REGULATORY APPRAISAL

THE LOCAL AUTHORITIES (CAPITAL FINANCE AND ACCOUNTING) (WALES) (AMENDMENT) REGULATIONS 2004

1. Purpose and Intended effect of the measure

The Local Government Act 2003 contains the primary legislation which gives effect to the first major change to local authority capital finance and accounting in over 10 years. The relevant Sections are contained in Part 1 of the Act that will replace Part IV of the Local Government and Housing Act 1989 (LGHA 1989).

The new primary legislation will provide local authorities with the freedom and responsibility to set their own affordable borrowing limits. This is in contrast to the current system whereby the amount a local authority can borrow is determined by the National Assembly for Wales through the system of credit approvals set out in the 1989 Act.

This policy change was initially consulted upon by the Welsh Assembly Government in ‘Simplifying the System’ (September 2000) on the basis that the current system blurs accountability, limits local financial freedom and has become an obstacle to securing effective capital investment. Following this consultation, in ‘Freedom and Responsibility in Local Government’ (March 2002) the clear intention was expressed to introduce primary legislation to give effect to a new system of local authority capital finance based on the premise of affordable borrowing limits. This system has come to be known as the ‘Prudential Borrowing System’.

The Welsh Assembly Government has stated that the following aims could be considered appropriate for a system of local authority capital finance at this time:

- The system should ensure that an authority cannot enter into financing arrangements to support capital investment which it cannot afford in the long term.
- There should be local freedom for an authority to determine what it can afford to borrow, whether this is ‘supported’ or ‘unsupported’.
- The system should be consistent with the local authority’s role in community leadership by providing scope for local decision making which is integrated with all levels of strategic planning across Wales.
- Any ‘artificial’ distinction, for budget planning purposes, between capital and revenue resources should be eliminated. For example, when authorities are preparing asset management plans and taking a view on how to tackle capital investment.
- The system should encourage local authorities to manage their capital resources effectively (i.e. local authority managers should not perceive capital assets as a ‘free good’) and provide adequate financial support.
- The system should ensure that public and private finance are considered on a level playing field.

- The system must support and be seen in the context of a move to longer term financial planning by local authorities and the Welsh Assembly Government.
- The system should not be overly complex and be in keeping with the broad aim of cutting red tape for local authorities
- The system should, wherever practicable, rely on ‘proper accounting practice’
- Wherever possible the system should support the introduction of the ‘Whole of Government of Wales Accounts’ (WOGOWA).

Local government finance forms part of the wider public finances and must operate within public expenditure targets and the fiscal rules i.e. that borrowing will be for investment and not to fund current spending; and that public debt as a proportion of national income will be held at a prudent level. Therefore, linkages between the local authority capital system and the operation of the UK public expenditure process, as it affects Wales, must also be considered.

Therefore, the ‘prudential system’ must be looked at:

a. holistically in the sense of how these component parts link and interact and;
b. in terms of each of its component parts:

- the legislative framework as set out in the Local Government Act 2003, including the requirement to set and monitor affordable borrowing limits;
- the supporting secondary legislation which ‘fleshes out’ the broad intentions laid out in the primary legislation
- the CIPFA ‘Prudential Code for Capital Finance in Local Authorities’;
- other professional codes of practice and statements such as those on treasury management, reserves and balances and the role of the finance director in local authorities;
- the ‘balanced budget requirement’;
- asset management plans;
- medium and longer-term financial strategies based on the most effective management of revenue and capital resources;
- the form of Assembly financial support to local authorities for capital investment.

It must be recognised that no single component will achieve all of the objectives set out above, but taken as a whole, the system should be capable of achieving the objectives.

Therefore, to achieve these aims the intention is that the primary legislation should set the broad framework of the system, supported by secondary legislation, but that the detail of the system should be contained in professional codes of practice compliance with which would form part of the audit process within local authorities.

