Review of Minimum Revenue Provision (MRP)

Purpose of this Paper

1. This paper is to appraise the Audit Committee of the outcomes of a review into the Council's Minimum Revenue Provision (MRP) policy and the resultant approach to MRP that will be recommended to Council for approval.

Minimum Revenue Provision (MRP) – Key Terms

2. The table below explains some of the key terms used throughout this report.

Term	Explanation
Capital Financing Requirement (CFR)	• The Capital Financing Requirement (CFR) is the underlying need to borrow money. • If the Council incurs capital expenditure without an immediate resource to pay for it (e.g. a grant or a capital receipt), it results in the need to borrow money. • It may not be necessary to take additional borrowing immediately, but the Council's underlying need to borrow, (its CFR), will increase.
Minimum Revenue Provision (MRP)	• In order to reduce the CFR, the Council has a statutory duty to make a "prudent provision" for the repayment of debt. • This takes the form of a charge to the revenue account, called the Minimum Revenue Provision (MRP.) • The MRP spreads the costs of borrowing, and helps to ensure that the Council is able to service the debt associated with the current and historic capital programmes.
Supported Borrowing	• Supported borrowing refers to borrowing costs that are supported by a funding allocation from Welsh Government (WG) within the Revenue Support Grant (RSG).
Unsupported Borrowing	• Unsupported borrowing (or prudential borrowing) is borrowing that is not supported by Government Grant. The Council must therefore determine that it can meet the borrowing costs itself from existing revenue resources or from savings (e.g. on an invest-to-save basis.)

Regulatory Background in respect of MRP

3. There is a duty on Local Authorities to make an annual charge for MRP. Previously, regulations prescribed how much an authority should charge as MRP, based on a formula linked to the CFR. However, the system was changed significantly in 2008 by the Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2008. These regulations, along with supplementary WG guidance, are intended to offer authorities much more local discretion in deciding the basis of their annual MRP. They replace the previous prescriptive MRP calculation with a requirement for local authorities to make a 'prudent provision' for the repayment of debt.

What is a Prudent Provision for MRP?

4. Regulations do not specifically define what constitutes a 'prudent provision.' The responsibility for determining what is 'prudent' is a matter for individual authorities on the advice of the Council's Section 151 Officer.

5. Guidance suggests that the broad aim of a 'prudent provision' is to ensure that debt is repaid over a period reasonably commensurate with the period over which the associated capital expenditure will benefit service delivery, or in the case of supported borrowing, over a period that is reasonably commensurate with the period implicit in the determination of the RSG.

6. WG guidance provides four examples to illustrate what may constitute prudent provision and these are set out at Annex A. Whilst Local Authorities must always have regard to this guidance, alternative approaches are permissible, should a local authority determine that they are more appropriate to the local context.

Cardiff Council's Approach to MRP

7. The Council regularly reviews its MRP policy. A high-level overview of the approaches used over the years are summarised in the table below:

Period	Supported Borrowing	Unsupported Borrowing
2004/05 – 2012/13	Straight line over 25 years	Straight line basis over 25 years / asset life if shorter
2013/14 – 2016/17	4.5% reducing balance basis	Straight line basis over 15 years for balances at that date and based on asset life going forward
2017/18 - current	4% reducing balance basis	Straight line basis / annuity based on asset life or life identified in financial modelling.

8. The Council's current policy with regards unsupported borrowing is linked to asset life. This approach is still considered appropriate and it is proposed that it remains unchanged.

9. The current approach with regards supported borrowing was previously linked to government support for debt repayment. However, it is considered that the system of local government finance has evolved considerably in recent years, to the extent that it is now difficult to relate back to the element of RSG for debt repayment. Previous links between government support for debt repayment and the annual MRP charge have been further eroded due to the reduction in overall Council funds over the last decade. It is therefore considered timely to review this aspect of the policy.

The Approach of Other Local Authorities to MRP

10. For benchmarking and comparative purposes, the following table summarises the MRP policies of other Welsh Local Authorities with regards supported borrowing.

