Executive Board – 12th March 2021

Subject:	Request to Ministry of Housing, Communities and Local Government (MHCLG) to capitalise revenue costs (capitalisation)
Corporate Director(s)/Director(s):	Clive Heaphy, Strategic Director of Finance
Portfolio Holder(s):	Councillor Sam Webster, Portfolio Holder for Finance, Growth and the City Centre
Report author and contact details:	Clive Heaphy, Strategic Director of Finance

Subject to call-in: ☐ Yes ☒ No

Key Decision: ☒ Yes ☐ No

Criteria for Key Decision:

(a) ☒ Expenditure ☐ Income ☐ Savings of £1,000,000 or more taking account of the overall impact of the decision

and/or

(b) Significant impact on communities living or working in two or more wards in the City

☒ Yes ☐ No

Type of expenditure: ☒ Revenue ☒ Capital

Total value of the decision: See Finance Comments £20m capitalisation

Wards affected: City Wide

Date of consultation with Portfolio Holder(s): December 2020 to March 2021

Relevant Council Plan Key Theme:

Nottingham People	☒
Living in Nottingham	☒
Growing Nottingham	☒
Respect for Nottingham	☒
Serving Nottingham Better	☒

Summary of issues (including benefits to citizens/service users):

Following a review of its financial resilience, the Council has requested MHCLG to issue it with a Capitalisation Direction to enable it to

i. Avoid over-drawing on reserves in 2020/21 and thus reducing its ability to finance current and future risks;

ii. Fund a comprehensive change management programme to enable it to meet the recommendations of the Non-Statutory Review (NSR).

The Chair of Overview and Scrutiny Committee has approved this report to be exempt from call in because the timescales set by MHCLG to notify them of a decision would not permit call in.

Exempt information:

None

Recommendation(s):

1 To note the Secretary of State's current position on capitalisation and agree to accept a capitalisation package in the sum of £35m as requested on 23rd December 2020, noting that £20 million for 2021/21 is on terms that are certain, and that the balance of up to £15m will be subject to further confirmation from the Secretary of

	State, subject to demonstrating need and mutually agreeable terms.
2	To agree to accept a Capitalisation Direction for 2020/21 for £20m on terms set out in Appendix A.
3	To note that the Secretary of State is minded to issue a Capitalisation Direction for 2021/22 later in the financial year subject to evidence of ongoing need and to certain conditions being met as set out in Appendix B and paragraph 2.6 below
4	To delegate authority to make the necessary accounting adjustments in 2020/21 and 2021/22 to the Strategic Director of Finance in consultation with the Portfolio Holder for Finance, Growth and the City Centre.

1 Reasons for recommendations

1.1 The Government-led Non-Statutory Review (NSR) undertaken in November 2020 by Max Caller CBE, highlighted that *"Nottingham City Council is not in a position to prepare and approve the legally required balanced budget for 2021/22, without significant external support or the imposition of spending reductions, which would not be likely to deliver services that meet their statutory duties."*

1.2 The Council was able to set a legally balanced budget for 2021/22, but it did so through a combination of the identification of £16.7m savings and a favourable spending settlement from the Government. Even so, it will require the use of an estimated £9.5m reserves (including estimated redundancy costs) to balance the budget.

1.3 The NSR required the Council to submit a detailed Recovery and Improvement Plan and established an Improvement Board to oversee progress against the plan over the next 3 years. In the event of a failure by the Council to demonstrate progress in its recovery, the Secretary of State will consider whether it is appropriate to use the Best Value powers available, including the appointment of Commissioners

1.4 The NSR followed on from a Public Interest Report (PIR) by its External Auditor in August 2020 following a decision to sell the customer book of Robin Hood Energy to a 3rd party and accept losses expected to be in the order of £38m.

1.5 The 2020/21 Interim Budget in September 2020 sought to address both the costs of RHE and costs/loss of income from COVID-19 and required the use of £71.2m of reserves – almost 50% of its total reserves. Although the latest published forecast outturn is estimating an improved position, it will still require some £56.1m (period 9) of reserves to be used which leaves it with little resilience to future financial shocks.

1.6 Looking forward, the NSR identified the need to "transform or reimagine" services in order to manage finances on a multi-year basis. The Council will need to fund a major change programme to boost capacity and specialist capability if it is to truly transform its services and move to a sustainable medium term planning and financial horizon.

1.7 The Council's finances were closely reviewed as part of the 2021/22 budget setting process including its reserves, likely calls for support from some of its companies (whose trading positions have been impacted by COVID-19) and the future risks and challenges faced by the Council as a result of COVD-19 and other service pressures. This includes identifying significant funding gaps for 2021/22 and 2022/23, for which plans will need to be developed in order to address those gaps

1.8 In order to both maintain its resilience (and that of its wholly owned companies) in the face of ongoing and future financial pressures *and* deliver a major change programme to transform its services, the Council will need to access additional financial resources. For these reasons, it was considered appropriate that a request for capitalisation of £35m of costs be made to maintain financial resilience (£20m) and fund a comprehensive change programme (£15m).