The primary legislation therefore contains the following Sections (those with regulation making powers for the Assembly are marked with a *):

Part 1- Local Government Act 2003

Section 1- Power to borrow
Section 2- Control of borrowing*
Section 3 - Duty to determine an affordable borrowing limit*
Section 4 - Imposition of borrowing limits*
Section 5 - Temporary Borrowing
Section 6 - Protection of lenders
Section 7- "Credit arrangements"*
Section 8 - Control of credit arrangements*
Section 9 - "Capital Receipt"*
Section 10 - Non-monetary receipts*
Section 11- Use of capital receipts*
Section 12 - Power to invest
Section 13- Security for money borrowed etc.*
Section 14 - Information
Section 15 - Guidance*
Section 16 - "Capital expenditure"*
Section 17 - External Funds
Section 18 - Local authority companies etc.*
Section 19 - Applications to parish and community councils
Section 20 - Directions
Section 21- Accounting practices*
Section 22 - "Revenue Account"
Section 23 - "Local authority"*
Section 24 - Wales
Schedule 1 - Capital finance: parish and community councils and charter trustees*

To support the primary legislation and operationalise the prudential borrowing system in Wales secondary legislation has been issued The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 (SI No. 3239 (W.319)) providing for the following:

- A requirement to charge a minimum revenue provision to local authority revenue accounts i.e. the consolidated general fund revenue account and the Housing revenue Account (Provision made under Section 21)
- A formula and details for the charging of a commutation adjustment against the minimum revenue provision (Provision made under Section 21)
- A requirement to comply with particular codes of practice (Provision made under Sections 3 and 15)
- Specification of professional codes which constitute proper accounting practice and clarification of items not to be charged to local authority revenue accounts (Section 21)

- Specification that certain amounts should be regarded as capital receipts (Section 9)
- A requirement for cash pooling of the housing capital receipts in respect of Housing Revenue Account (HRA) debt free authorities (Section 11)
- A requirement that capital receipts generated from the sale of Housing Revenue Account assets are retained to either repay HRA debt or purchase further HRA assets (Section 11)
- Clarification of items which are not to be considered as credit arrangements for the purposes of the prudential system (Section 7)
- Application of the prudential system to classes of authorities other than those contained on the face of the Act (Section 23)
- Miscellaneous provisions on transition (Section 9) and specifying qualifying local government bodies (Schedule 1)

The rationale behind the making of these particular regulations at that time was to support the introduction of the prudential borrowing system in 2004/05 and ensure that the main Parts of the Act are supported by the legislative framework and were in place in time for local authorities to undertake their budgetary processes in the run up to 1 April 2004.

Detailed calculations on affordability, process and governance are therefore contained in the 'Prudential Code' which has been developed by the Chartered Institute of Public Finance and Accountancy. The primary legislation will require authorities to follow proper practices in respect of their accounting arrangements and existing generally accepted accounting practice will be followed in this respect. There will be some exceptions in the areas agreed with representatives of local government and relevant interested parties where statutory treatment of transaction should take precedent.

However, following further discussions with local authorities additional regulations will be required relating to local authority investments and other issues which have come to light as a consequence of the consultation on the 2003 Regulations in Wales (and the equivalent consultation in England). These provide clarification in particular areas:

- Acquisition of share capital is to be defined as capital expenditure as this type of investment would reflect the fact that such transactions are usually entered into for service purposes rather than as a part of the stewardship of funds. (Provision to be made under Section 16)
- To clarify the transitional position if a lease transaction or arrangement that existed on 31 March 2004 is varied on or after 1 April 2004 and creates a fixed asset then this will be treated in the same way as a new credit arrangement. (Provision to be made under Section 7 and 8)
- Loans by community councils and charter trustees to third parties for capital expenditure will not be treated as capital expenditure and their repayment will not result in a capital receipt. (Provision to be made under Sections 9 and 16)

- If an authority leases an asset to third party any income received which would normally in accordance with proper practices be credited to a revenue account would not be a capital receipt. (Provision to be made under Section 9)
- If an authority has to repay a grant which was originally awarded for capital expenditure then this may be classified as capital expenditure. Allowing the authority the flexibility to refund out of capital resources rather than revenue, if it so decides. (Provision to be made under Section 16)
- Where an authority carries out (capital) works on buildings owned by other parties this will be treated as capital expenditure as if it had been carried out on the authority's own buildings. (Provision to be made under Section 16)
- The regulations need to be amended (a minor wording change) so that they will make it clear that the current versions of the relevant codes of practice as updated or altered in the future, rather than the editions in existence when the regulations were issued, constitute proper practices. (Provision to be made under Section 21)
- Clarification will be provided in accordance with section 19 of the Act of the application of Part 1 to community councils setting out commencement arrangements and interpretation of provisions relating to the definitions and capital expenditure and the definitions and use of capital receipts.

