STATUTORY GUIDANCE ON MINIMUM REVENUE PROVISION

Guidance issued by the Secretary of State under section 21(1A) of the *Local Government Act 2003*

POWER UNDER WHICH THE GUIDANCE IS ISSUED

1. The following Guidance is issued by the Secretary of State under section 21(1A) of the *Local Government Act 2003.* Under that section local authorities are required to "have regard" to this guidance.

DEFINITION OF TERMS

2. The **2003 Act** means the *Local Government Act 2003.*

3. The **2007 Act** means the *Local Government and Public Involvement in Health Act 2007.*

4. The **2003 Regulations** means the L*ocal Authorities (Capital Finance and Accounting) (England) Regulations 2003* [as amended].

5. **Local authority** has the meaning given in section 23 of the 2003 Act.

6. **MRP** means Minimum Revenue Provision.

7. The **Prudential Code** means the statutory code of practice, issued by CIPFA, referred to in Regulation 2 of the 2003 Regulations.

8. **CFR** means the Capital Financing Requirement, as defined in the Prudential Code.

9. **Non-housing CFR** has the meaning given in Regulation 28(11) of the 2003 Regulations, before this was amended. This is the total CFR for a local authority less the Housing Revenue Account CFR, where a local authority has a Housing Revenue Account.

10. **Credit Arrangement** has the meaning given in Section 7 of the 2003 Act.

11. **Supported Capital Expenditure** means the total amount of capital expenditure which a local authority had been notified by one or more Government departments was to be taken into account in the calculation of the revenue grant due to the local authority in respect of it its use of borrowing and credit. It excludes any expenditure that is supported by capital grant.

12. **Housing assets** means any land, dwellings or other property to which Section 74(1) of the Local Government Housing Act 1989 (duty to keep a Housing Revenue Account) applies.

13. **UL** means the estimated useful life of an asset as determined by proper accounting practices.

14. **Lease** means a lease transaction as defined under proper accounting practices.

APPLICATION

Effective date

15. This Guidance applies for accounting periods starting on or after 1 April 2019, with the exception of paragraphs 27-29 of this Guidance "Changing Methods for Calculating MRP", which apply from accounting periods starting on or after 1 April 2018. However, early adoption is encouraged. It supersedes all previous versions of this Guidance.

Local authorities

16. This guidance applies to all local authorities in England and their relevant bodies. It does not apply to parish councils or charter trustees.

INTRODUCTION

17. Under Regulation 27 of the 2003 Regulations, local authorities are required to charge MRP to their revenue account in each financial year. Before 2008, the 2003 Regulations contained details of the method that local authorities were required to use when calculating MRP. This has been replaced by the current Regulation 28 of the 2003 Regulations, which gives local authorities flexibility in how they calculate MRP, providing the calculation is 'prudent'. In calculating a prudent provision, local authorities are required to have regard to this guidance.

ANNUAL MRP STATEMENT

18. Before the start of each financial year a local authority should prepare a statement of its policy on making MRP in respect of that financial year and submit it to full Council for approval. For local authorities without a full Council the statement should be presented for approval at the closest equivalent level. The statement should describe how it is proposed to discharge the duty to make prudent MRP during that year.

19. Local authorities can vary the methodologies that they use to make prudent provision during the year. If they do so they should present a revised MRP statement to the next full Council or equivalent. Where a change in MRP

methodology would impact on the value for money assessment of non-financial investments, the updated statement should summarise this impact.

MEANING OF PRUDENT PROVISION

20. Regulation 28 of the 2003 Regulations requires a local authority to calculate in each financial year an amount of MRP that it considers to be prudent.

21. An underpinning principle of the local authority financial system is that all capital expenditure has to be financed either from capital receipts, capital grants (or other contributions) or eventually from revenue income. The broad aim of prudent provision is to require local authorities to put aside revenue over time to cover their CFR. In doing so, local authorities should align the period over which they charge MRP to one that is commensurate with the period over which their capital expenditure provides benefits.

22. In the case of historical borrowing originally supported by grant income rolled into Revenue Support Grant the meaning of prudent provision is to put funds aside over a period commensurate with the period implicit in the determination of that original grant.

23. The Secretary of State considers that the methods of making prudent provision include the options set out in paragraphs 31 to 37. However, this does not rule out or otherwise preclude a local authority from using an alternative method should it decide that is more appropriate. Any method used is subject to the conditions in paragraphs 38 to 42 as far as these are relevant.

OVERPAYMENTS OF MRP

24. Local authorities may choose to pay more MRP than they consider prudent in any given year. If they do so they should separately disclose the in-year and cumulative amount of MRP overpaid in the Statement presented to full council

MEANING OF CHARGE TO A REVENUE ACCOUNT

25. A charge to a revenue account for MRP cannot be a negative charge.

26. A charge to a revenue account for MRP can only be £nil if:
    - A local authority's CFR was nil or negative on the last day of the preceding financial year; or
    - A local authority chooses to offset a previous year's overpayment (as set out in paragraph 24) against the current year's prudent provision. If a local authority chooses to offset a previous year's overpayment, they should disclose this fact and any remaining cumulative overpayment of MRP in the Statement presented to full council.

