Appendix 3

Capital Financing Policy

1 Purpose

Currently, the Council is financing the majority of its capital programme from capital receipts, but these will be fully allocated within the next year. Consideration needs to be given as to what level of capital expenditure can be afforded in future years, how it is to be financed and the revenue implications.

2 Background

The transfer of the Councils housing stock in 2001 generated a considerable capital receipt. This was used to repay all of the Councils debt and provide the financing for the capital programme since that time. The prudential borrowing regime was introduced in 2004 and this allows authorities to set their own limit on borrowing for capital purposes, provided that it is affordable, sustainable and prudent. The government also gives grants towards capital expenditure, which can be either for specific purposes e.g. disabled facilities, or generally to support capital expenditure. Expenditure can be financed from revenue meeting the full cost in the year in which the expenditure takes place. The Council currently finances the purchase of vehicles from a renewal reserve and makes contributions to the reserve from revenue over the life of the vehicle. Assets have also been acquired through leasing, but this would now be included in the prudential borrowing regime and the asset may also need to be included on the balance sheet.

Prior to April 1990 most authorities financed their capital programme by borrowing. The borrowing cost charged to service accounts reflected the life of the asset or the notional benefit of the grant.

3 Key Issues

An analysis of the bids for future years' capital programmes shows that the proposed level of expenditure can be ranked as follows:

- Grants
- Short life assets such as vehicles and computers
- Refurbishment of existing assets
- Provision/development of assets

This shows that although the Council is spending a significant amount it is adding very little to its long-term asset base. It will become increasingly difficult to charge refurbishment costs to capital unless it can be established that they will significantly increase the use, life or value of an asset or make good a dilapidation that has previously been recognised in the authority's accounts.

The Government has expressed the wish to move towards generally accepted accounting practice, including charging the full cost of depreciation to revenue. However the latest indications are that this is unlikely to be before 2011/12. The current accounting arrangements are that depreciation is charged to service accounts but is neutralised by a corresponding credit in the summary accounts and replaced with the minimum revenue payment (MRP). Interest paid is also a revenue charge.

Where the capital expenditure is on a grant for a non-council owned asset then the amount is written off to the service account as a ‘deferred charge’. This is neutralised by the financing being written off to the summary accounts. For 2006/07 the service depreciation is estimated at £1.5m and deferred charges are £2.8m.

When financing from capital receipts the cost to revenue is the loss of interest that is earned as the amount of capital receipts invested reduces. With borrowing the cost is the interest paid together with the principal element of the loan. The law requires that each year councils must provide MRP of 4% of the amount that they have borrowed. If the Council borrows £1m each year then

	Amount Outstanding	4% MRP	Interest @ 5%	Revenue cost
	£	£	£	£
After 5 years	4.616m	0.185m	0.256m	0.441m
After 10 years	8.379m	0.335m	0.444m	0.779m
After 15 years	11.448m	0.458m	0.572m	1.030m

Based on West Wiltshire’s passed capital spending, the amount outstanding at the end of 15 years is likely to be well in excess of the increase in the value of assets.

The council could increase MRP; a figure of 10% would give

	Amount Outstanding	10% MRP	Interest @ 5%	Total cost
	£	£	£	£
After 5 years	4.095m	0.409m	0.230m	0.639m
After 10 years	6.513m	0.651m	0.361m	1.002m
After 15 years	7.941m	0.794m	0.397m	1.191m

With short-life assets, such as computers, using borrowing will mean that they will be obsolete before much of the loan is repaid. Therefore future taxpayers will be paying for an asset that they are no longer benefiting from and they could also be paying for its replacement.

4 Options

1) The simplest method is to borrow for all capital expenditure that is not financed by grants, contributions or capital receipts. The MRP is set at

4%. This will give the lowest revenue cost but will create debt to be repaid by future taxpayers that may not benefit from the original expenditure.

Increasing MRP will increase the revenue cost but will reduce the amount being paid by future taxpayers. Recent circulars from the Department for Communities and Local Government suggest that authorities consider repayments above the minimum if that is a more prudent approach.

MRP could be set as a fixed amount or series of fixed amounts by dividing the amount borrowed by the useful life or period of benefit. This is likely to increase revenue costs but will ensure that taxpayers are paying for the benefit that they enjoy. This would be similar to depreciation but would also cover items where there is no asset on the balance sheet.

2) A mixed approach to financing using revenue, reserves and borrowing could be employed. The capital expenditure limit, currently £10,000, could be raised causing more to be met from revenue. Items that are acquired every year, such as p.c.s, could be financed from revenue; this will also reduce some of the asset monitoring and record keeping. With the outsourcing of the grounds and street cleansing functions the call on the vehicle replacement reserve will be reduced. The reserve could also be used to finance the purchase of p.c.s and other equipment and the depreciation charged would replenish the reserve. This would leave the larger cost/longer life items to be met by borrowing.

3) An alternative approach is to determine what affordable level of revenue is available to support capital expenditure and to set a programme where the revenue consequences are within that limit. A prudent approach to these costs needs to be maintained.

4) An extension to this approach is to calculate the annual revenue cost of each capital bid. This would allow both revenue and capital bids to be considered at the same time and the available revenue resources can be allocated to the highest priority bids, irrespective of whether they are capital or revenue. There is a complication in that the prudential code requires three-year capital programmes to allow prudent borrowing to be demonstrated and undertaken. It is unlikely that revenue budgets will be determined three years in advance therefore some reasonable estimate of minimum future capital expenditure will need to be made.

5 Way Forward

The suggested financing policy is

- Council has yet to borrow under the Prudential Code therefore it may be beneficial to continue with a separate capital programme so that the potential commitment to borrowing is clearly indicated.
- The vehicle replacement reserve should be used to finance computer and other equipment with depreciation charged over the useful life of the item.
- MRP should be set for each scheme so that the borrowing is repaid at the end of the asset's life.
- MRP for grants made should be set so that the borrowing is repaid at the lesser of either the end of the life of the asset for which the grant was given or 20 years.

The policy will be included in the Capital Strategy for 2007/08.