

Investment in Local Authority Assets in Wales

*The 2001 Report
of the Capital Sub Group*

October 2001

1. SUMMARY

Introduction

1. This report has been prepared by the Capital Sub Group for consideration by the Consultative Forum on Finance and the National Assembly for Wales. It draws on information provided by all authorities in Wales on their capital expenditure for the current financial year and previous year, as well as the Assembly's budget plans for the next two years.
2. The purpose of the report is to report on aspects of the group's work with respect to the capital finance system, including the formula used to distribute general capital funding, and to set out from local government's perspective the business case for continuing investment in capital expenditure by local authorities.
3. The report makes clear where points are made on behalf of local government – in that respect, the report does not necessarily reflect the views of the Assembly officials who are members of the group or of the Assembly Cabinet. The main findings of the report, summarised in paragraph 1.5, are endorsed by the Capital Sub Group although there has not been sufficient time for Assembly officials to consider the main body of the report.

1.4 The report has 4 other aims, namely to:

- establish where capital expenditure is currently being spent and how it is being funded
- estimate future capital spending on the basis of the Assembly's budget plans and whether this meets the requirements for investment
- examine the work done in developing effective asset management strategies
- support the case for introduction of a prudential borrowing system, replacing central control in the form of credit approvals.

Main Findings

1.5 The main findings can be summarised as follows:

1. the group recommends only one minor change to the formula for distributing general capital resources for 2002-03: data on unemployment should be a 12 month average to September rather than an average of the figures for April and October (paragraph 2.7);
2. the capital investment needed to maintain local government assets worth over £9 billion cannot come solely from receipts following disposal of assets (paragraphs 2.2 to 2.5);
3. capital spending planned for 2001-02 is significantly higher than last year: up 17% in the case of councils (table 2) although some of this expenditure is dependent on the outcome of bids for capital finance. The growth is not the result of increased capital resources being provided by the Assembly (paragraphs 3.4 and 3.5);
4. capital expenditure on schools is increasing in absolute and relative terms. This trend is likely to continue (paragraphs 3.6 and 3.8);
5. growth in capital funding in Wales is significantly slower than in England, with the result that Wales' funding advantage has disappeared (paragraph 3.9);
6. a task and finish group has developed guidance on asset management plans, which could be put fully in place by 2006. The Association seeks clear policy encouragement and additional resources from the Assembly to kick start improvements to the asset management process (paragraphs 4.15 to 4.18);
7. the Association seeks additional capital funding from the Assembly over and above its budget plans. Examples of additional resources required are in paragraph 4.2;
8. the Association is disappointed that the Assembly is not introducing a major repairs allowance for 2002-03 and is concerned at proposals for a significant change in the way that social housing grant may be used (paragraphs 4.5 and 4.6);
9. the private finance initiative is contributing a growing amount of capital investment, particularly for schools (paragraph 3.3). The Association would support further bidding rounds for PFI projects only as a transitional measure before implementation of the prudential borrowing system, which will give a level playing field for capital investment decisions (paragraph 4.14);
10. the Association strongly supports the introduction of the prudential borrowing system and seeks implementation from 2004-05 (paragraph 4.19). A task and finish group has identified helpful changes that the Assembly could make to the current capital finance system in the meantime (paragraph 4.10).

The business case for capital investment by local authorities

1. At 31 March 2000 local authorities in Wales reported capital assets worth over £9 billion with the bulk being represented by housing (£3.1 billion), schools (£2.3 billion) and transport including roads (£1.1 billion). A summary is in table 1.

Table 1 Local authority assets

	£ billion
Housing	3.134
Education	2.299
Highway and transport	1.057
Social services	0.244

Leisure services	0.778
"Home Office" services	0.247
Other (includes administrative buildings and depots)	0.787
Total operational assets	8.546
Investment properties	0.341
Other non-operational assets (includes assets under construction)	0.247
Total non-operational assets	0.588
TOTAL FIXED ASSETS	9.135

