility in being able to finance capital expenditure using borrowing. This includes any investment needed for projects that improve efficiency of service delivery, reduce costs, or increase income. Generally, the bigger constraint is the associated revenue costs, due to the statutory requirement to set a balanced budget each year. Where revenue budgets are constrained, it may not be affordable for authorities to proceed with projects where the return on investment is not seen for a number of years. The *flexible use of capital receipts* offers the means to use capital receipts to support projects that produce ongoing revenue savings, but has limitations.

Capitalisation is the most common form of support offered by the Government to local authorities. The *Exceptional Financial Support* (EFS) framework can use capitalisation directions to allow authorities to address revenue pressures. It is not limited to capital receipts but can also be applied to capital from borrowing, and may be used for costs other than invest-to-save. As such, the EFS process is rigorous and generally requires an external review of the council, and may have conditions such as increased interest rates on any borrowing for capitalisation purposes. Given that it is a departure from normal accounting practice, we generally take the view that capitalisation is only appropriate as a means to address time-limited or one-off costs rather than ongoing pressures.

Purpose of engagement

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; and,
- 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.

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

This option 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.

With this option, the capitalised costs are not necessarily related to invest-to-save measures but represent a broader agreement to allow a local authority to deal with immediate pressures on the condition that it will take forward cost reduction and efficiency plans to bring itself back into sustainability. This will support authorities with immediate financial pressures and provide a period in which the authority can put in place measures to reduce costs. It also has the longer-term effect of promoting efficiency. It also provides an additional route other than EFS, which is currently the only way for local authorities to seek permission to capitalise any non-transformation costs.

This option could be constrained to only allow capitalisation of specific types of expenditure – for example, common areas of spend that contribute to financial pressures.

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

This option has the potential to meet the objectives set out above provided the capital receipts are generated in a planned way with careful consideration of the needs of the local authority and the population that they serve. We agree that any proposals should be consistent with the best value duty and the prudential framework.

There is a risk that this proposal diminishes the delivery of best value and the statutory requirement, as set out in Local Government Act 2003, to consider the affordability of capital investments in all the years in which it will have a financial impact. Paragraph 70 of the Prudential Code states:

"In considering the affordability of its capital plans, the authority is required to consider its forecast financial position, including all of the resources currently available to it and estimated for the future, together with the totality of its capital, borrowing and investment plans, income and expenditure forecasts and risks."

Local authorities have a capital strategy which has been approved by full council and which sets out their approach to asset management and the delivery of capital receipts. CIPFA guidance on the implementation of the Prudential Code states the following:

"Prudence is more than simply a narrow financial concept. It requires an authority to ensure that its capital investment decisions can deliver the authority's asset management and community strategy. Prudence is also closely associated with sustainability and for that reason its consideration demands medium-to-long-term strategic planning. The capital strategy and asset management planning between them set out the requirements for capital investment by the authority."

However, there are significant risks that an authority finding themself in financial distress will resort to the sale of assets to generate capital receipts at pace without the usual due consideration in order to manage general cost pressures. This could result in a fire sale of assets in a particular area. This could be damaging for the local economy andmost certainly won't deliver value for money for the local taxpayer. This would also be in contravention of paragraph 20 of the Prudential Code, which states:

"In order to demonstrate that the authority takes capital expenditure and investment decisions in line with service objectives and properly takes account of stewardship, value for money, prudence, sustainability and affordability, authorities should have in place a capital strategy that sets out the long-term context in which capital expenditure and investment decisions are made and gives due consideration to both risk and reward and impact on the achievement of priority outcomes. The capital strategy should form a part of the authority's integrated revenue, capital and Balance Sheet planning."

In addition, the Royal Institute of Chartered Surveyors' (RICS) Public Sector Asset Management Guidelines (2012) includes the following paragraph highlighting the importance of asset management as a strategic activity, not one in response to a sort term financial risk:

"Strategic asset management is the activity that seeks to align the asset base with the organisation's corporate goals and objectives. It ensures that the land and buildings asset base of an organisation is optimally structured in the best corporate interest of the organisation concerned."

The government must recognise that many authorities who find themselves in financial distress and who may choose to use the flexibility afforded by this proposal, do so as a direct consequence of policy decisions taken by this government. In many cases local authorities find themselves under financial pressure due to the cost of delivery far exceeding inflation and any growth in funding. It seems this is a short term measure designed to alleviate financial pressure as a result of funding shortfalls over a number of years. In particular, reforms to social care provision and associated funding have been consistently delayed with the result that an increasing proportion of local authority expenditure is directed to social care at the expense of other vital services.