CHANGING METHODS FOR CALCULATING MRP

27. A local authority may change the method(s) that it uses for calculating part or all of its MRP at any time.

28. Where a local authority changes the method(s) that it uses to calculate MRP, it should explain in its Statement, why the change will better allow it to make prudent provision.

29. The calculation of MRP under the new method(s) should be based on the residual CFR at the point the change in method is made (i.e. it should not be applied retrospectively). Changing the method used to calculate MRP can never give rise to an overpayment in respect of previous years, and should not result in a local authority making a reduced charge or a charge of £nil for the accounting period in which the change is made, or in any subsequent period, on the grounds that it needs to recover overpayments of MRP relating to previous years.

TRANSFERRING DEBT

30. Where debt is transferred between authorities, the authorities concerned should agree on the arrangements for the continued making of MRP and adjust their unfunded CFRs accordingly. Normally the authority releasing the debt should cease to make MRP in respect of it and the authority taking it over should begin to make MRP in the same way that it would do for any other increase in CFR.

OPTIONS FOR MAKING PRUDENT PROVISION

31. This Guidance presents four ready-made options for calculating prudent provision. Local authorities can use a mix of these options for debt taken out at different times should they consider it appropriate to do so.

<u>Option 1: Regulatory method</u>

32. MRP is equal to the amount determined in accordance with the former Regulations 28 and 29 of the 2003 Regulations as if they had not been revoked by the 2008 amendment to those regulations. For the purposes of that calculation, the adjustment A should normally continue to have the value attributed to it by the local authority in the financial year 2004-05. However, it would be reasonable for local authorities to correct any perceived errors in adjustment A, if the correction would be in their favour.

33. The former Regulations 28 and 29 of the 2003 Regulations are included at **Annex A**.

Option 2: CFR method

34. MRP is equal to 4% of the non-housing CFR at the end of the preceding financial year.

Option 3: Asset Life Method

35. Where capital expenditure on an asset is financed wholly or partly by borrowing or credit arrangements, MRP is to be determined by reference to the useful life of the asset. There are two main methods by which this can be achieved, as described below.

(a) Equal instalment method

MRP is the amount given by the following formula:

$$\frac{A - B}{C}$$

Where:

A is the amount of capital expenditure in respect of the asset financed by borrowing or credit arrangements.

B is the total provision made before the current financial year in respect of that expenditure.

C is the inclusive number of financial years from the current year to that in which the estimated useful life of the asset expires.

(b) Annuity method

MRP is the principal element for the year of the annuity required to repay over the asset's useful life the amount of capital expenditure financed by borrowing or credit arrangements. The authority should use an appropriate interest rate to calculate the amount. Adjustments to the calculation to take account of repayment by other methods during repayment period (e.g. by the application of capital receipts) should be made as necessary.

Option 4: Depreciation method

36. MRP is deemed to be equal to the provision required in accordance with deprecation accounting in respect of the asset on which expenditure has been financed by borrowing or credit arrangements. This should include any amount for impairment charged to the income and expenditure accounts.

37. For this purpose standard depreciation accounting procedures should be followed, except in the following respects:

- MRP should continue to be made annually until the cumulative amount of provision made is equal to the expenditure originally financed by borrowing or credit arrangements. Thereafter the authority will cease to make MRP.
- On disposal of the asset, the charge should continue in accordance with the depreciation schedule as if the disposal had not taken place. This does not affect the ability to apply capital receipts or other funding sources at any time to repay all or part of the outstanding debt.

Where the percentage of the expenditure on the asset financed by borrowing or credit arrangements is less than 100%, MRP should be equal to the same percentage of the provision required under depreciation accounting.

CONDITIONS FOR USING THE OPTIONS

38. **Use of options.** Options 1 and 2 may only be used in relation to capital expenditure incurred before 1 April 2008, which form part of its supported capital expenditure.

39. For expenditure incurred on or after 1 April 2008, which does not form part of the authority's supported capital expenditure, prudent approaches include options 3 and 4.

40. **Commencement of provision.** Subject to paragraph 41 below, MRP should normally commence in the financial year following the one in which the expenditure was incurred.

41. **MRP Commencement.** When borrowing to provide an asset, the authority may treat the asset life as commencing in the year in which the asset first becomes operational. Therefore, it may postpone beginning to make MRP until the financial year following the one in which the asset becomes operational. 'Operational' here means when an asset transfers from Assets under Construction to an Assets in Use category under normal accounting rules.

42. Estimated useful life of assets. Where a local authority uses options 3 or 4 or where it uses another methodology that has the UL of assets as a component to the calculation, it should normally not exceed a maximum UL of 50 years. Local authorities can exceed this maximum in two scenarios:

- where a local authority has an opinion from an appropriately qualified professional advisor that an asset will deliver service functionality for more than 50 years it can use the life suggested by its professional advisor; and
- for a lease or PFI asset, where the length of the lease/PFI contract exceeds 50 years. In this case the length of the lease/PFI contract should be used.