MRP Policy for Supported Borrowing	No of Welsh LAs
50 years (2%) Straight Line	9
45 Years (2.22%) Straight Line	2
40 Years (2.5%) Straight Line	6
50 years annuity	1
49 years annuity	1
3% reducing balance	1
4% reducing balance (including Cardiff)	2

11. Care should be taken in benchmarking information of this nature because, as already set out, what constitutes prudent provision must be determined with particular reference to local circumstances.

MRP Review January 2020 – an overview

12. The Council last changed its MRP policy in 2017/18, following a detailed option appraisal. Whilst annual consideration is given to the setting of an appropriate policy, three years on from the last detailed appraisal, it was considered timely to conduct another in depth option appraisal in respect of potential policies. The intention to conduct an MRP review during 2019/20 was noted in the 2019/20 Budget Report.

13. The Council approached its Treasury Advisors, Link Asset Services, to conduct an independent review of the Council's MRP policy with a focus on supported borrowing. They were requested to consider alternative options that may also meet the definition of a prudent provision. The alternative options considered included:

    - A straight line approach (including 30yr, 40yr, 45yr, 50yr)
    - An annuity approach (including 30yr, 40yr, 45yr, 50yr)

MRP Review January 2020 – summary of detailed findings

14. The following table summarises the findings of Link Asset Services, comparing potential straight-line approaches to the current 4% reducing balance method. The table shows the difference in the charges to revenue that would be made if the MRP policy were to be changed to each of the listed approaches. In order to take account of the time value of money, the NPV of each option using a discount rate of 3.5% is also shown.

	Potential Straight Line Approaches			
	50yr SL	**45yr SL**	**40yr SL**	**30 yr SL**
Year	**£000**	**£000**	**£000**	**£000**
2019/20	(5,316)	(4,725)	(3,987)	(1,772)
Years 2-5	(15,836)	(13,666)	(10,954)	(2,819)
Years 6-10	(10,660)	(8,336)	(5,430)	3,284
Years 11-25	(1,853)	3,139	9,378	28,096
Years 26-40	11,679	14,659	18,383	2,385
Years 41-60	5,926	1,340	(5,632)	(5,632)
Year 60 onwards*	(1,608)	(1,608)	(1,608)	(1,608)
Total NPV @ 3.5%	**(17,667)**	**(9,198)**	**150**	**21,935**

- *Years 60 onwards relate to the comparison with the 4% reducing balance method. This approach will take in excess of 300 years to fully provide for the debt.*

15. The following table summarises the findings of Link Asset Services comparing potential annuity approaches to the current 4% reducing balance method.

	Potential Annuity Approaches			
	50yr Annuity	**45yr Annuity**	**40yr Annuity**	**30 yr Annuity**
Year	**£000**	**£000**	**£000**	**£000**
2019/20	(7,975)	(7,462)	(6,797)	(4,510)
Years 2-5	(24,967)	(22,951)	(20,237)	(11,500)
Years 6-10	(19,088)	(16,652)	(13,406)	(3,110)
Years 11-25	(12,457)	(5,685)	3,158	30,262
Years 26-40	14,927	20,964	28,604	7,989
Years 41-60	12,308	5,399	(5,632)	(5,632)
Year 60 onwards*	(1,608)	(1,608)	(1,608)	(1,608)
Total NPV @ 3.5%	**(38,861)**	**(27,995)**	**(15,889)**	**11,891**

- *Years 60 onwards relate to the comparison with the 4% reducing balance method. This approach will take in excess of 300 years to fully provide for the debt.*

16. Purely in financial terms, and focussing on the NPV analysis as an overall means of comparison, the above tables suggests that the various options range from a £38.861 million saving to revenue over the medium term (under the 50 yr annuity approach) to an additional cost of £21.935 million over the medium term (under the 30 year straight line method.)

17. The next section sets out the wider considerations that need to be considered in assessing which of the above, (or indeed the current policy), is on balance, the most appropriate approach to MRP for 2020/21 onwards.