5. If you are a local authority, would you use the flexibility in the foreseeable future if available?

Only as part of a planned asset disposal strategy where the capital receipts have been included in the Medium Term Financial Strategy as a source of non-recurrent funding.

Please provide any further detail

Sheffield City Council will consider the use of this additional flexibility as part of our Medium Term Financial Strategy. We do not expect this flexibility to result in an increased pace or scale of asset disposal but this may offer an alternative to using reserves to fund one-off cost pressures.

6. If you are a local authority and you think you would use the flexibility, please provide an approximate value of capital receipts you would potentially use in 2024/25 (£'m).

£3.5m

Please provide any further narrative on use of capital receipts for 2024/25

Sheffield City Council will publish its plans for capital receipts within the capital strategy presented to full council in March 2024. Within this is an estimated amount of capital receipts totalling £3.5m which are not currently forecast to fund invest-to-save projects under the existing flexibility.

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

Provide further detail on whether the flexibility should be constrained

The existing prudential system is based on principles rather than prescription. Local authorities should retain the autonomy to determine the constraints for this flexibility based upon their local circumstances. The responsibility for operating within the current system is placed upon the professional judgement of council officers and practitioners and this principle should remain. Cost pressures will arise in different localities in various ways and constraining the application of this flexibility to particular areas or types of expenditure may limit the usefulness of the flexibility across the sector.

8. In your view, are there any risks or unintended consequences that the Government should consider?

As described above, the main risk arising from this proposal is that local authorities in financial distress may dispose of assets to fund cost pressures through a process that is ill-considered and does not deliver Best Value for the local taxpayer.

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).

This would have the benefit of allowing authorities that do not have access to capital receipts to also progress eligible projects where they otherwise may not be able to afford to do so. We are mindful, however, that borrowing comes with additional costs in the form of interest costs and Minimum Revenue Provision, which may mean that some authorities are still not able to take forward projects if borrowing is unaffordable.

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

This proposal would provide greater flexibility to fund invest-to-save activity in order to release savings within a defined payback period. It would be an additional tool to use when considering the approach to funding within the Medium Term Financial Strategy. However, financial planning must take into account the future revenue cost associated with additional borrowing in comparison to other needs for revenue expenditure.

The payback period for invest-to-save projects funded from borrowing would be a key consideration and would need to be matched to the borrowing period as far as possible to ensure that the future revenue implications are not put off into the future or defrayed over an extended period of time.

10. If you are a local authority, do you have projects ready to take forward that this flexibility would support/enable? If yes, please provide detail on the number, type and cost of the projects.

Transformation plans are being scoped now for implementation in Q3/4 of 2024/25 and 2025/26.

11. If you are a local authority and you think you would use the flexibility if available, please provide an approximate value of borrowing you would use in 2024/25 (£'m).

£0m

Please provide further detail

The Council has already included revenue funding for transformational invest-to-save projects within the budget for 2024/25. The Council anticipates this funding will be sufficient for 2024/25. The Council may consider using the flexibility in 2025/26 subject to financial planning and updates to the Council's Medium Term Financial Strategy.

12. In your view, are there any risks or unintended consequences the Government should consider?

There is a degree of uncertainty and risk that an invest-to-save project will fail to realise the financial benefits set out in the approved business case. Where projects are funded through capital receipts the risk to the local authority is relatively low as the ongoing financial costs from the use of capital receipts are limited to the opportunity cost of an alternative use of the capital receipt rather than an ongoing revenue cost, which would be the case if the project were funded through borrowing. There is an increased risk that a project that fails to deliver the anticipated financial saving results in an additional cost pressure from the cost of borrowing.

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

The sector has an estimated £23.2bn in value of investment properties (as at 31 March 2021). This figure is taken from the Whole of Government Accounts (WGA) data and values may have changed subsequently, however, it is undoubtedly the case that the sector holds a significant amount of value in investment properties. Investment properties in this case refers to property held under accounting standard "IAS 40" – any properties classified as an 'investment property' under this standard can only be held for rental income or capital appreciation.

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).

The intent is to encourage divestment of assets held only for revenue and not for the delivering the objectives of the local authority, and providing additional incentives to recognise that local authorities selling such assets will likely be foregoing future revenue income.