LEASES AND PFI

43. In the case of finance leases (or, when applicable, leases where a right-of-use asset is on balance sheet) and on balance sheet PFI contracts, the MRP requirement would be regarded as met by a charge equal to the element of the rent/charge that goes to write down the balance sheet liability. Where a lease (or part of a lease) or PFI contract is brought onto the balance sheet, having previously been accounted for off- balance sheet, the MRP requirement would be regarded as having been met by the inclusion in the charge for the year in which the restatement occurs, of an amount equal to the write-down for that year plus retrospective writing down of the balance sheet liability that arises from the restatement.

HOUSING ASSETS

44. The duty to make MRP does not extend to cover borrowing or credit arrangements used to finance capital expenditure on housing assets (as defined in paragraph 12 above).

INVESTMENT PROPERTIES

45. The duty to make MRP extends to investment properties where their acquisition has been partially or fully funded by an increase in borrowing or credit arrangements. As depreciation is not charged on investment properties, Option 4: the Depreciation method is not a suitable approach for calculating the MRP to be charged in respect of investment properties.

CAPITALISED EXPENDITURE

46. Where on or after 1 April 2008 an authority incurs expenditure which is:
    - Financed by borrowing and credit arrangements; and
    - Treated as capital expenditure by virtue of either a direction under section 16(2)(b) of the 2003 Act or Regulation 25(1) of the 2003 Regulations,

    The authority should calculate MRP in accordance with Option 3.

47. For the purpose of the formula in paragraph 35 above, in the initial year of making MRP the variable "C" should be given the maximum values as set out in the following table:

Expenditure type	**Maximum value of "C" in initial year**
Expenditure capitalised by virtue of a **direction under s.16(2)(b)**	"C" equals 20 years
Regulation 25(1)(a) Expenditure on computer programmes	"C" equals the shorter of the UL of the hardware or the length of the software license.
Regulation 25(1)(b) Loans and grants towards capital	"C" equals the UL of the assets for in relation to which the third party

expenditure by third parties.	expenditure is incurred.
Regulation 25(1)(c) Repayment of grants and loans for capital expenditure	"C" equals 25 years or the period of the loan if longer.
Regulation 25(1)(d) Acquisition of share capital	"C" equals 20 years.
Regulation 25(1)(e) Expenditure on works to assets not owned by the authority	"C" equals the UL of the assets.
Regulation 25(1)(ea) Expenditure on assets for use by others.	"C" equals the UL of the assets.
Regulation 25(1)(f) Payment of levy on large scale voluntary transfers (LSVT) of dwellings	"C" equals 25 years.

ANNEX A – REGULATIONS 28 AND 29 OF THE 2003 REGULATIONS BEFORE THESE WERE AMENDED

Calculation of minimum revenue provision

28.—(1) Subject to paragraphs (2) and (3) and regulation 29, the minimum revenue provision for the current financial year shall be calculated by the local authority in accordance with the following formula—

$$\frac{4[CFR - (A - HC)]}{100}$$

where—

- CFR is the capital financing requirement at the end of the preceding financial year;
- A is an adjustment (which may be a positive, nil or negative amount) to be calculated in accordance with the following formula—

$$[CFRM - (HA + NHA)] + \frac{(HA - HB)}{2}$$

where—

  - CFRM is the capital financing requirement on 31st March 2004;
  - HA is the housing amount on 31st March 2004;
  - HB is the opening HRA capital financing requirement for the financial year beginning on 1st April 2004, except that if that opening HRA capital financing requirement is a negative amount, HB is nil; and
- NHA is the non-housing amount on 31st March 2004; and
- HC is the opening HRA capital financing requirement for the current financial year, except that if that opening HRA capital financing requirement is a negative amount, HC is nil.

(2) An additional amount of minimum revenue provision for the current financial year ("the additional amount") shall be calculated by the local authority where—

(a)a credit approval, within the meaning of regulation 136 of the Local Authorities (Capital Finance) Regulations 1997 (use of certain credit approvals)(1), was issued to the local authority before 1st April 2004; and

(b)the amortisation period specified in the credit approval expires during or after the current financial year,

and the additional amount shall be the total amount determined by the local authority under regulation 136(2) of those Regulations for the current financial year, as if those Regulations were still in force for the purposes of this regulation.

(3) Where, in relation to the current financial year, the total of—

(a)the amount calculated in accordance with the formula for the minimum revenue provision in paragraph (1); and (b)the additional amount, if any, calculated under paragraph (2),

is a negative amount, the minimum revenue provision for the current financial year shall be treated as nil.

(4) For the purposes of this regulation—

“arms length management organisation” means a body set up by a local authority as a housing management company to exercise management functions as agent of the local authority under an arrangement approved by the Secretary of State under section 27 of the Housing Act 1985 (management agreements)(**2**);

“capital financing requirement” has the same meaning as in the “Prudential Code for Capital Finance in Local Authorities” published by CIPFA, as amended or reissued from time to time(**3**);

“certified value” means the market value certified by the district valuer or by a suitably qualified valuer employed by the local authority;

“current financial year” means any financial year for which the local authority is determining the amount of its minimum revenue provision;

“district valuer”, in relation to any land in the district of a local authority, means an officer of the Commissioners of Inland Revenue appointed by them for the purpose of exercising, in relation to that district, the functions of the district valuer under the Housing Act 1985;

