
NORTH AYRSHIRE COUNCIL

15 February 2023

North Ayrshire Council

Title:	Review of Accounting Arrangements for PFI and Similar Contracts
Purpose:	To seek approval of Council to revise the current methodology used to determine the statutory repayment of debt charged to the General Fund in relation to the Council's service concession contracts.
Recommendation:	That Council approve the adoption of the revised accounting arrangements under Local Government Finance Circular 10/2022 for the recalculation of debt repayments arising from the Council's service concession contracts aligned to the useful economic life of the assets under the contracts.

1. Executive Summary

- 1.1 This report was originally presented to Council on 14 December 2022. A motion was subsequently approved, and the Council agreed as follows: "(a) that officers organise an all-Member briefing to fully understand the decision to be made and the potential implications of it; and (b) thereafter, the report be submitted to the meeting of the full Council on 15 February 2023 for decision". An all-member briefing was delivered by the Head of Finance on the 20 January, 2023. This included a presentation on the proposed flexibility, and this was followed by a discussion with elected members.
- 1.2 The Scottish Government has issued Finance Circular 10/2022 to all local authorities which enables the application of a financial flexibility in relation to the accounting for service concession arrangements, leases and similar arrangements. Under this flexibility, the accounting arrangements in relation to the capital repayment element of the Council's PPP and DBFM contracts have been reviewed and it is recommended that these are adjusted in a manner consistent with the accounting for other local authority fixed assets financed through more traditional arrangements.
- 1.3 The adoption of an annuity-based repayment schedule is considered prudent, sustainable and affordable and will result in the rescheduling of charges to the General Fund over the 50 year useful economic life of the assets rather than the current contract terms. This will result in the release of a one-off retrospective

repayment adjustment of £21.546m with a short to medium term reduction in the annual debt repayment charges over the period to 2037/38.

- 1.4 It is emphasised that the reductions highlighted are purely in relation to timing and that the overall repayments charged to the General Fund remain unchanged. This change will result in repayment charges to the General Fund extending beyond the periods of 2037/38 for current PPP contracts and 2042/43 for the current DBFM contract to years 2056/57 and 2066/67 respectively.
- 1.5 It is proposed that the short to medium term cost reductions are considered as part of the Council's budget planning arrangements over the medium-term and are applied to address the rising cost pressures within the 10-year General Services Capital Programme. The retrospective element of this change would be utilised to help temporarily and partially mitigate the significant challenges identified in the budget gap within the medium-term General Services Revenue Budget. Due to the scale of the challenge it is recognised that this proposed flexibility would play a key role in managing the financial impact over the medium-term. Use of this flexibility, however, would have to be applied in a limited and controlled manner across several financial years, and critically, that this runs in parallel with more sustainable measures to reduce the cost base of the Council in line with available funding and the key priorities.

2. Background

- 2.1 During 2007/08, North Ayrshire Council entered into a 30 year PPP contract for the construction, maintenance and operation of four schools with a principal capital repayment value of £81.845m. Subsequently, during 2018/19, the Council entered into a 25 year Design, Build, Finance and Maintain (DBFM) contract for the provision of Largs Campus with a principal capital repayment value of £46.626m. The statutory accounting requirements in relation to these "service concession" arrangements requires Councils to separately identify the capital repayment elements of the unitary charge payments and account for them as debt repayments over the term of the respective contracts.
- 2.2 If these assets had been financed through traditional borrowing methods, the borrowing would have been managed through the Council's Loans Fund with the repayment of the principal capital element calculated over the useful economic life of the assets. In the case of schools, this would have resulted in repayment over a 50-year period rather than over the 25 – 30 year contract period currently in place, allowing for a lower annual charge to the General Fund over the longer repayment period. It should also be noted that the Council has previously undertaken a review of loans fund advances for all local authority assets in accordance with the Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016. The result of which led to the creation of the Council's £8.800m Investment Fund to support environmental, infrastructure and Community Wealth Building activity.
- 2.3 Representations from local authorities to Scottish Government ministers have highlighted the inherent anomaly in the current accounting treatment and the resultant issue in terms of inter-generational equity, whereby current Council Tax payers are required to meet the full cost of acquiring the schools while future generations will

continue to receive the benefit of the assets without any requirement to contribute towards the acquisition costs.