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

Investment assets provide income for local authorities often where they have invested to mitigate the reductions in funding from government over a sustained period of time. Had local government not been subjected to such reductions in funding from government the quantum of investment assets across the sector would be lower. As described in the responses to option 1, asset disposal must be carefully considered within the asset management strategy and must provide Best Value for the local taxpayer.

Should a local authority in financial distress dispose of an investment asset for less than the book value or purchase price, they are likely to face criticism from the public and reputational damage as this would represent poor value for money. Investment assets are predominantly held as long term investments and are relatively illiquid. However, provided the asset disposal is properly considered and good value for money can be demonstrated, this is an option that may be useful to some authorities.

14. If you are a local authority, do you have investment properties (as per the IAS 40 definition)?

Yes, advertising hoardings.

15. Please provide the latest valuation (£'m) and specify the date of the valuation.

£18.630m valued as at 31 March 2023

16. Please provide the total forecast net return for your IAS 40 properties 2024/25 (£'m).

£1.111m

17. If you are a local authority would this option provide incentive to divest of some or all of your investments assets?

No

18. Are there alternative or additional incentives that, in your view, would be effective?

No.

19. In your view, are there any risks or unintended consequences the Government should consider?

As described above, the main risk arising from this proposal is that local authorities in financial distress may dispose of assets to fund cost pressures through a process that is ill-considered and does not deliver Best Value for the local taxpayer.

Discounted PWLB interest rate

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.

20. If you are a local authority, if this discount rate were offered, would you use it in 2024/25?

No.

21. If yes, please indicate approximately how much your authority would seek to borrow (£'m).

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

It may enable some invest-to-save projects with marginal financial viability to become financially viable and could make this source of funding more appealing. It is unlikely to have a significant impact on the overall scale of projects delivered but any additional incentive would be welcome.

23. Please provide details. Examples and case studies are particularly useful, but all views are welcome.

Risks and mitigations

The Government is mindful that introducing any further flexibility on the use of capital resources and borrowing inherently increases risk. The key concerns are that authorities could use capital receipts or borrowing to meeting their revenue costs under one of these flexibilities in a way that is ineffective, increases risk or defers it to the future or masks indicators of financial failure against a council's relevant statutory duties. These risks may arise from local authorities applying the flexibilities incorrectly, such as using capital receipts for ineligible costs or using the flexibilities for projects which ultimately do not produce any long-term savings.

The Government is not proposing a centrally managed system whereby authorities have to apply. The premise of these flexibilities is to enable local actions to take action locally and build in enduring improvements to efficiency. It is therefore important that any risk associated with additional flexibilities must be mitigated to an acceptable level commensurate to the benefits to the sector and achieving the Government's objectives while being consistent with local control and local accountability.

Proposed controls to mitigate risks

The following are a list of additional controls that are intended to reduce risk to an acceptable level without the need for a centrally controlled process. These options are not mutually exclusive and can be taken in any combination or in total. The proposal at this time is that, subject to refining the details further through sector engagement, all of these would be introduced and any authority seeking to use the flexibilities would be required to comply.

1. **Full transparency.** A condition that 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 – not for approval, but 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. The premise is that the flexibilities are used 'in plain sight'.
2. **Mandate a payback period.** Efficiency/invest-to-save plans must have a payback period of no more than a fixed number of years e.g. 10 years. This should include the capitalised cost of revenue as part of the investment.
3. **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.
4. **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.
5. **Assurance engagement.** The Government can commission an independent review of the use of the flexibilities at its discretion.

24. 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.

The transparency, payback period and assurance controls proposed seem an acceptable way to balance the risks described in the responses above.

Care should be exercised to ensure that any independent review is not burdensome and costly for local authorities to comply with. It would be helpful for the Government to provide examples of organisations that could perform an independent review and an assessment of their capacity to perform these reviews.

Local authorities who wish to use the flexibilities in options 1 and 3 should be free to determine how these are applied in their particular circumstances. As previously stated, cost pressures may be exhibited in local authorities in different ways and restricting the proposed flexibilities to prescribed types of expenditure may limit the usefulness of the flexibility.

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

The Government should engage with CIPFA as the standard setter for Local Government and ensure that the proposed flexibilities are consistent with the Prudential Code. The Government must also ensure that the approach taken by external auditors has been fully considered in consultation with CIPFA, the NAO and the FRC.