“housing amount” and “non-housing amount” have the same meaning as those terms had on 31st March 2004 in Part XII of the Local Authorities (Capital Finance) Regulations 1997 (minimum revenue provision);

“Housing Revenue Account”, also referred to as “HRA”, has the same meaning as in section 74 of the Local Government and Housing Act 1989 (duty to keep Housing Revenue Account)(**4**);

“major repairs reserve” has the same meaning as in regulation 7(5) of the Accounts and Audit Regulations 2003 (statement of accounts)(**5**);

“opening HRA capital financing requirement” means—

(a) for the financial year beginning on 1st April 2004, the amount calculated in accordance with paragraph (5);
(b) for the financial year beginning on 1st April 2005 and any subsequent financial year, the amount calculated In accordance with paragraph (6); and

“preceding financial year” means the financial year immediately preceding the current financial year.

(5) The amount referred to in sub-paragraph (a) of the definition of “opening HRA capital financing requirement” in paragraph (4) is the amount calculated in accordance with the following formula—

$$OHCC + IA - ID$$

where—

OHCC is the opening HRA credit ceiling for the financial year beginning on 1st April 2003, which has the same meaning as the “opening HRA credit ceiling” in paragraph 7.1 of the Item 8 Credit and Item 8 Debit (General) Determination 2003-2004 (“the Determination”)(**6**);

IA means the total of—

(a)

the items to be aggregated as specified in paragraph 7.2 of the Determination but substituting “2003-2004” for “2002-2003” in each place where it occurs in that paragraph; and

(b)

the amounts of all supplementary credit approvals issued in respect of financial years beginning before 1st April 2004 under section 54 of the Local Government and Housing Act 1989 (supplementary credit approvals)(7) for the purposes of expenditure in relation to arms length management organisations; and

ID means the items to be deducted as specified in paragraph 7.3 of the Determination but substituting “2003-2004” for “2002-2003” in each place where it occurs in that paragraph.

(6) The amount referred to in sub-paragraph (b) of the definition of “opening HRA capital financing requirement” in paragraph (4) is the amount calculated in accordance with the following formula—

$$OCFR + TIA - TID$$

where—

- OCFR means the opening HRA capital financing requirement for the preceding financial year;
- TIA means the total items to be aggregated, being the total of the following—

(a) the capital expenditure of the local authority financed by borrowing or credit arrangements which was incurred during the preceding financial year on any interest in housing land; and

(b) the certified value of any interest in housing land which commenced or recommenced to be accounted for in the Housing Revenue Account in the preceding financial year for a reason other than acquisition by the local authority;

- TID means the total items to be deducted, being the total of the following—

(a) such part of any capital receipt from the disposal of an interest in housing land which was used during the preceding financial year to repay the principal of any amount borrowed by the local authority or to meet any liability in respect of credit arrangements;

(b) 75 per cent. of the certified value of any interest in a dwelling, and 50 per cent. of the certified value of any interest in other housing land, that ceased to be accounted for in the Housing Revenue Account in the preceding financial year other than by virtue of disposal by the local authority;

(c) the amount of the provision for the repayment of the principal of any amount borrowed by the local authority or the meeting of any liability in respect of credit arrangements which the local authority determined during the preceding financial year to make from the Housing Revenue Account; and

(d) the amount of the provision for the repayment of the principal of any amount borrowed by the local authority or the meeting of any liability in respect of credit arrangements which the local authority determined during the preceding financial year to make from the major repairs reserve.

Commutation adjustment

29.—(1) Subject to paragraph (2), where a commuted payment was made to or for the benefit of a local authority in the financial year beginning on 1st April 1992, the local authority may reduce the amount of its minimum revenue provision for the current financial year, calculated in accordance with regulation 28, by an amount calculated in accordance with the following formula—

$$G \quad (I - M)$$

where—

- G is the total amount of contributions, grants and subsidies which would have been payable to the local authority by the Secretary of State for the current financial year but for commutation;
- I is the total of—

(a) the amount by which interest, payable by the local authority in the current financial year on loans, is reduced; and

(b) the amount by which interest, payable to the local authority in the current financial year on deposits and investments, is increased, by virtue of commutation; and

- M is the amount of minimum revenue provision for the current financial year which would have been calculated by the local authority in accordance with regulation 28 but for commutation, less the amount of minimum revenue provision for the current financial year actually calculated in accordance with regulation 28.

(2) Where the amount calculated in accordance with the formula in paragraph (1) is a negative amount, that amount shall be treated as nil.

(3) For the purposes of paragraph (1)—

"commutation" means the making of a commuted payment to, or for the benefit of, a local authority in the financial year beginning on 1st April 1992;

"commuted payment" has the same meaning as that term had on 31st March 2004 in section 157 of the Local Government and Housing Act 1989 (commutation of, and interest on, periodic payments of grants etc.)(8); and

"current financial year" has the same meaning as in regulation 28(4).