Overall, the prudential system will be a considerable simplification on the existing system of local authority capital finance. This is because there will be far fewer detailed regulations and greater reliance will be placed on proper accounting practice. Therefore, the regulatory burden on local authorities should be considerably reduced.

2. Risk Assessment

There is a risk within the new system that local authorities will attempt to set themselves limits which are not affordable. However, there are several controls within the system to prevent this scenario. Firstly, there are duties placed on the professional chief finance officer to ensure that authorities undertake all of the appropriate deliberations as set out in the prudential code and that corporate governance requirements therein are given due process. Compliance with the code is then audited by the local authorities' external auditor.

In extremis, the Assembly has reserve powers to set affordable limits for an authority but it is not envisaged at this time that these reserve powers will need to be exercised.

There is also a possible scenario whereby total local authority borrowing in Wales might be affordable at an individual local authority level but not at an all Wales level because of public expenditure and national economic reasons. In this scenario the Assembly again has a reserve power to determine affordable borrowing limits for welsh local authorities. This would be based on an overall limit for Wales determined by HM Treasury.

Neither of these regulation making powers are included here as orders will be made as and when the necessity arises.

3. Options

The development of the prudential system has taken place over a period of time since 2000. The guiding principles have been the general aims for a local authority capital finance system as set out above.

With these aims in mind various options have been discussed with local authorities at the following joint working groups:

- The Capital Finance System Task and Finish Group
- The Capital Sub Group
- The Distribution Sub Group

All of the proposals and the minuted recommendations of these groups are available on the National Assembly website. A commentary on the main issues in respect of why certain secondary legislative provisions are being suggested is included in the consultation paper on the draft regulations.

4. Benefits

The main benefit to local authorities of the introduction of the prudential borrowing system is that it will provide authorities with the flexibility to determine how much they can afford to borrow. It will also place all forms of capital funding on an equal footing so that the option appraisal of a capital project should drive and determine the financing method which provides the greatest level of value for money, rather than the availability of a particular form of finance.

Overall, there is a reduction in complexity in both the statutory system and the supporting accounting requirements which should reduce the burden of regulation on local authorities.

5. Costs

The introduction of the prudential borrowing system should not result in additional costs to either local government or the National Assembly. The amount of funding which the Assembly provides to local authorities for capital investment is a separate issue to the introduction of the prudential system itself.

Whilst there may be initial set up costs such as staff training for local authorities which are the natural result of any significant system change these should be absorbed in normal running costs and be outweighed by the benefits provided from a lighter touch regulatory system.

6. Competition Assessment

This is not applicable to these regulations. Local authorities are permitted to borrow only in sterling and from institutions with a record of stability. Most conduct all of their borrowing with the Public Works Loans Board as this provides the most competitive rate.

Authorities will be free to determine the most appropriate financing package for particular projects and their capital programmes as a whole.

7. Consultation

The policy contained in these draft regulations was the subject of consultation from 12 January to 9 February 2004 to ensure that all stakeholders, including county and county borough councils, the Welsh Local Government Association (WLGA), fire and police authorities, the Audit Commission and professional bodies could comment. The reduced consultation period was agreed with the WLGA.

8. Review

Once the prudential system is in operation the Assembly will continue to review the efficacy of the regulations and supporting mechanisms with its relevant joint working groups.

9. Summary

In summary, these regulations are required to support and operationalise the introduction of the prudential borrowing system in Wales as set out in the broad framework within the Local Government Act 2003.

The intention is that this system will provide local authorities with the freedom to make responsible decisions about all of the resources and assets at their disposal. The prudential system will also represent a simplification on the existing complex system of local authority capital finance.