- 2.4 Under Local Government Finance Circular 10/2022 – Finance Leases and Service Concession Arrangements, the Scottish Government has outlined a provision for financial flexibility which will allow local authorities to apply a retrospective recalculation of the annual charges to the General Fund in relation to the principal capital repayment element of service concession arrangements, including PPP and DBFM contracts. There would be no change to the actual payments to the contractor or to the value of interest or service charges made against the General Fund and the schools would still transfer to North Ayrshire Council at the end of the current contract for nil consideration.
- 2.5 In order to apply this flexibility, the Finance Circular requires that the decision must be taken to full Council, setting out the reasons for the change and demonstrating that the change is prudent, sustainable and affordable over the life of the assets.
- 2.6 The tables attached at Appendix 1 highlight the current arrangements for charging the debt repayment element to the General Fund. This highlights that total principal repayments to 31 March 2022 were £28.755m with a further £99.716m due to be charged over the remaining period of the contracts, which are due to end in 2037/38 and 2042/43. This will result in total debt repayments of £128.471m over the 25-30 year period.
- 2.7 Under Finance Circular 10/2022, local authorities have the option to exercise a financial flexibility to align the statutory debt repayments to the asset life using either equal instalments or the annuity method.
- 2.8 Under the equal instalment's method the same amount of principal repayment is applied annually. The annuity method assumes that the total payments, including interest charges, are equal across all years, with the principal repayment increasing as the interest charge reduces. It has been determined that the annuity method appropriately reflects the consumption of the assets over their useful lives as maintenance costs tend to increase in later years. Further, it is recognised that the annuity method provides a fairer charge than equal instalments as it takes better account of the time value of money e.g., paying £1,000,000 in ten years' time is less of a burden than paying £1,000,000 now. The schedule of charges produced by the annuity method thus results in a consistent charge over an asset's life, considering the real value of the amounts when they fall due. It should also be stressed that the annuity approach is consistent with the repayment method adopted by North Ayrshire Council in relation to existing Loans Fund advance repayments under the current Treasury Management and Investment Strategy.
- 2.9 The application of the financial flexibility has been recalculated in Appendix 1 on the annuity basis, discounted using the interest rate implicit in the relevant contracts as specified in the Circular. These rates are 6.52% and 4.4% for PPP and DBFM respectively. This is consistent with the 5% annuity rate applied to standard Loans Fund repayment arrangement for more traditionally funded acquisitions over the same periods. On this basis, the total repayments remain at £128.471m.

- 2.10 It is important to emphasise that the service concession flexibility is a timing related transaction under which the total liability remains unchanged but is spread over a longer period aligned to the useful economic lives of the schools in question. The amount that would have been charged to the General Fund to 31 March 2022 is reduced to £7.209m with a further £121.262m due to be charged over the remaining period of the assets' useful economic lives, which have been calculated as 2056/57 and 2066/67 respectively. This will result in £86.664m of repayments, which would have been charged to the General Fund over the original repayment periods, being deferred and charged over the period 2038/39 to 2066/67, resulting in additional General Fund revenue pressures across those years.
- 2.11 As detailed in Appendix 1, the application of the financial flexibility on this basis will result in a retrospective financial benefit to 31 March 2022 of £21.546m with an average annual reduction in charges to the General Fund over the 10 year period to 2031/32 of £3.380m per year. However, the final accounting adjustments will be subject to further scrutiny and confirmation as part of the annual external audit.
- 2.12 As indicated in the Medium-Term Financial Outlook, considered by Council on 2 November 2022, it is currently recommended that the recurring element of the annual cost reductions is allocated to help address the rising cost pressures within the 10 year General Services Capital Programme, providing an additional element of headroom in relation to both inflationary pressures and borrowing costs.
- 2.13 In addition, it is recommended that the potential utilisation of the non-recurring, retrospective element is considered as part of the Council's Medium-Term Financial Planning. Due to the scale of the challenge, it is recognised that this proposed flexibility would play a key role in managing the financial impact over the medium-term. Use of this flexibility, however, would have to be applied in a limited and controlled manner across several financial years, and critically, that this runs in parallel with more sustainable measures to reduce the cost base of the Council in line with available funding and the key priorities..

3. Proposals

- 3.1 It is proposed that That Council approve the adoption of the revised accounting arrangements under Local Government Finance Circular 10/2022 for the recalculation of debt repayments arising from the Council's service concession contracts aligned to the useful economic life of the assets under the contracts.

4. Implications/Socio-economic Duty

Financial

- 4.1 The financial implications are as outlined in the report. The resultant adjustments to the debt repayment charges to the General Fund will be considered as part of the Medium Term Financial Plan 2023/24 to 2025/26.

It is the opinion of the Chief Finance Officer that the recommended adoption of the financial flexibility on an annuity basis is prudent and will contribute to the medium and long term financial planning arrangements of North Ayrshire Council.

Human Resources

4.2 None.

Legal

4.3 The application of this financial flexibility is an internal accounting adjustment for North Ayrshire Council and has no contractual implications in relation to the existing PPP or DBFM contracts.

Equality/Socio-economic

4.4 None.

Climate Change and Carbon

4.5 None.

Key Priorities

4.6 This proposal supports the key priority of “An efficient Council that maximises resources and provides value for money”

Community Wealth Building

4.7 None.

5. Consultation

5.1 The Finance Service has consulted with the Council's treasury advisors, Arlingclose Ltd, and our appointed external auditors, Audit Scotland, in the preparation of this report.