ANNEX B – INFORMAL COMMENTARY ON THE STATUTORY GUIDANCE ON MINIMUM REVENUE PROVISION

Introduction

1. **The main section** of this document contains Statutory Guidance on Minimum Revenue Provision ("the Guidance") issued by the Secretary of State. **Annex A** provides the former Regulations 28 and 29 of the (Capital Finance and Accounting) (England) Regulations 2003. These have now been amended and have no force in statute. However, the calculations in these Regulations are still used for recommended option 1, the CFR method, so the former Regulations have been included as an Annex to this Guidance. **Annex B** provides an informal commentary ("the commentary") on that statutory guidance. **Annex C** provides the transitional arrangements.

2. Local authorities are normally required each year to set aside some of their revenues as provision for debt. More precisely, the provision is in respect of capital expenditure financed by borrowing or credit arrangements but, both in these guidance notes and in the statutory guidance, it has generally proved more convenient to use the term "debt" as shorthand for that technically more accurate form of expression.

Application Date

3. The Guidance and the commentary apply from 1 April 2019. The exception is paragraphs 27-29 of the Guidance and the commentary on those paragraphs, which apply from 1 April 2018. All previous editions of the MRP Guidance and any commentary published with that Guidance are superseded.

4. When considering transitional arrangements local authorities should refer to the Q&A published alongside the consultation, which is reproduced at **Annex C**.

MRP Calculation – Amendment Regulation

5. Amendment regulation 4(1) of the 2008 Regulations revised the former regulation 28. In the new regulation 28, the detailed rules are replaced with a simple duty for an authority each year to make an amount of MRP which it considers to be "prudent". The regulation does not itself define "prudent provision". However, the MRP guidance makes recommendations to authorities on the interpretation of that term. The operative date of the change is 31 March 2008, which means that it applies to the financial year 2007-08 and to subsequent years.

Power to Issue Guidance

6. The issue of statutory MRP guidance was made possible by section 238(2) of the *Local Government and Public Involvement in Health Act 2007*, which amends section 21 of the *Local Government Act 2003*. Section 21 already allowed

regulations to be made on accounting practices and is the power under which the existing MRP regulations were made. The amendment inserts a new section 21(1A) into the 2003 Act, enabling the Secretary of State also to issue *guidance* on accounting practices and thus on MRP.

7. Authorities are obliged by new section 21(1B) to "have regard" to such guidance – which is exactly the same duty as applies to other pieces of statutory guidance including, for example, the CIPFA Prudential Code, the CIPFA Treasury Management Code and the MHCLG Guidance on Local Government Investments.

8. The statutory MRP guidance itself is the front section of the present document. Annex B of this document is an informal commentary, explaining the policy intention in more detail and including other information to help practitioners; it has no statutory force.

9. Specific requirements of the statutory guidance are considered in more detail below.

<u>Annual MRP Statement [paragraphs 18-19 of the guidance]</u>

10. Authorities are asked to prepare an annual statement of their policy on making MRP for submission to their full council (for authorities without a full council, approval of the statement should be at the closest equivalent level). This mirrors the existing requirements to report to the council on the prudential borrowing limit and investment policy. The aim is to give elected Members the opportunity to scrutinise the proposed use of the additional freedoms conferred under the new arrangements. If it is ever proposed to vary the terms of the original statement during the year, a revised statement should be put to the council at that time. It is for each council to consider with its officers the preferred format of the statement and MHCLG will not being issuing any advice on the matter.

11. To underpin this recommendation, it was necessary to amend the *Local Authorities (Functions and Responsibilities) (England) Regulations 2000 [SI 2000/2853].* Regulation 4(1)(b) specifies functions which are not to be the sole responsibility of an authority's executive and includes the authority's borrowing, investments, capital expenditure and now also the making of MRP.

<u>Meaning of prudent provision [paragraphs 20 – 23 of the guidance]</u>

12. The main part of the guidance is concerned with recommendations on the interpretation of the term "prudent provision" as used in the amended Regulation 28. The guidance includes specific examples of options for making "prudent provision".

13. It explains that provision for the debt which financed the acquisition of an asset should be made over a period bearing some relation to that over which the asset continues to provide a service. However, some local authorities have increased their debt to acquire assets that do not generate direct service benefits, for example assets held for investment purposes or as part of regeneration schemes. In addition, there may be a significant mismatch between the period over which an asset provides a direct service benefit and the lifetime of the debt that has been taken out to acquire assets taken out.

14. Whilst recognising that local authorities have options other than building up prudent provision to repay debt, the Government has identified that there is a mismatch between the weighted average lifetime of local authority debt and the length of time it would take to fully provide for that debt based on current levels of MRP charged. Whilst this is not a risk if ease of access to PWLB remains unchanged, assuming that this will remain the case over the length of longer dated local authority debt instruments is not a prudent approach. For this reason, the Government has changed the definition of "prudent provision" to highlight that there is a balance between matching MRP to the service potential of assets and to the weighted average lifetime of local authority debt.

<u>Meaning of a charge to a revenue account [paragraphs 25-26]</u>

15. The Government has identified that there are some local authorities who have adopted very aggressive strategies with regard to making provision for repayment of debt. In some cases these have resulted in charges of £nil or negative charges being made. Feedback from external auditors indicates a lack of understanding about whether such practices are lawful.

