

Proposed Changes to MRP Calculation Methodology

Introduction

The Councils Capital Financing Requirement (CFR) is an indication of the amount of historic capital spend that has yet to be financed (i.e. funded through borrowing including PFI). Guidance issued by Central Government indicates that the Council must make a prudent charge to the General Fund through a calculation of Minimum Revenue Provision (MRP) as a replacement of the depreciation charge. This is effectively setting aside revenue resources to fund the payment of the principal element of Council debt.

The Guidance does not stipulate how the MRP is to be calculated, although it does provide four “suggested” options, but does not rule out or preclude a Council from choosing its own method.

Background

The Council has historically charged MRP to the revenue accounts of the council on a straight-line basis. This method, whilst prudent and acceptable within the Guidelines, does not necessarily match the flow of economic benefits of the assets the borrowing was used to purchase. A more effective method is to move to an annuity basis which is being used by a large number of Councils.

CIPFA put forward the following reasoning for using an annuity method in ‘The Practitioner’s Guide to Capital Finance in Local Government (2019)’ which states:

‘The annuity method provides a fairer charge than equal instalments as it takes account of the time value of money, whereby paying £100 in 10 years’ time is less of a burden than paying £100 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.

The annuity method would then be a prudent basis for providing for assets that provided a steady flow of benefits over their useful life.’

The Council therefore commissioned Link (the Council’s treasury advisors) to review the method currently used to calculate MRP and provide options for consideration.

The result is that by moving to an annuity basis of calculation generates substantial savings in the early years. A change to an annuity method is not less prudent than the current method as the overall period of repayment remains unchanged nor does the overall payment total.

The CFR is derived from a number of different sources, not all of which require an MRP (e.g. the Housing Revenue Account). The MRP Policy Statement draws on the areas where the Council is required to make such a charge:

- Outstanding amounts relating to borrowing supported by Central Government
- Outstanding amounts relating to unsupported borrowing (Prudential Borrowing)
- Outstanding liabilities relating to PFI contracts and Finance Leases

Options Considered

A – Do Nothing (Straight Line)

B – Annuity Basis (PWLB Annuity Rate – Scheme Specific)

C – Annuity Basis (PWLB Annuity Rate – Weighted Average Life)

D – Annuity Basis (Council's Weighted Average Borrowing Rate – Scheme Specific)

E – Annuity Basis (Council's Weighted Average Borrowing Rate – Weighted Average Life)

For all options the supported borrowing element of the CFR will be written down over a period of 47 years, being the remaining average useful life of the Councils assets. This will either be on a straight line basis (Option A) or utilising the PWLB Annuity Rate for 47 years on 1st April 2022 of 2.85% (Options B and C) or the Council's Weighted Average Borrowing Rate (WABR) for external debt help on 1st April 2022 of 4.86% (Options D and E).

For the unsupported borrowing element of the CFR as well as using the straight line method there are two further sub-methods of calculating the amounts to which the annuity rate is applied (using either appropriate PWLB annuity rate for the asset life or WABR):

- i. Scheme Specific: each asset funded by borrowing is assigned an asset life and the MRP charged over that period on an individual scheme basis.
- ii. Weighted Average Life: for each financial year the assets funded by borrowing are combined with their individual asset lives to provide a single amount of borrowing for that financial year with an average asset life. The