Source: Local Authorities Assets Statistics 31 March 2000, IPF

2. Local authorities must undertake capital investment in order to maintain the assets that they own. Buildings and other assets must be "fit for purpose" and comply with legislation on health and safety and disability discrimination. New assets may be required, and existing assets adapted or sold, to meet changing patterns of service delivery or shifts in population.
3. The level of investment necessary to sustain assets in this way cannot be funded wholly by disposal of other, surplus assets. While capital receipts make a valuable contribution of about £50 million every year to authorities' capital programmes, it is essential that those programmes are also supported by capital grants and borrowing.
4. In simplistic terms, the current level of capital expenditure represents about 6% of the value of the assets with capital receipts accounting for about a tenth of this figure. However this is not a like-for-like comparison because some expenditure (e.g. economic development grants) does not benefit local government assets. Also the valuation of assets says nothing about their condition and what investment is needed. If local highway infrastructure were valued on the same basis as the trunk roads maintained by the Assembly (replacement cost) it is expected that there would be a significant increase in reported values – which would result in a decrease in the simplistic percentage mentioned at the beginning of this paragraph.
5. On the basis of estimates provided by local and central government, the Audit Commission report "Capital Gains" identified a need to spend an extra £15 billion across Wales and England over 5 years to clear maintenance backlogs, bring existing assets up to acceptable standards and provide new assets to meet future demands. While the report concludes that this figure is exaggerated, it does not dispute that there is a substantial level of unmet need brought about by past underinvestment. Among more recent publications, the National Road Maintenance Condition Survey for 2000 (DETR, April 2001) has shown that the condition of local roads continues to deteriorate and is the worst ever recorded.
6. The following section analyses current capital programmes and estimates what level of investment the Assembly's budget plans will support in the following two years. The Welsh Local Government Association believes that existing funding plans continue to fall short of what is needed to meet requirements for investment and tackling backlogs in maintenance. For instance, the increase in contributions from revenue in 2001-02, despite the demands on front line services, suggests that

capital funding continues to be inadequate.

The formula for general capital funding

7. The group has kept under review the formula for distributing general capital funding. It recommends only one minor change for 2002-03. One quarter of the regeneration and other services element of the formula is distributed on the number of persons aged 18 or over who are unemployed. Previously this has been based on an average of the unemployment figures for April and October. The group recommends changing to an average of 12 months' unemployment data for the period up to September. This will ensure that any sudden peaks or troughs which could occur from using two months' data are smoothed out; and that the most up-to-date data are used in the capital funding announcements which are expected to occur earlier this year.

Capital investment by local government

3.1 Table 2 shows the investment made by local government in recent years and plans for the current year. This investment is supported by borrowing, capital grants, capital receipts and revenue contributions to capital expenditure.

Table 2: capital expenditure

	1999-2000		2000-01		2001-02	
	(outturn)		(provisional outturn)		(budgets)	
	£ million	%	£ million	%	£ million	%
Education	58.9	11.5%	71.9	13.7%	94.2	15.3%
Social services	8.2	1.6%	7.5	1.4%	9.7	1.6%
Roads & transport	73.8	14.5%	93.2	17.8%	102.1	16.6%
Culture & sport	26.5	5.2%	18.5	3.5%	28.2	4.6%
Environmental, regeneration & other services	149.6	29.3%	139.6	26.7%	154.3	25.1%
Housing	193.3	37.9%	192.9	36.8%	225.3	36.7%
Total: councils	510.3	100.0%	523.5	100.0%	613.7	100.0%
Police & fire	20.3		17.7		33.9	
Total	530.6		541.2		647.6	

Capital projects procured under the private finance initiative

- For 2000-01 onwards, we have begun to collect information on the capital value of assets procured under the private finance initiative (PFI) where the assets have been brought into use. These are not included in the figures in table 2. So far, all the assets reported relate to education.

Table 3: value of capital assets procured under PFI

	1999-2000 (outturn)	2000-01 (provisional outturn)	2001-02 (budgets)
	£ million	£ million	£ million
Councils	N/A	12.0	8.0

- The contribution from the PFI to total capital investment is expected to grow over the coming years as more projects are completed and brought into use. A secondary school and a primary school are already in operation, and substantial contracts have been signed for two comprehensive schools and a waste recycling facility. The Assembly has not provided additional resources for the latter project.

Trends in expenditure and funding

- There is a significant overall increase of 17% in councils' capital expenditure according to budgets for 2001-02. It is thought that some of this expenditure is dependent on the outcome of bids for capital finance. The growth is not being funded by an increase in mainstream capital funding from the National Assembly. Indeed, Assembly funding in 2001-02 is 3% *lower* than last year.
- The increased expenditure depends on an increased contribution from a combination of capital receipts, contributions from revenue and other sources of funding, of which European programmes are believed to be a major factor. Despite the pressures on front line services, councils are increasing their revenue contributions by £13.8m compared to last year, part of which may be from reserves.
- The effect of the Assembly's decision to provide relatively more resources for education, much of it being in the form of specific grant, has increased expenditure on schools in both absolute and relative terms. Schools also stand to benefit from significant investment through PFI over the next few years.