16. The Government is of the view that this is not the most prudent approach that local authorities could adopt, and those that do so are deferring cost so that it falls on future rather than current council tax payers. Therefore, this update clarifies that except in cases where a local authority has a negative or nil CFR or is offsetting a previous overpayment of MRP, MRP should not be £nil or a negative charge.

<u>Negative CFR</u>

17. Where the CFR (as calculated for the normal purposes of the Prudential Code and not the adjusted CFR mentioned above) is nil or negative on the last day of a financial year, this indicates that the authority's provision for debt is equal to or greater than the debt incurred. There is accordingly no need to make MRP in the following financial year under any of the specified options, or in any other way.

Change in methods for calculating MRP [paragraphs 27 – 29]

18. The most common justification for local authorities who have decided to significantly reduce their MRP charge or take a payment holiday is that a changing the methodology that they use to calculate MRP has resulted in identification of a historical overpayment. The mechanism tends to be a reassessment of the assumptions underpinning Option 3: The Asset Life Method.

19. Given that conceptually, this recommended option requires local authorities to charge MRP as a proxy for depreciation, and depreciation is an accounting estimate, the Government believes that local authorities should follow proper accounting practices when changing an accounting estimate. In depreciation accounting, when an entity reassesses the life of an asset, it does not recalculate the depreciation it has charged from acquisition of the asset. Instead, depreciation must be recalculated over the revised asset life using the current net book value of the asset as the new starting point.

20. Adopting this approach will require local authorities to spread the benefit of charging a lower annual MRP to council tax payers over time, rather than taking all of the benefits up front at the expense of longer term financial sustainability.

OPTIONS FOR PRUDENT PROVISION

21. Four ready-made options are included in the guidance (and there are two alternatives under Option 3). The options are those likely to be most relevant for the majority of authorities but other approaches are not meant to be ruled out, provided that they are fully consistent with the statutory duty to make prudent revenue provision. Authorities must always have regard to the guidance, but having done so, may in some cases consider that a more individually designed MRP approach is justified. That could involve taking account of detailed local circumstances, including specific project timetables and revenue-earning profiles. Authorities may wish to consult their legal advisers and external auditors about their approach to MRP if it involves a significant departure from the guidance or relates to any large, complex or novel schemes. However, the decision on what is prudent is for the authority and it is not for MHCLG to say in particular cases whether any proposed arrangement is consistent with the statutory duty.

Option 1: Regulatory Method [paragraphs 32 - 33]

22. For debt which is supported by the Government through the RSG system, authorities may continue to use the formulae in the current regulations, since the RSG is calculated on that basis. Although the existing regulation 28 is revoked by regulation 4(1) of the 2008 Regulations, authorities will be able to calculate MRP as if it were still in force. The earlier regulations relevant to MRP are included in this Guidance at **Annex A**.

23. Normally, under this option, the former regulations should be followed exactly as if they had not been revoked. That includes taking advantage, if desired, of the **commutation adjustment** in the former regulation 29.

24. When introducing the new MRP regime in 2004, as part of the Prudential system framework, the Government's policy aim was that the move from the former MRP scheme should not itself increase any authority's MRP liability. Safeguards to achieve that result were built in from the outset (or added later as anomalies came to light).

25. The main device for achieving the neutrality between old and new MRP systems was "Adjustment A" in the original regulation 28. This was an amount to be calculated at the start of the new system in 2004 and not subsequently varied. For the purposes of Option 1, Adjustment A should therefore continue to be given the value attributed to it in the financial year 2004-05, even if that value reflected erroneous calculations under the former capital finance system which reduce MRP liability under the present system. If, however, Adjustment A reflects an error which increases the current MRP liability, the authority would be justified in recalculating it and hence reducing MRP to its proper level.

26. Similarly, if an authority considers that, in its particular circumstances, strict compliance with any other aspect of the former regulations would produce an anomalous and disadvantageous result, it may consider modifying the rules to achieve the intended neutrality. Again, such a step should be discussed in advance with external auditors.

<u>Option 2: CFR Method [paragraph 34]</u>

27. This is a technically much simpler alternative to Option 1 which may be used in relation to supported debt. While still based on the concept of the Capital Financing Requirement [CFR], which is easily derived from the balance sheet, it avoids the complexities of the formulae in the old regulation 28 (though for most authorities it will probably result in a higher level of provision than Option 1). It does however still rely on definitions in regulation 28(11), which are as follows:

"Non-housing CFR" means that part of the capital financing requirement which is not housing CFR. "Housing CFR" means that part, if any, of the capital financing requirement which is in respect of borrowing or credit arrangements used to finance capital expenditure on housing assets. "Housing assets" means any land, houses or other property to which subsection (1) of section 74 of the Local Government and Housing Act 1989 (duty to keep Housing Revenue Account) for the time being applies.

<u>Option 3: Asset Life Method [paragraph 35]</u>

28. For new borrowing under the Prudential system for which no Government support is being given and is therefore self-financed, there are two options included in the guidance.

29. Option 3 is to make provision over the estimated life of the asset for which the borrowing is undertaken. This is a possibly simpler alternative to the use of depreciation accounting (Option 4), though it has some similarities to that approach. Within option 3, two methods are identified.

