AGENDA ITEM NO 5(q)

REPORT NO 55/23

ANGUS COUNCIL

SPECIAL ANGUS COUNCIL MEETING – 2 MARCH 2023

AMENDMENT OF SERVICE CONCESSIONS ACCOUNTING POLICY

REPORT BY DIRECTOR OF FINANCE

ABSTRACT
This report presents a proposed amendment to the Council's accounting policy in relation to service concession arrangements. This amendment will provide significant ongoing and one-off financial benefit to the Council's General Fund budget as set out in the report.

1. RECOMMENDATIONS

1.1 It is recommended that the Council:-

(i) Note the background, assessment and financial implications set out in this report;

(ii) Approve the proposed amendment to the Council's accounting policy in relation to service concession arrangements as set out in this report; and

(iii) Note that proposals for deployment of the financial benefit arising from this policy amendment are set out in Report 57 / 23 on the agenda for this meeting.

2. ALIGNMENT TO THE COUNCIL PLAN

2.1 This report contributes to the achievement of the priorities in the Angus Council Plan that we want: our communities to be strong, resilient and led by citizens; and Angus Council is efficient and effective.

3. BACKGROUND

3.1 Service concessions is the collective name given to capital projects undertaken through the Private Finance Initiative (PFI) or Public Private Partnership (PPP) methods of funding. Angus Council has several capital projects which have been delivered in this way, as do most Councils in Scotland.

3.2 PFI / PPP schemes were conceived by UK / Scottish Government as a method of funding investment in public sector infrastructure, such as new schools, without increasing public sector debt. This results from the project construction costs being financed through private sector sources – usually by the contractor undertaking bank lending and issuing equity.

3.3 In PFI / PPP schemes the Council pays a unitary charge to the contractor over the contract life. This covers the initial cost of building the asset, ongoing repairs and maintenance to that asset and, in some cases, other costs such as facilities management to enable the asset to operate. PFI / PPP contracts vary in length depending on the project but are typically for 25 to 30 years. A significant part of the unitary charge the Council pays during the life of a PFI / PPP contract is used by the contractor to repay the borrowing they undertook to fund the cost of building the asset in the first place.

3.4 Where the Council funds the cost of building an asset through what is termed "conventional borrowing" (borrowing through the Council's Loans Fund usually via the Public Works Loans Board), the repayment of that borrowing would be take place over the expected useful life of the asset e.g. for a school this would be 50 to 60 years. Repayment over the useful life is proper accounting practice because it reflects how the asset is "consumed" over its life and in, a public sector context, is equitable in the resulting financial burden on current and future taxpayers.

3.5 The borrowing undertaken to pay for a school by the private sector through a PFI / PPP contract is, therefore, repaid over a much shorter period (the contract life) even though the asset would be expected to have a useful life well beyond the contract e.g. around 50 years for a school. For existing

PFI / PPP contracts, which are part way through their term, councils are likely to have charged more expenditure in their Accounts for the use of those assets than would have been the case if they had been funded by conventional borrowing. This is clearly an inconsistent approach in the repaying of debt which arises solely because of how the asset's creation was funded. This inconsistency does not sit well with accounting principles but, until recently, Scottish Government accounting guidance prohibited the writing off of PFI / PPP borrowing over what would be regarded as "normal" periods i.e. those that would apply under conventional borrowing.

4. SERVICE CONCESSION FLEXIBILITY

4.1 The idea of reconsidering the accounting treatment of public assets funded through PFI / PPP was first raised as a potential option in mid-2020 as a means of giving councils, what was termed at the time, "fiscal flexibility" (additional financial headroom) to deal with the additional costs arising from the pandemic. In the end, additional grant funding was provided for COVID-19 and the fiscal flexibility in relation to service concessions became less urgent. However, having raised the potential for this councils were keen to still have the flexibility to help with the wider cost pressures across local government. The cost-of-living crisis and huge inflationary pressures on the Council's budget mean the service concession flexibility is now crucial to alleviating some of those pressures, even if mostly on a one-off basis.

4.2 After many months of discussion and lobbying by COSLA on behalf of Councils, the Scottish Government agreed to allow a change in accounting treatment for PFI / PPP assets by issuing Finance Circular 10/2022 (Accounting for Service Concession Arrangements, Leases and Similar Arrangements). This statutory accounting guidance gives councils options (see Section 5) on how to account for assets acquired through PFI / PPP. The key part of this guidance relates to the accounting treatment of service concessions which allows Councils to change how the debt element of a PFI / PPP contract is written off in the Council's Accounts.

4.3 The Council has four PFI / PPP schemes to which the service concessions flexibility applies. Table 1 below shows the schemes, the value of the capital cost (debt) to create them, the contract life and when the contract is due to end. The contract life is the period over which the capital cost is currently being repaid / written off.

