Mr J Haswell  
Chief Finance Officer  
Pembrokeshire County Council  
County Hall  
Haverfordwest  
SA61 1TP

Dear Mr Haswell

Minimum Revenue Provision for the redemption of debt

A number of local authorities in Wales have approached their audit teams recently regarding their approach to setting a prudent provision for the redemption of debt as required by the Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 (as amended). As this is an area that is under consideration by a number of bodies, you may find it useful to see our views on this area in our role as the external auditor and on the factors that authorities should take into account when determining their policy.

Statutory basis for the provision for the redemption of debt

Under regulation 21 of the Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 as amended ("the Regulations") local authorities (including police, fire and national park bodies) must charge to a revenue account a minimum revenue provision (MRP) in respect of capital expenditure incurred in a prior year.

Until 2008, MRP was calculated in accordance with a formula set out in the Regulations. In 2008, this requirement was replaced by Regulation 22 (Calculation of minimum revenue provision) which states "A local authority must calculate for the current financial year an amount of minimum revenue provision which it considers to be prudent."

Welsh Government statutory guidance

In March 2008, the Welsh Government published statutory guidance entitled "Guidance on Minimum Revenue Provision." Local authorities in Wales are required to have regard to this guidance. The guidance notes that the prudent amount of provision should normally be determined in accordance with the principle that:

"The broad aim of prudent provision is to ensure that debt is repaid over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by the Welsh
Assembly Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant."

It goes on to note that Welsh Ministers consider that the methods of making prudent provision include four options set out in the guidance but notes that approaches differing from those exemplified are not ruled out.

**Our role as the external auditor**

As stated in the Regulations, the responsibility for determining what is a prudent MRP lies with the Authority. It is not the role of the external auditor to determine for the authority what is prudent.

In relation to the financial statements, auditors will routinely check that an MRP has been calculated and charged to a revenue account. We also have a responsibility to consider whether there are any matters which come to our attention during the course of the audit that should be brought to the attention of the public. This responsibility includes consideration of whether or not the Authority has complied with its statutory duties. Therefore audit teams will consider the approach taken by authorities in setting MRP.

**Welsh Government statutory guidance**

Authorities are required to have regard to the Welsh Government guidance when determining a prudent MRP. The Guidance states that MRP should be set at a level reasonably commensurate with the expected life of the asset or reasonably commensurate with the period implicit in the determination of Revenue Support Grant (RSG).

The Guidance contains four examples of how a prudent MRP may be determined. These are not exhaustive. In our view, these form a base line against which an authority’s policies can be measured.

Under options 1 and 2 (as set out in the Guidance) a prudent MRP could be calculated at 4% reducing balance based on the Capital Financing Requirement. Authorities will be aware that RSG calculations include an element of funding for supported borrowing on a 4% reducing balance basis. Therefore, under this method MRP would be consistent with the funding stream from the Welsh Government.

Where an authority wishes to change its MRP for supported borrowing to an amount lower than 4% reducing balance, we would expect the authority to be able to demonstrate that:

- The lower charge more accurately reflects the lives of assets employed by the authority; or
• The lower charge is reasonably commensurate with the period implicit in the determination of RSG (i.e. a 4% reducing balance basis).

**The Well-being of Future Generations (Wales) Act 2015**

Reducing MRP now will inevitably increase the charges that must be made in future years. For example, reducing MRP from a 4% to a lower rate will mean that an authority will have a lower MRP charge in the early years but in future years, MRP will exceed the amount that would be charged at 4% reducing balance thus increasing costs in future years.

The Well-being of Future Generations (Wales) Act 2015, when fully commenced, will put in place a “sustainable development duty” and a requirement to perform that duty in accordance with a "sustainable development principle". As part of the sustainable development duty, authorities must set and pursue well-being objectives to contribute to the well-being goals set out the Act. Doing something “in accordance with the sustainable development principle” means that the body must “act in a manner which seeks to ensure that the needs of the present are met without compromising the ability of future generations to meet their own needs”. It also requires that authorities must take account of, among other things, “the importance of balancing short term needs with the need to safeguard the ability to meet long term needs”.