30. The first of these, the **equal instalment method**, allows the use of the simple formula in paragraph 35(a) of the guidance. This will normally generate a series of equal annual amounts over the estimated life of the asset. The original amount of expenditure ("A" in the formula) remains constant. The cumulative total of the MRP made to date ("B" in the formula) will increase each year.

31. The outstanding period of the **estimated life** of the asset ("C" in the formula) reduces by 1 each year. For example, if the life of the asset is originally estimated at 25 years, then in the initial year when MRP is made, C will be equal to 25. In the second year, C will be equal to 24, and so on. The original estimate of the life is determined at the outset and should not be varied thereafter, even if in reality the condition of the asset has changed significantly (paragraph 11).

32. The formula allows an authority to make **voluntary extra provision** in any year. This will be reflected by an increase in amount B and will automatically ensure that in future years the amount of provision determined by the formula is reduced.

33. The alternative is the **annuity method**, which has the advantage of linking MRP to the flow of benefits from an asset where the benefits are expected to increase in later years. It may be particularly attractive in connection with projects promoting regeneration or administrative efficiencies or schemes where revenues will increase over time. Guidance on the calculation method is given by CIPFA in its publication *Practitioners Guide to Capital Finance in Local Government (2012 Edition).*

34. **Freehold land** (paragraph 12) cannot properly have a life attributed to it, so for the purposes of Option 3 it should be treated as equal to a maximum of 50 years. But if there is a structure on the land which the authority considers to have a life longer than 50 years, that same life estimate may be used for the land.

35. Provision for debt under Option 3 will normally commence in the financial year following the one in which the expenditure is incurred [paragraph 40]. But paragraph 41 of the guidance highlights an important exception to this rule. In the case of the provision of a new asset, MRP would not have to be charged until the asset came into service and would begin in the financial year following the one in

which the asset became operational. This “**MRP holiday**” would be perhaps 2 or 3 years in the case of major projects, or possibly longer for some complex infrastructure schemes, and could make them more affordable. There would be a similar effect in the case of Option 4 under normal depreciation rules.

<u>Option 4: Depreciation Method [paragraphs 36 to 37]</u>

36. Alternatively, for new borrowing under the Prudential system for which no Government support is being given, Option 4 may be used. This means making MRP in accordance with the standard rules for depreciation accounting.

37. Authorities will normally need to follow the standard procedures for calculating depreciation provision. But this Guidance identifies some necessary exceptions:

(a) MRP continues until the total provision made is equal to the original amount of the debt and may then cease.

(b) The capital receipt from the disposal of the asset may not be used for revenue spending, since that would run counter to the Government’s “golden rule”. Capital receipts may be used only as specified in regulation 23 of the 2003 regulations.

(c) If only part of the expenditure on the asset was financed by debt, the depreciation provision is proportionately reduced.

<u>CONDITIONS FOR USING THE OPTIONS</u>

<u>Use of Options [paragraphs 38 – 39]</u>

38. The intention is that Options 1 and 2 should normally be available only for **Government-supported borrowing**. Options 3 and 4 are meant to be used for all **self-financed borrowing**.

<u>Commencement of MRP [paragraphs 40-41]</u>

39. The Guidance recognises that MRP should not be provided for Assets under Construction. Long term projects, for example infrastructure or regeneration, may be transferred from **Assets under Construction** to **Assets in Use** over a number of years. Local authorities should consider commencing to provide MRP on debt, apportioned by when each stage of the project transfers to **Assets in Use**.

<u>Estimated useful life of assets [paragraph 42]</u>

40. The Government is concerned that some local authorities are making capital investments that can only be justified as being value for money, by providing for MRP over a much longer period that any debt instruments taken out to finance acquisition. Under current PWLB terms of trade, local authorities can always refinance their debt. However, it is impossible to guarantee that PWLB terms of

trade for new loans will remain unchanged over the lifetime of existing loans. If PWLB terms of trade changed for new loans, local authorities that had otherwise expected to be able to freely refinance existing debt may instead be required to choose between significantly increasing their annual charge to 'top-up' their MRP or develop other plans to manage increased liquidity risk on repayment of debt.

41. Whilst the normal maximum asset life has been set at 50 years, the Guidance recognises that there may be circumstances where this maximum can be prudently exceeded. By service functionality, the Guidance means assets that are directly used to deliver the functions of the authority. It does not include investment assets.

<u>Leases and PFI [paragraph43]</u>

42. At the time of drafting this Guidance, it is anticipated that proper practices for leases will move to being based on *International Financial Reporting Standard (IFRS) 16: Leases,* with effect from 1 April 2019, the effective date of this Guidance. However, at the time of drafting the extant proper practices are based on *International Accounting Standard (IAS) 17: Leases* and this Guidance maintains the provisions in relation to finance leases under that standard. Guidance in relation to finance leases under IAS 17 as adopted by proper practices should be used, until proper practices replace that standard with provisions based on IFRS 16.

43. IFRS 16 introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is low value. Implementation of this standard is expected to bring more lease contracts, and the related assets and liabilities onto the balance sheet.