Table 1 – PFI / PPP schemes

Scheme / Project and year contract started	Capital Value	Contract Life	Contract Ends
A92 Dual Carriageway – Arbroath to Dundee (2005)	£51m	31 years	2035/36
Forfar/Carnoustie Schools (2007)	£42m	31 years	2037/38
Forfar Community Campus (2016)	£34m	26 years	2041/42
Arbroath Schools (2018)	£15m	26 years	2043/44

5. PROPOSALS

5.1 There are three key decisions to consider following the issuing of the new Government guidance in Finance Circular 10/2022: whether to apply the service concession flexibility; if so, the revision of expected asset useful life to apply; and the method of reprofiling the debt. Proposals in this regard are set out below.

<u>Should the Flexibility be Applied?</u>

5.2 The guidance in Finance Circular 10/2022 allows the Council to choose between 3 options in how it accounts for service concessions into the future – the Council can continue existing practice (no change), can apply the Accounting Code or can apply the new flexibility which had been sought by local authorities and COSLA.

5.3 Applying existing accounting practice would continue to see the debt element of PFI / PPP assets being written off over a shorter period than their useful lives meaning current taxpayers are in effect paying too much for how those assets are being consumed. This option delivers no financial benefits to the Council.

5.4 Applying the Accounting Code would require applying the Code on an unmodified basis from the point the assets were created and this is expected to have a negative financial impact on the Council.

5.5 Applying the new flexibility would result in the debt element of PFI / PPP assets being written off over a similar period to assets which have been funded through conventional borrowing. This brings consistency of approach in accounting and a fairer impact to current and future taxpayers for the consumption (use) of those assets. The new flexibility also delivers a significant financial benefit for the Council which is to be welcomed at a time of financial crisis in local government caused by funding constraints and high inflation.

5.6 Applying the new service concessions flexibility results in significant financial benefits for the Council but also results in debt having to be repaid beyond the PFI / PPP contract periods. At present the Council will have fully "paid off" the cost of PFI / PPP assets when the contracts come to an end. Applying the service concession flexibility will mean that the debt is reprofiled over a longer period which stretches beyond the contract end dates. While this may be of concern to elected members, it is important to highlight that this approach and period of write off would be no different than that which would apply if those assets had been funded from conventional borrowing.

5.7 Officers recommend applying the new service concession flexibility and accounting policy change on the grounds that this:-

- brings a consistency of approach to how the cost of creating assets is accounted for;
- is fairer to current and future taxpayers; and
- brings significant financial benefits at a time when the Council faces a funding crisis which can therefore help to partially protect services and jobs.

Expected Useful Life

5.8 The assets which have been created through the PFI / PPP schemes noted in Table 1 will have useful lives beyond the end of the contracts. Determining the useful life of those assets is the key judgement to be made. This judgement is important because it determines the period over which the PFI / PPP debt will be written off under the service concession flexibility. Based on our experience of the useful life of existing assets, and taking a prudent approach, the following useful lives are proposed:-

- Schools: 50 years
- A92: 40 years

5.9 Taking the Forfar / Carnoustie Schools project as an example, the service concession flexibility will mean the Council adjusting its accounting position to repay the £42m capital cost over 50 years rather than the 31 years of the contract as presently.

Method of Reprofiling

5.10 Having determined what useful life is to be assumed the Council must then choose a method of writing off the capital cost (debt) over that useful life. The statutory guidance allows the choice of either Equal Instalments of Principal (EIP) or Annuity. The Council uses the annuity method to write off its debt on conventional borrowing and it is proposed to apply that same approach to the service concessions debt. The annuity approach takes account of the time value of money and is considered by CIPFA, among others, to be a fairer approach to current and future taxpayers than EIP.

5.11 The useful life assumptions and annuity approach will be scrutinised by the Council's external auditor but finance officers are confident these assumptions are reasonable and prudent. They are in line with the assumptions being made by other Councils with similar PFI / PPP schemes.

5.12 In summary, it is proposed that the Council use the flexibility offered by the statutory guidance to:-

- Repay debt in relation to PPP / PFI assets over their useful life rather than the contract term;
- Repay this debt over the useful lives noted at paragraph 5.8; and
- Apply the Annuity method to repay this debt for the reasons set out in paragraph 5.10.

6. FINANCIAL IMPLICATIONS

6.1 The projected benefits from deploying the accounting flexibility, on the basis of the proposals set out in Section 5, vary from scheme to scheme. This is because of the different contract periods remaining and the varying levels of capital cost to create the assets. Appendix A (covering the 4 Council schemes) gives the details of the current repayment amounts, the revised repayment amount now being proposed based on the useful lives assumed in Section 5 and the savings / cost increases which arise.

6.2 The Appendix also shows the impact of the savings and cost increases in Net Present Value (NPV) terms which takes into account the time value of money. The total repayment of debt before and after deployment of the flexibility is unchanged. However, it may be noted that, in NPV terms, the proposals represent a saving over the whole term of the debt repayment. This demonstrates that what is being proposed is prudent and in line with best value principles.