The Assembly's funding plans

3.7 Table 4 shows the Assembly's funding for capital investment together with total capital expenditure by councils.

Table 4: capital funding from the Assembly

	2000-01	2001-02	2002-03 (plans)	2003-04 (plans)
	£ million	£ million	£ million	£ million

Councils: expenditure	523.5	613.7	N/A	N/A
<i>Of which</i> - capital receipts, revenue contributions, funding from other sources	91.8	195.3	N/A	N/A
- Assembly funding (grants and credit approvals)	431.7	418.4	465.0	486.3
Year-on-year change in Assembly funding	N/A	-3.1%	+11.1%	+4.6%

8. The real-terms growth in capital funding from the Assembly in 2002-03 and 2003-04 should feed through to a growth in capital expenditure by councils. In particular, the capital grant for schools is expected to lead to a continued growth in spending on education, although the Association believes that this will only help with the backlog of maintenance: it will not necessarily tackle the need for improvement and remodelling of schools.
9. However it must be recorded that the growth in capital funding in Wales is not as significant in percentage terms as in England. Analysis by the Welsh Local Government Association suggests that the Assembly has chosen to give lower priority to capital investment by local government compared to other programmes (which include, of course, revenue funding for local government). It is difficult to be precise but it is estimated that, if the Assembly had passed on the Barnett formula consequential of changes in England, capital funding would have grown by about £125m-£200m in 2003-04 compared to budget plans that existed prior to the Comprehensive Spending Review in 2000. The actual increase over previously announced budget plans for 2003-04 is £83 million. The result is that the advantage in capital funding hitherto enjoyed by Welsh local government disappears this year. By 2003-04 Wales will have fallen significantly behind England. This analysis excludes the massive growth in support for PFI projects in England which is estimated to provide capital investment worth over £4bn in the three years beginning with 2001-02.

Table 5: comparison with capital funding in England

	2000-01	2001-02	2002-03 (plans)	2003-04 (plans)
England	£5520 m	£7154 m	£8413 m	£9600 m
Total capital funding, excluding PFI				
Growth over previous year	N/A	+30%	+18%	+14%
Funding per head	£111	£144	£169	£193

Wales	£432 m	£418 m	£465 m	£486 m
Assembly capital funding, excluding PFI				
Growth over previous year	N/A	-3%	+11%	+5%
Funding per head	£147	£142	£158	£166

Note: the figures are not directly comparable because those for England include all capital funding for local government – the Assembly is not responsible for all capital funding in Wales but is responsible for the vast majority of it (the exceptions include police, fire etc.).

Source: LGA Circular 367/01; analysis by WLGA

Unmet needs in 2002-03 onwards

1. The Welsh Local Government Association believes that further capital investment is justified over and above the level of the Assembly's budget plans. It urges the Assembly to consider these in finalising its budget for 2002-03 and later years.
2. Examples are:

E-government

The Society of Information Technology Managers has estimated that authorities will require an additional £25 million a year over the next five years to deliver the aspirations set out in the report on e-government approved by the Partnership Council earlier this year.

Highway infrastructure

The National Road Maintenance Condition Survey found that the condition of local roads was again the most defective ever recorded by the survey, having deteriorated further in 2000. There has been a deteriorating trend in the visual condition of local roads since the start of the 1990s. This reflects a more pronounced deterioration in the condition of urban roads and of rural unclassified roads, since the trend in the condition of rural principal and rural classified roads has been towards modest improvement. Maintenance expenditure by Welsh authorities fell by 6% in 1999-2000 compared to a 4% increase in England.

The present level of funding means that progress in upgrading bridges to carry 44 tonne lorries is very slow: it is unlikely that compliance with the EU Directive will be achieved until 2020 or beyond.

The Assembly's budget plans provide no increase in general funding for roads (the increase in transport grant is focussed on particular schemes, and much of the increase will be for integrated transport packages which do not tackle the backlog in maintenance).

As a minimum, an additional £40 million a year is sought in order to make a start in tackling these serious issues.

Care Standards Act

There will be substantial capital costs to modify residential care homes to meet the new standards, or to fund changes of use to more appropriate types of provision. This will provide higher standards of care. Estimate: £20 million

National Parks

Investment is needed that cannot be funded from the existing level of capital grant, which has been frozen for several years now. (The Assembly is consulting on rolling capital grant into National Park grant but this would not address the expenditure needs identified here.)

Office Accommodation at Brecon £1.2m

and Pembrokeshire Coast £250,000 short-term; £500,000 long-term

Local capital schemes £500,000

Landfill sites

The Environment Agency is demanding work on many of these (whether closed or still in operation) to prevent leachate entering watercourses etc. The costs can be significant. Since 1996, one council has spent about £300,000 in capital improvement schemes on closed landfill sites.