44. When these lease contracts along with the related assets and liabilities come onto the balance sheet, a local authority will increase its long term liabilities. This will increase the quantum of debt that MRP needs to cover. Generally accepted accounting practice requires these changes to be accounted for retrospectively, with the result that an element of the rental or service charge payable in previous years (and previously charged to revenue accounts) will be taken to the balance sheet to reduce the liability. On its own, this change in the accounting arrangements would result in a one-off increase to the capital financing requirement and an equal increase in revenue account balances.

45. This is not seen as a prudent course of action and the guidance aims to ensure authorities are in the same position as if the change had not occurred. It does this by recommending the inclusion in the annual MRP charge of an amount equal to the amount that has been taken to the balance sheet to reduce the

liability, including the retrospective element in the first year. (This approach will produce an MRP charge comparable to that under Option 3, in that it will run over the life of the lease or PFI scheme and will have a profile similar to what the annuity method gives). MHCLG recognises the complexity of the accounting in this area and acknowledges that the recommendations in paragraph 43 of the formal guidance and in this commentary may not be entirely appropriate in all cases. It will be open to authorities to consider a different approach to the calculation, subject to compliance with the overriding statutory requirement to make a prudent level of MRP.

Housing assets

46. As was the case under regulation 28 of the 2003 Regulations prior to its amendment by the 2008 Regulations, the duty to make MRP does not extend to cover borrowing or credit arrangements used to finance capital expenditure on housing assets [as defined in paragraph 12]. Options 1 and 2 above already automatically achieve this; and when using options 3 or 4 (or any other method) the authority should not take account of capital expenditure on housing assets.

47. The rationale for this is that assets held in the Housing Revenue Account are self-financing. Instead, local authorities with Housing Revenue Accounts are required to make a charge to their Major Repairs Reserve, to maintain the functionality of housing assets.

Investment Properties [paragraph 45]

48. Where a local authority classifies an asset as an investment property, it is declaring that it is holding that asset for commercial reasons. Therefore, it should fully provide for debt taken on to acquire that asset over the lifetime of that debt. In addition as investment properties are not subject to depreciation, Option 4 – the depreciation method, is not appropriate for calculating prudent provision.

49. The Guidance recognises that some local authorities may have made different assumptions when they acquired investment properties. For this reason the maximum life that should be used for calculating MRP on such assets has been set at 50 years, which is the maximum loan period for PWLB debt.

Capitalised expenditure [paragraphs 46 – 47]

50. Authorities may borrow to meet expenditure which is treated as capital expenditure by virtue of either a capitalisation direction (section 16(2)(b) of the 2003 Act) or regulation 25(1) of the 2003 Regulations. The guidance recommends that MRP in such cases is determined under Option 3. However, since the expenditure does not relate (directly at least) to an asset for which a life can be estimated, guidance is given on how to determine the value of the variable “C” in the formula in paragraph 9 of the guidance.

51. The table in paragraph 24 of the guidance gives the value of “C” for each of the categories listed in regulation 25(1). The basic principle is that, where the capitalised expenditure can be indirectly linked to an asset, the estimated life of that asset should be used.

52. In other cases, 25 years is proposed as a reasonable default. But for the acquisition of **share capital** (regulation 25(1)(d)), the slightly shorter period of 20 years is specified, because the aim of that regulation is to discourage the use of those particular forms of investment.

53. Similarly, 20 years is specified in the case of expenditure **capitalised by direction**, since the Government again does not wish to encourage reliance upon that practice.

54. It should be noted that the value of “C” given in each case applies only in the *initial* year of making MRP. Subsequently, the value will decrease by 1 in each successive year.

Annex C - Transitional arrangements

1. The Government wants to ensure that local authorities make prudent provision for the repayment of debt. The Government believes that it is for local authorities to assess what is prudent according to their circumstances. The proposals aim to continue to give local authorities flexibility to define prudent provision and to change the methodology that they use to assess this if needed.

2. There is no requirement for local authorities to make decisions based on prospective Guidance. It is for individual local authorities to make their own judgement as to whether they apply the current Guidance or the prospective Guidance to decisions that they take prior to 1 April 2019, in consultation with their external auditors where they feel that is appropriate. Government has no intention of seeking to second guess or comment on local decisions taken in accordance with local Standing Orders.

3. The Government does not expect any local authority to recalculate MRP charged in the 2017-18 financial year or any prior year due to the proposed changes in methodology. Where a local authority has changed the methodology that it uses to calculate prudent provision and generated what the current Guidance calls an 'overpayment' it can continue to incorporate that overpayment into future calculations of prudent provision.

4. As set out in **paragraph 15** of the statutory guidance, a local authority that changes the methodology it uses to calculate MRP in 2018-19 does not generate an overpayment by doing so.

5. Where a local authority has selected a long asset life for borrowing or has decided not to charge MRP on non-Housing Revenue Account debt, we would expect the calculation of future year's MRP to be made under the new guidance, as set out in the Government response following completion of the consultation. We have suggested maximum useful economic lives in the draft for consultation, but if any local authority believes that there are reasons why these maximums are inappropriate for borrowing to support particular activities, we would encourage them provide the evidence to us. If a local authority feels that it needs to adjust the useful economic lives that it is basing its MRP charge on, then that adjustment should only be applied to calculations made in 2019-20 and subsequent years.