6.3 The results from Appendix A are summarised in Table 2 below covering the 4 Council PFI / PPP schemes. Table 2 assumes that the Council applies the accounting change to service concessions arrangements in financial year 2022/23.

Table 2 – Summary of Benefits

	A92 £M	**Arb Schools £M**	**For & Car Schools £M**	**Forfar Campus £M**	**Totals £M**
One-off Benefit pre 2022/23	9.5	0.8	6.3	3.5	*20.1
One-off Benefit in 2022/23	0.8	0.4	0.8	0.9	*2.8
Total One-Off Benefit	**10.3**	**1.2**	**7.1**	**4.3**	**22.9**
Ongoing Benefit from 2023/24	**0.8**	**0.4**	**0.8**	**0.9**	***2.9**

*these figures are highlighted in green in Appendix A

Use of Financial Benefits

6.4 The level of one-off benefit is significant (£22.9m) and specific proposals on the use of this are covered in Report 57/23 for this meeting but include a number of measures intended to reduce the Council's ongoing cost base. Appendix A shows that the ongoing benefit is around £2.8m to £2.9m in the 3 years 2023/24 to 2025/26 and then increases until 2033/34. After that the benefit reduces and from 2038/39 becomes an additional cost. The benefit in the initial 3 years averages £2.9m and remains at least at that level for another 11 years thereafter. It can, therefore, be considered an ongoing benefit and £2.9m has thus been provided for in the 2023/24 revenue budget.

Longer Term Budget Implications

6.5 Appendix A ("Total (reduction / cost)" column) shows that there will be additional costs to be borne from financial year 2038/39 until 2068/69 ranging from £1.2m initially up to £5.9m and then falling again to £0.85m in the final year. The cost legacy from 2038/39 onwards is a natural consequence of re-profiling the capital cost of the PFI / PPP asset. Successor councils will need to ensure that future taxpayers pay an equitable share of the assets to address these additional costs at the appropriate time, but this is not expected to be an issue for the reasons stated below.

6.6 At present the Council's budget includes provision to meet PFI / PPP payments due to contractors. In financial year 2022/23 this amounts to £19.3m gross. The Council receives £7.2m of grant support for these payments which will cease when the contracts end. This means that there is a net budget provision of £12.1m built into the Council's base budget at present. This figure will need to increase year on year to address contractual inflationary increases. This budget provision covers more than just the cost of debt so can't be compared directly with the figures in Appendix A. Nevertheless, at the point at which each PPP / PFI contract naturally comes to an end the Council will have adequate provision within its base budget to continue to meet the remaining debt costs. These debt cost would continue to be payable but now alongside ongoing maintenance and other costs for the asset which would now become the Council's responsibility rather than that of the contractor. It is also highlighted that the PFI / PPP contract end dates span an 8 year period which will allow a phased approach to addressing this within the Council's future revenue budgets.

Implications for Payments to PFI / PPP Contractors

6.7 It is important to point out that the service concession accounting change does not change the unitary charge payments made by the Council to the contractor in any way – those will continue to be made in line with the original contracts until those contracts expire. This means the Council will still pay out the same amount of cash to the contractor. The PFI / PPP contractors will not be paid any more or less and will not be paid for any longer than planned under the accounting policy change which only affects how the Council accounts for the debt element of the payments it makes to those contractors.

Implications for the Council's Cash/Treasury Position

6.8 Since the Council will continue to pay out the same amount of cash payments to PFI / PPP contractors, the financial benefit arising is in the form of a boost to the Council's Reserves. Applying the flexibility therefore gives us an accounting benefit in our General Fund Reserve, but we can only use that benefit in practice if we have the cash balances to support it. Applying the change will increase the Council's Capital Financing Requirement which is our underlying need to borrow. This reflects the correction of the overborrowing that the Council has theoretically undertaken in prior years. This overborrowing position will be addressed through a reduction in our cash investments / balances rather than via extinguishing borrowing / loans. The implications of this will require to be managed through the Council's Treasury Management approach and the existing cash flow management arrangements. This may result in increased borrowing costs as interest will be incurred, however, there are many other factors which influence treasury management activities and cash flow such as levels of slippage, grant profiles, expenditure patterns, interest rates and our budget provision for Capital Financing Costs. Therefore, this requirement to borrow will be managed in totality and the working assumption is that any additional costs can be met from existing the Capital Finance Costs budget.

7. EQUALITY IMPACT ASSESSMENT

7.1 An Equality Impact Assessment screening has been undertaken and a full EIA is not required as there is no impact on people and it is a technical report concerning accounting policy.

NOTE: The background papers, as defined by Section 50D of the Local Government (Scotland) Act 1973 (other than any containing confidential or exempt information) which were relied on to any material extent in preparing the above report are:

- Local Government Finance Circular 10/2022: Accounting for Service Concession Arrangements, Leases and Similar Arrangements

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List of Appendices:
Appendix A: Angus Council Service Concessions