Leisure centres, parks and open spaces

District councils spent a significant amount on leisure centres from the mid 1970s onwards. Many of these assets are coming to the end of their life at broadly the same time. Without additional investment, the important contribution that they make to sport and health will reduce – yet leisure centres are not eligible for support under EU programmes.

Councils operate at least 300 formal parks and over 1650 playgrounds, and maintain at least 4500 hectares of open spaces. It is estimated that councils need to spend £90m to refurbish these facilities. Again these assets make a valuable contribution to healthy living and the environment.

An additional £15m a year would enable councils to start to tackle these issues.

Housing

3. Housing assets deserve separate, more detailed comment. The Association supports the aim in the Assembly's National Housing Strategy of giving everyone the opportunity to live in good quality housing. All councils in Wales want to invest in their council housing to bring it up to decent standards after decades of underinvestment. Councils would prefer central government either to provide them with more resources for investment in maintenance and refurbishment or to allow them the same freedom as housing associations to borrow to make this investment. The Association's view is that the

planned increase in capital funding for housing, of £10m next year and £20m in 2003-04, is not sufficient. In May the Assembly's Local Government and Housing Committee recommended that local authorities should be able to borrow on the same terms as housing associations when they need to raise money to repair and renovate council housing.

4. The cumulative effect of various proposals and announcements appears to the Association to force councils ever more down the line of stock transfer as the only realistic option of securing more investment in council housing. For example, the announcement that the UK Government would cover the cost of any overhanging debt where councils transfer their stock suggests that it has a particular objective in mind. Some councils in Wales are considering the option of stock transfer, but whether or not to transfer must be a matter for local decision by councils and their tenants. The Association welcomes that councils will not have to worry about whether they would be left with overhanging debt if the decision is in favour of transfer. However it also believes that a council should not be penalised from examining other funding options if tenants vote to reject stock transfer.
5. The Association is disappointed that, in discussion with officials, it has been indicated that the Assembly Cabinet does not intend to introduce a major repairs allowance within Housing Revenue Account subsidy for 2002-03. This has been implemented in England since April 2001 and involves replacing credit approvals £ for £ with additional cash support in the form of HRA subsidy. While it would increase hypothecation of resources, the Association nevertheless believes that such a change would have significant attractions for Wales – it would provide additional resources within the Housing Revenue Account that could be used either for capital works or to support PFI projects. Looking ahead to the prudential borrowing system, the additional subsidy could support significant extra borrowing for investment in council housing.
6. The Association is also concerned at proposals that social housing grant should no longer be available for new schemes involving council housing stock. Such a change would prevent councils from taking a strategic response in respect of local housing needs and, quite simply, reduce the level of resources potentially available to invest in improving council houses. This is the opposite of what the Assembly should be doing, namely increasing funding for investment in housing.

Other changes the Association would like to see

7. If the Assembly provides any increase in capital funding above existing plans for 2002-03 or later years, the Association strongly urges that such funding should take the form of capital grant only. Grant is preferable to credit approvals, because the borrowing costs of credit approvals have to be supported and give rise to an ongoing call on local government and the Assembly's resources.
8. There is scope to simplify some of the existing arrangements for capital funding. The Association suggests that capital funding which is provided as a mixture of grant and credit approvals, such as transport grant and flood defence, should move to being solely grant from April 2002. This will simplify administration and reduce one of the factors that can cause instability in finalising the revenue settlement (because revenue funding is provided in respect of the costs of borrowing taken out under credit approvals, and the distribution is not even).
9. For later years, prior to the introduction of the prudential borrowing system, the Association suggest that the Assembly Cabinet should bring forward any bidding rounds for supplementary credit approvals so that decisions on allocations can be taken before the provisional revenue settlement is unveiled. This would have the twin benefit of giving authorities better forewarning of capital projects that were to be supported and of improving stability of revenue funding figures.
10. In the task and finish group on changes to the capital finance system, the Association has been discussing with Assembly officials potential changes that the Assembly could make to the present capital finance system by means of secondary legislation. The Association has put forward the following proposals:

- amending the approved investments regulations, to give local authorities the ability to invest in a wider range of secure investments and to remove the artificial limit of 364 days on the period for which they may make investments;
- amending the capital finance regulations to simplify the treatment of leases. This would reduce bureaucracy and complexity, and would remove some of the hurdles to making decisions about the terms of leases in accordance with best value.

It looks forward to early consultation on, and implementation of, amending regulations in these areas.