Mark Boyd
Head of Service (Finance)

For further information please contact **David Forbes, Senior Manager (Strategic Business Partner)**, on **01294 324551** or **DavidForbes@north-ayrshire.gov.uk**.

Background Papers

Medium-Term Financial Outlook 2023/24 to 2025/26

Appendix 1

	PPP			DBFM			Combined		
Financial Year	Current Profile	Revised Profile	Movement	Current Profile	Revised Profile	Movement	Current Profile	Revised Profile	Movement
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Pre 2022/23	22.113	5.737	(16.376)	6.642	1.472	(5.170)	28.755	7.209	(21.546)
2022/23	1.946	0.611	(1.335)	1.764	0.334	(1.430)	3.710	0.945	(2.765)
2023/24	1.926	0.651	(1.275)	1.762	0.349	(1.413)	3.688	1.000	(2.688)
2024/25	2.305	0.693	(1.612)	1.890	0.364	(1.526)	4.195	1.057	(3.138)
2025/26	2.375	0.738	(1.637)	1.911	0.380	(1.531)	4.286	1.118	(3.168)
2026/27	2.512	0.787	(1.725)	1.870	0.397	(1.473)	4.382	1.184	(3.198)
2027/28	2.752	0.838	(1.914)	1.789	0.415	(1.374)	4.541	1.253	(3.288)
2028/29	3.120	0.893	(2.227)	1.787	0.433	(1.354)	4.907	1.326	(3.581)
2029/30	3.261	0.951	(2.310)	2.080	0.452	(1.628)	5.341	1.403	(3.938)
2030/31	3.540	1.013	(2.527)	1.874	0.472	(1.402)	5.414	1.485	(3.929)
2031/32	3.826	1.079	(2.747)	1.855	0.493	(1.362)	5.681	1.572	(4.109)
2032/33	3.917	1.149	(2.768)	1.889	0.514	(1.375)	5.806	1.663	(4.143)
2033/34	3.988	1.224	(2.764)	1.957	0.537	(1.420)	5.945	1.761	(4.184)
2034/35	5.211	1.304	(3.907)	1.945	0.561	(1.384)	7.156	1.865	(5.291)
2035/36	5.551	1.389	(4.162)	1.746	0.585	(1.161)	7.297	1.974	(5.323)
2036/37	5.913	1.479	(4.434)	1.589	0.611	(0.978)	7.502	2.090	(5.412)
2037/38	7.589	1.576	(6.013)	1.588	0.638	(0.950)	9.177	2.214	(6.963)
2038/39		1.679	1.679	1.769	0.666	(1.103)	1.769	2.345	0.576
2039/40		1.788	1.788	2.022	0.695	(1.327)	2.022	2.483	0.461
2040/41		1.905	1.905	2.141	0.726	(1.415)	2.141	2.631	0.490
2041/42		2.029	2.029	2.235	0.758	(1.477)	2.235	2.787	0.552
2042/43		2.161	2.161	2.521	0.791	(1.730)	2.521	2.952	0.431
2043/44		2.302	2.302		0.826	0.826	-	3.128	3.128
2044/45		2.452	2.452		0.862	0.862	-	3.314	3.314
2045/46		2.612	2.612		0.900	0.900	-	3.512	3.512
2046/47		2.782	2.782		0.940	0.940	-	3.722	3.722
2047/48		2.963	2.963		0.981	0.981	-	3.944	3.944
2048/49		3.157	3.157		1.024	1.024	-	4.181	4.181
2049/50		3.363	3.363		1.069	1.069	-	4.432	4.432
2050/51		3.582	3.582		1.116	1.116	-	4.698	4.698
2051/52		3.815	3.815		1.165	1.165	-	4.980	4.980
2052/53		4.064	4.064		1.217	1.217	-	5.281	5.281
2053/54		4.329	4.329		1.270	1.270	-	5.599	5.599
2054/55		4.611	4.611		1.326	1.326	-	5.937	5.937
2055/56		4.912	4.912		1.385	1.385	-	6.297	6.297
2056/57		5.227	5.227		1.445	1.445	-	6.672	6.672
2057/58			-		1.509	1.509	-	1.509	1.509
2058/59			-		1.575	1.575	-	1.575	1.575
2059/60			-		1.645	1.645	-	1.645	1.645
2060/61			-		1.717	1.717	-	1.717	1.717
2061/62			-		1.793	1.793	-	1.793	1.793
2062/63			-		1.872	1.872	-	1.872	1.872
2063/64			-		1.954	1.954	-	1.954	1.954
2064/65			-		2.040	2.040	-	2.040	2.040
2065/66			-		2.130	2.130	-	2.130	2.130
2066/67			-		2.222	2.222	-	2.222	2.222
	81.845	81.845	(0.000)	46.626	46.626	0.000	128.471	128.471	(0.000)