1.9 Capitalisation is a process that allows Councils to treat certain revenue (day to day) costs as capital expenditure and hence to spread those costs over a number of years – in the case of NCC to avoid reducing reserves too quickly and to fund a major change programme. This action requires Government approval.

1.10 Transformation will be critical in delivering on the council's adopted Recovery and Improvement Plan, to ensure that we council can deliver its policy priorities and statutory duties within a framework of sustainable medium term finances.

1.11 In arriving at his decision, the Secretary of State considered the views of the MHCLG appointed Improvement and Assurance Board who reviewed the council's logic for submitting a capitalisation request.

1.12 The Council sought this direction because it determined it to be a prudent response to the financial challenges it faced and its lack of financial reliance to deal with those challenges. Although the financial forecast for 2020/21 period 9 has improved compared with the Interim Budget in September 2020 it will still need to utilise c£56m of reserves and is financially weaker to deal with future challenges and risks without capitalisation than it would like.

1.13 Having applied for and been offered capitalisation, on terms broadly expected, to reject it would risk damaging the Council's credibility and should the Council continue to find itself under financial stress or in financial difficulty, this route would not be open to it again.

2 Background (including outcomes of consultation)

2.1 The background to this request to MHCLG is set out in section 1 above.

2.2 The request to MHCLG was submitted on 23rd December 2020 and subsequent to that, extensive and regular meetings were held and documents submitted. On Friday 5th March 2021, a response was received from MHCLG, too late to include in budget papers. The response concluded that *"The Secretary of State has now fully considered the capitalisation request and although this does not constitute a capitalisation direction, this letter sets out his current position."* The letter goes on to state that: -

2.3 *"With respect to the financial year of 2020/21, the Secretary of State is content to approve a total capitalisation direction to fund revenue expenditure not exceeding £20 million, subject to conditions. The conditions would be set out in the capitalisation direction when issued."* The proposed conditions are shown in Appendix A to this report. It is expected that the Direction would expire on 31st March 2021 and authority to draw any further sums would lapse and not be renewed.

2.4 *With respect to the financial year of 2021/22, the Secretary of State is* *<u>minded to</u>* *approve a capitalisation direction of a total not exceeding £15 million. Again, such a direction may be subject to conditions, which will be set out in the capitalisation direction when issued. If the Secretary of State decides to give a direction, he expects to confirm the final amount of capitalisation support and any conditions that would be applied in summer 2021. His consideration will include taking account of the following."* The proposed conditions are shown in Appendix B to this report. The Secretary of State also reserves the right to attach additional bespoke conditions to a direction in respect of 2021/22 depending on the Council's individual circumstances.

2.5 At its meeting of 8th March 2021, the Council agreed a voluntary debt reduction policy, the impact of which would be a reduction in borrowing of £150m over the next 4 years. In spite of this, the letter also includes a clause stating that "*The Secretary of State will also seek an assessment from the Improvement Board on options for limiting the Council's borrowing, in line with the recommendation in the non-statutory review, and this could include using statutory powers."*

2.6 The Secretary of State also reserves the right to attach additional bespoke conditions to a direction in respect of 2021/22 depending on the Council's individual circumstances.

2.7 In accepting the recommendations in this report, the Council would be agreeing to accept the overall capitalisation package of £35m.

2.8 For 2020/21, this would lead to an immediate capitalisation direction of £20m to be drawn by 31 March 2021. Rejection of the 2020/21 Capitalisation Direction would constitute rejection of the entire package.

2.9 For 2021/22, the Secretary of State is 'minded to' support a further Capitalisation Direction but this would be subject to an assessment in Q3 2021/22, in conjunction with the Improvement Board, on whether further capitalisation was still needed and whether the terms indicated in this report along with any other 'bespoke' terms proposed by the Secretary of State at that time, were acceptable.

3 Other options considered in making recommendations

3.1 The alternative approach – not to seek a Capitalisation Direction - would have left the Council highly exposed to more and greater financial risks from COVID-19, service pressures, and the adverse trading condition faced by its wholly-owned companies.

3.2 In addition, the Council would be unable to fund a major change programme leading to transformed services necessary to successfully deliver its range of statutory and non-statutory functions within a cost envelope that is demonstrably affordable over the medium term.

4 Finance colleague comments (including implications and value for money/VAT)

4.1 Capitalisation would permit the Council to treat revenue expenditure incurred in 2020/21 as capital expenditure and thus allows it to spread its costs over a number a number of years. It would also allow the Council to meet the costs of transformation and redundancy as well as providing for bad debts in relation to its wholly owned companies.

4.2 Taking advantage of the full £20m capitalisation direction in 2020/21and the maximum term of 20 years would increase the Capital Financing Requirement (CFR) by £20m in 2020/21. This would trigger a 1% premium on the PWLB loan associated with this increase in CLF.

4.3 The current interest rate of payable on 20 year loans is 2.80% based on the 20 year standard PWLB rate and a 1% premium. The average cost of financing this would be £1.3m per year and would commence in 2021/22.