MRP Review January 2020 - Wider Assessment of Potential Approaches including impact on Future Generations

18. A key factor in evaluating a potential MRP policy is its impact on Future Generations. The Wellbeing of Future Generational (Wales) Act 2015 requires authorities to ensure that decisions are sustainable whereby the needs of the present are met without compromising the ability of the future generations to meet their own needs."

19. The following table considers the implications for MRP payments, from a future generations' perspective of each of the three over-arching methods.

Method	Summary of Approach and the consequent MRP Provision in future
Reducing Balance	• A reducing balance methodology for MRP front-loads provision • A downside of a reducing balance methodology is that it will take hundreds of years to fully provide for the debt.
Straight Line	• A straight-line methodology has a fixed end-point at which point debt will have been fully provided for (e.g. 50 years, 45 years, 40 years or 30 years under the considered scenarios.) • The debt burden is fully relieved over a much shorter period compared to a reducing balance basis.
Annuity	• An annuity basis takes into account the time value of money – i.e. that paying £100 in 10 years' time is less of a burden than paying it now • Like the straight-line method, an annuity method also has the advantage of having a fixed end-point at which point debt will have been fully provided for (e.g. 50 years, 45 years, 40 years or 30 years under the considered scenarios.) • A downside of this approach from a future generations' perspective is that because it adjusts for the time value of money, it weights MRP payments to future generations.

20. In view of the above, a straight-line approach is considered to strike the most appropriate balance between current and future generations' perspective. Spreading debt repayments more evenly over the generations that will benefit from the associated assets, has the effect of reducing debt provision requirements in the short to medium term. This has the advantage of providing an opportunity to put the Council in a stronger position financial position for the future, by establishing a Treasury Management Reserve to mitigate key current and future risks (described in more detail in paragraph 27.)

The Proposed Approach

21. It is proposed that it is more prudent for outstanding debt to be written down through MRP over a fixed period of 45 years, in preference to the current 4% reducing balance basis.

22. As set out in the previous section, the attraction of a straight-line methodology is that both current and future generations who make use of assets, will pay an equal and consistent amount of MRP and there is a defined point at which debt will be fully provided. The Authority's asset life is considered to be between 40 and 45 years. As such, 45 years, is considered the most appropriate of the straight-line options considered.

23. The table below outlines the impact the proposed approach would have on charges to the revenue account in the current and next five financial years:

	£000
2019/20	(4,725)
2020/21	(4,300)
2021/22	(3,892)
2022/23	(3,500)
2023/24	(3,124)
2024/25	(2,762)

24. Other approaches, (including an annuity approach or a 50-year straight-line approach) would result in increased revenue savings for the Authority. However, whilst the potential for revenue savings is a factor in decision-making, it is not the impetus of this review. In fact, it is proposed that the reduction in revenue charges outlined above are ***not*** taken as a revenue budget saving.

25. Instead, it is proposed that the revenue budget made available by changing the MRP policy is used to strengthen the Local Authority's financial resilience in respect of capital and treasury, through the development of a Treasury Management Reserve. This approach will provide the Authority with greater capacity and flexibility in a number of respects. In particular it should:

- Assist with the management of risk in relation to major projects. This would include providing flexibility to help smooth costs and to meet costs of a one off nature such as feasibility costs.
- Assist with the management of risk in relation to the wider capital programme, including for example the timing and quantum of anticipated capital receipts.
- Improve financial resilience by creating a specific reserve for treasury and capital risk. Cardiff's reserves are currently one of the lowest in Wales.
- Assist in mitigating any future adverse changes to interest rates, as well as providing an element of flexibility as to the timing of borrowing.
- Assist with asset management planning and asset maintenance strategies.
- Assist in managing any timing issues associated with Invest to Save Schemes
- Act as a mitigation for any potential future changes in WG policy re: supported borrowing within the RSG.

Summary

26. It is proposed that there is a change in approach to MRP policy from a 4% reducing balance basis to a 45-year straight-line basis. The revised MRP policy recommended for Council to approve is include in the Draft Treasury Management Strategy for 2020/21. It is also proposed that this policy will apply from the 2019/20 financial year.