The future of PFI

1. The Association has given evidence to the Local Government and Housing Committee on the future of PFI following the policy document published last December, and looks forward to a statement soon by the Minister on the way forward.
2. The Association supports PFI as a procurement option for capital projects. However, as with stock transfer, the Association does not believe that it should be "the only game in town". It wants to see the use of bidding rounds kept to a minimum because they favour PFI over other procurement options - and revenue support for successful projects is merely top-sliced from the total funding for all authorities.
3. The massive growth in support for PFI projects in England illustrates the extent to which top-slicing will grow there. The Association does not wish to see such a development in Wales.

Table 6: PFI in England

	2000-01	2001-02	2002-03 (plans)	2003-04 (plans)
PFI credits (i.e. approximate capital value of projects)	£830 m	£1052 m	£1380 m	£1600 m
Growth over previous year	+4%	+27%	+31%	+16%

Source: LGA Circular 367/01; analysis by WLGA

4.14 The Association suggests that:

- the prudential borrowing system is urgently needed, in order to give a level playing field for decisions. Authorities could then assess the revenue cost of borrowing and providing a service directly against the revenue cost of a PFI contract;
- bidding rounds are appropriate therefore only as a transitional measure until the prudential borrowing system is in place. Continuing with bidding rounds for PFI projects forever that would mean that the Assembly would be trying to tilt the playing field in favour of PFI, which would not be acceptable;
- It is probable that we are talking about a maximum of one or possibly two more bidding rounds. It would be helpful if the Assembly were to set out in advance a limited number of priorities for types of

project that it will support. This would minimise wasteful expenditure on bids that are not likely to succeed;

- The Association feels that projects should have a capital value of at least £25 million, to ensure either that they were significant in their own right or that councils were taking a strategic approach, for example by tackling several schools in a package – it would also help to reduce transaction costs in negotiating a contract;
- PFI projects for council housing could be supported within HRA subsidy without the need for bidding rounds but one of the key prerequisites would be the introduction of a major repairs allowance (see paragraph 4.5 above).

Asset management plans

15. A task and finish group, led by local government and involving officials from the Assembly, Audit Commission and Consortium of Local Authorities Wales (CLAW), was set up in January 2001 to produce guidance for local authorities on the production of asset management plans. The guidance was launched at a joint CLAW/WLGA seminar on 13 September 2001.
16. CLAW undertook a survey as part of this work on authorities' preparations for asset management plans. The results showed that, among the authorities that responded, none had yet prepared an asset management plan and only a few had the corporate structure, data systems and condition surveys in place to support such a process. However the majority intended to start the process during 2001.
17. The group's work has identified the need for clear policy encouragement from the Assembly, backed by an injection of resources, if authorities are to make demonstrable progress by April 2002. The guidance suggests that, starting this year, it will take up to 5 years before asset management plans are fully in place across all assets in all authorities although assets other than housing and infrastructure should be covered by April 2004. One of the benefits from comprehensive asset management planning will be more robust information on the need for capital investment, which will inform the Assembly's decisions on allocating resources for this purpose.
18. The Association's view is that, in the short term, authorities need additional resources to kick start improvements in the asset management process, for example to undertake condition surveys and put in data systems. Some funding is being provided by the Assembly at the moment but in respect of specific sectors (e.g. councils can use education and housing capital resources for condition surveys in those sectors, but in the case of the latter only as a prerequisite to stock transfer). The Association believes that the Assembly should provide additional funding to allow councils to improve asset management in a holistic way.

A prudential borrowing system

19. The Welsh Local Government Association strongly supported the proposals for ending central control over borrowing and its replacement by a prudential borrowing system. It welcomes the UK Government's announcement in March 2001 that it will legislate for its introduction but is disappointed that no Bill has been included in the UK Government's legislative programme for the 2001/02 session. The Association seeks legislation to deliver this commitment, with a view to implementation in 2004-05.
20. In itself the prudential borrowing system is not a panacea to the backlogs in capital investment by local authorities. The Association believes that, if the benefits of the new system are to be exploited, local government will need additional revenue resources in order to support extra borrowing. These resources might come from a number of different, existing funding streams and the Association looks forward to discussing options with the Assembly for maximising the benefits.
21. A joint working group of officials has been established to examine the changes in detail, as well as

beneficial changes to the present system that the Assembly could make in the meantime (see paragraph 4.10 above).

22. Among the significant issues that the Association believes will need to be addressed are:

- what is to happen to receipts set aside under the present rules but not used for debt redemption at the point of transition to the prudential borrowing system;
- preparing for the new system by reducing use of credit approvals wherever possible. In particular 2 year SCAs should not be issued by the Assembly in the final year of the current system;
- the revenue support mechanisms for borrowing under the new system;
- the public expenditure treatment of local government borrowing in the Assembly's budget.