4.4 The Interim Budget had assumed that the Council would borrow £31.3m from its own PFI reserve to part fund a deficit of £71.2m. Following Tranche 4 COVID funding and quarter 3 underspending, this requirement to borrow fell from £31.3m to £17.4m assumed over a period of 5 years with average repayments of c£3.4m per annum, ranging from £2.4m in 2021/22 to £5m in 2022/23.

4.5 The forecast level of reserves at 1 April 2021 are currently estimated to be

4.5.1 Unearmarked £12.6m

4.5.2 Earmarked c£102.0m

Most earmarked reserves are set aside for specific purposes and hence not useable to support revenue expenditure.

4.6 Capitalisation would avoid the need to borrow from reserves and yield an average revenue saving of £2.2m per annum, ranging from £1.1m in 2021/22 to £3.7m in 2022/23, by adopting capitalisation over the full 20 years.

4.7 Without capitalisation, the Council could fund the 2021/22 budget gap of £2.3m but would be unable to meet the estimated £15m to fund a major change programme and would not be able to deliver the transformation needed to move towards a medium term services and financial framework.

4.8 The impacts of a further £15m capitalisation in 2021/22, should it both be offered and accepted will depend upon a number of variables including the conditions of acceptance, interest rate at that time and any premium deemed payable by the Secretary of State

Theresa Channell, Head of Strategic Finance, 10th March 2021

5 Legal and Procurement colleague comments (including risk management issues, and legal, Crime and Disorder Act and procurement implications)

5.1 The decision to accept, or reject, any Capitalisation Direction should, ideally, be taken having full regard to all the terms and conditions associated with it.

In the case of the initial offer of £20m, these are set out in Appendix A below. With regard to the second tranche, the Council is only in receipt of draft proposed conditions (see Appendix B) which will be finalised at a later date. Whilst this is not ideal from the Council's perspective its options appear to be limited to either accepting or rejecting the overall offer.

In all other regards the recommendation to accept the offer of a Capitalisation Direction raises no significant legal issues and is supported.

Malcolm R. Townroe – Director of Legal and Governance 10 March 2021

6 Strategic Assets & Property colleague comments (for decisions relating to all property assets and associated infrastructure)

6.1 Not applicable

7 Social value considerations

7.1 Not applicable

8 Regard to the NHS Constitution

8.1 Not applicable

9 Equality Impact Assessment (EIA)

9.1 Has the equality impact of the proposals in this report been assessed?

No ☒

An EIA is not required because this does not represent a change of policy that will impact on equality.

Yes ☐

10 List of background papers relied upon in writing this report (not including published documents or confidential or exempt information)

10.1 None

11 Published documents referred to in this report

11.1 None

Appendix A

2020/21 Capitalisation Direction - Proposed Conditions

The Secretary of State is content to approve a total capitalisation direction to fund revenue expenditure not exceeding **£20 million**, subject to conditions.

The conditions would be set out in the capitalisation direction when issued.

The conditions are as follows:

A. The Authority may only capitalise expenditure when it is incurred;

B. Where expenditure is capitalised, that the Authority shall charge annual Minimum Revenue Provision using the asset life method with a proxy 'asset life' of no more than 20 years, in accordance with relevant guidance;

C. Where the Authority's capital financing requirement is increased as a result of the capitalisation of expenditure under this direction, any further borrowing from the date of the capitalisation letter up to and including, but not exceeding, the increase in the financing requirement must be obtained from the PWLB and must be subject to an additional 1 percentage point premium on the interest rate above the rate the loan would otherwise be subject to. This requirement does not apply to borrowing in relation to your Housing Revenue Account. Where any borrowing to which these conditions initially apply is refinanced, the conditions must continue to apply to the resulting borrowing;

D. The Authority continues to make good progress against its Recovery Plan, as assessed by the Improvement and Assurance Board in their regular reports to the Secretary of State.

Appendix B

2021/22 Capitalisation Direction – Draft Proposed Conditions

With respect to the financial year of 2021/22, the Secretary of State is ***minded to*** approve a capitalisation direction of a total not exceeding £15 million. Again, such a direction may be subject to conditions, which will be set out in the capitalisation direction when issued.

If the Secretary of State decides to give a direction, he expects to confirm the final amount of capitalisation support and any conditions that would be applied in summer 2021.

His consideration will include taking account of the following:

A. Evidence that the conditions set out in any capitalisation direction in respect of 2020/21 have been complied with;

B. Evidence from the Improvement Board of the Authority's progress against its Recovery Plan, as reflected in forthcoming progress reports from the Board;

C. Evidence from the Improvement Board of the Authority's financial position and its ability to meet any or all of the identified budget gap without additional borrowing;

D. Evidence from the Improvement Board, and the Authority's forthcoming Asset Disposal Strategy and Debt Management Strategy;

E. Evidence against the other areas of Improvement as identified in the Board's February update to the Department including progress made to change the culture of the organisation, as well as delineation of the respective roles and responsibilities of both officer and member teams, providing clarity of decision making and accountability, and implementation of organisational development strategy.

F. Evidence and recommendations from the Improvement Board on the steps that the Authority may need to take to, for example, improve its governance arrangements, financial management, operational delivery and to reduce risk, ensuring that transformation is at the heart of the Recovery Plan.