It appears therefore that local authorities need to make sure that when making decisions in respect of MRP that relate to actions taken in pursuit of their well-being objectives (or other sustainable development action) they act in a manner which seeks to ensure that the needs of the present are met without compromising the ability of future generations. Similarly, in respect of such decisions, it appears that they should take into account the importance of balancing short term needs with the need to safeguard the ability to meet long term needs. An authority wishing to modify its MRP policy should therefore consider how the amended policy would affect its compliance with its legal duties under the Well-being of Future Generations Act.

**Asset lives**

Some authorities have considered the assets lives for those assets financed by supported borrowing and whether or not there is scope for modifying the MRP charge to more accurately reflect asset lives albeit retaining the reducing balance basis.

Authorities should note that the percentage applied under a reducing balance method does not readily translate into the equivalent of an asset life. For example, a 3% reducing balance does not equate to a 33 year asset life. After 33 years, 38% of the original debt will not have been provided for. In comparison, a 4% reducing balance leaves 27% not provided for after 33 years. After 50 years, the unprovided balances are 22% (at 3% reducing balance) and 13% (4% reducing balance). Applying a reducing balance basis
will mean that the debt is never fully extinguished and therefore may significantly outlast the related assets. At 3% reducing balance, debt is only 95% provided for after 100 years (4% - 75 years). The following chart illustrates how much of debt remains unprovided for over time on a 4%, 3% and 2% reducing balance basis.

### Reducing balance of unprovided debt

Where authorities wish to make a prudent provision based on asset lives, they may wish to consider an alternative to the reducing balance model (e.g. straight line or weighted to reflect consumption of service potential). For example, if an authority’s average asset live was 50 years and it determined to provide MRP on a 2% straight line basis, the amount of the loans unprovided for each year would be as shown below. In this case, the debt is fully provided for after 50 years.
Setting MRP on a cumulative basis

In some cases, authorities have charged MRP since 2008 at a higher level than that suggested by the Welsh Government guidance. For example:

- MRP provided at 4% straight line rather than 4% reducing balance; or
- MRP provided at 5% reducing balance rather than 4% reducing balance.

In some cases, authorities now wish to change their MRP charge to a 4% reducing balance, in line with the guidance. In these circumstances, MRP provided from 2008 to 2015 will have been greater than if a 4% reducing balance calculation had been applied since 2008. It has been suggested that authorities are able to take advantage of such an 'over-provision' and set MRP in the first year of the new policy such that the cumulative MRP charged since 2008 is as would have been calculated under the amended policy. The impact of this is to set a reduced, a zero or even a negative MRP in the first year of the amended policy.

At present we would not be minded to challenge the overall approach of setting the current year MRP taking into account the cumulative differences between the amended and original policies subject to the following.
The Regulations require an authority to make a prudent provision for the financing of capital expenditure. The statutory guidance refers to redemption i.e. the clearing, of debt. Adjusting the current year MRP to take account of the differences between the amended and original policies may result in a negative or a zero MRP in one year:

- A negative MRP would have the effect of increasing the amount of unprovided debt. In our view, setting a negative MRP would therefore be contrary to law.
- In our view, where there is a positive Capital Financing Requirement and an authority wishes to set MRP at £0, it needs to be very clear how such a provision meets the requirement to make a prudent provision.

If in future, the MRP policy were to be changed again and a higher MRP charged, the authority should then consider also calculating MRP in the first year on a cumulative basis, noting that this would result in a significantly higher MRP in the first year of a revised arrangement.

**Impact on changes on MRP provided in year**

The following chart exemplifies the impact of MRP calculated on a reducing balance basis at 3% and 2% compared with 4% based on £10m CFR. In both cases, in the early years an authority makes savings. However, after a period of 25-35 years, MRP will be greater than that charged at 4%.
Conclusion

As explained above, it is for each authority to determine what is a 'prudent' MRP.

In our view, where an authority has used unsupported borrowing to finance its capital programme, a prudent MRP should reflect the asset lives. For supported borrowing, authorities may consider whether it is more appropriate to use asset lives or to consider Welsh Government funding via RSG.

Where an authority wishes to change its policy, we would encourage them to discuss the proposals with their external audit team at an early stage. We would also encourage authorities to ensure that any proposals are properly supported by adequate evidence and professional advice to justify the provision made.

Please note that these comments do not constitute guidance and should not be relied upon as such. The comments also reflect our current thinking in relation to MRP and this letter does not preclude us from coming to a different conclusion at a later date, based on particular circumstances.

Yours sincerely

[Signature]

Anthony Barrett
Assistant Auditor General