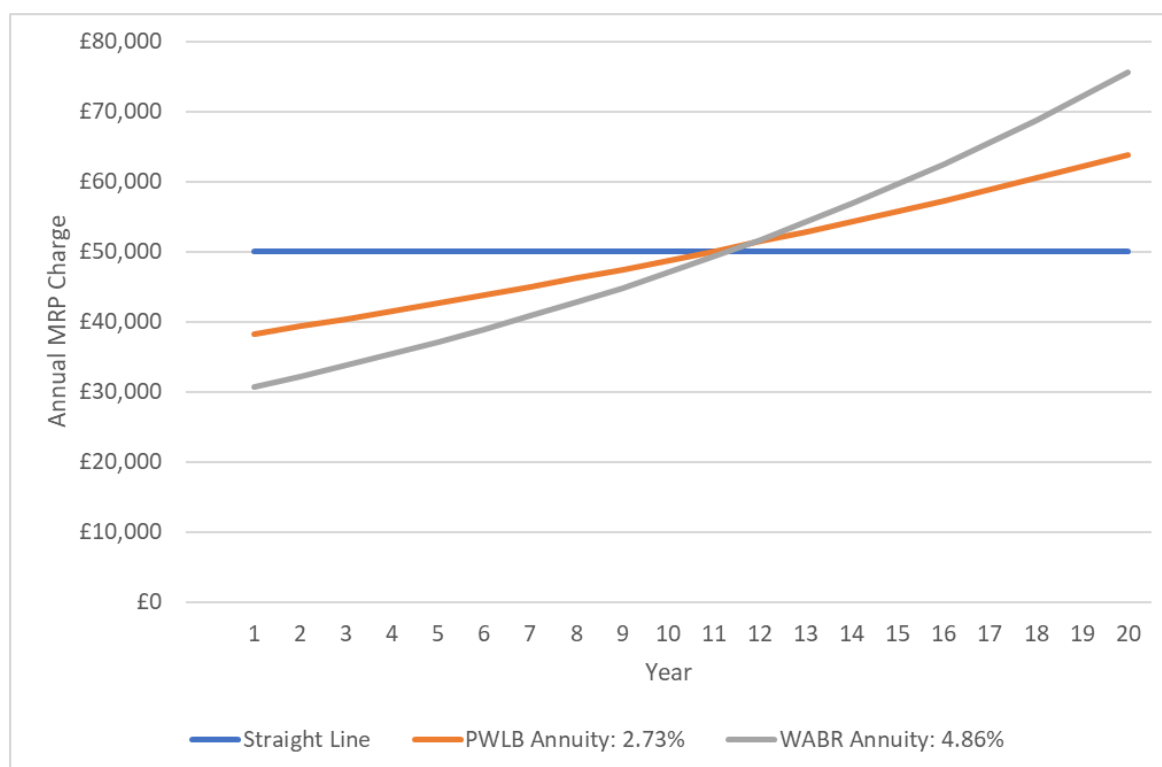
total balance for each year financial year is then charged over the average asset life.

This therefore generated four options (B through to E).

Preferred Choice

Option B through to Option E all generate savings in the early years compared to Option A of doing nothing. However, it should be noted that as amounts charged in later years fall in Option A, they increase in other options as the annual annuity charge increases over the life of the asset. This can be seen in a graphical illustration in **Chart 1** below. The total amount charged over the period is the same for all options.

Chart 1 : Illustration of £1m Borrowing charged over 20 year straight line vs Annuity (PWLB and WABR)



Notwithstanding the fact that future years would incur higher charges compared to the current method, the time value of money referred to earlier in this note means that the overall benefit to the council is beneficial by opting for an annuity basis.

To compare options presented in this report, a Net Present Value (NPV) has been calculated over the entire period of MRP repayments utilising the HM Treasury suggested discount rate of 3.5%. The NPV considers the time value

of money and allows comparison to the current straight-line basis. The resultant NPV savings are shown in the table below:

Option:	Net NPV Saving compared to Option A – Do Nothing £m
B – Annuity Basis (PWLB Annuity Rate – Scheme Specific)	16.46
C – Annuity Basis (PWLB Annuity Rate – Weighted Average Life)	16.38
D – Annuity Basis (Council’s Weighted Average Borrowing Rate – Scheme Specific)	26.08
E – Annuity Basis (Council’s Weighted Average Borrowing Rate – Weighted Average Life)	25.93

Option D provides the greatest NPV saving and is considered a prudent and effective method of calculating MRP and is therefore proposed as the preferred method for adoption.

The benefits of this method are

- The calculation is scheme specific and therefore each charge made to the General Fund Revenue Account is directly linked to the life of the asset funded through borrowing.
- Utilising the WABR as the annuity rate is a direct link to the Council’s actual debt portfolio and not the PWLB rates as published each year (which may not reflect the Council’s debt for any given year).

Chart 2 below shows the annual MRP charges calculated under Option D compared to Option A. This shows the savings that can be generated by implementing this option although future years rates will increase, albeit not to levels the Council are current paying through its MRP).

Chart 2 : Annual MRP Charge - Option A vs Option D

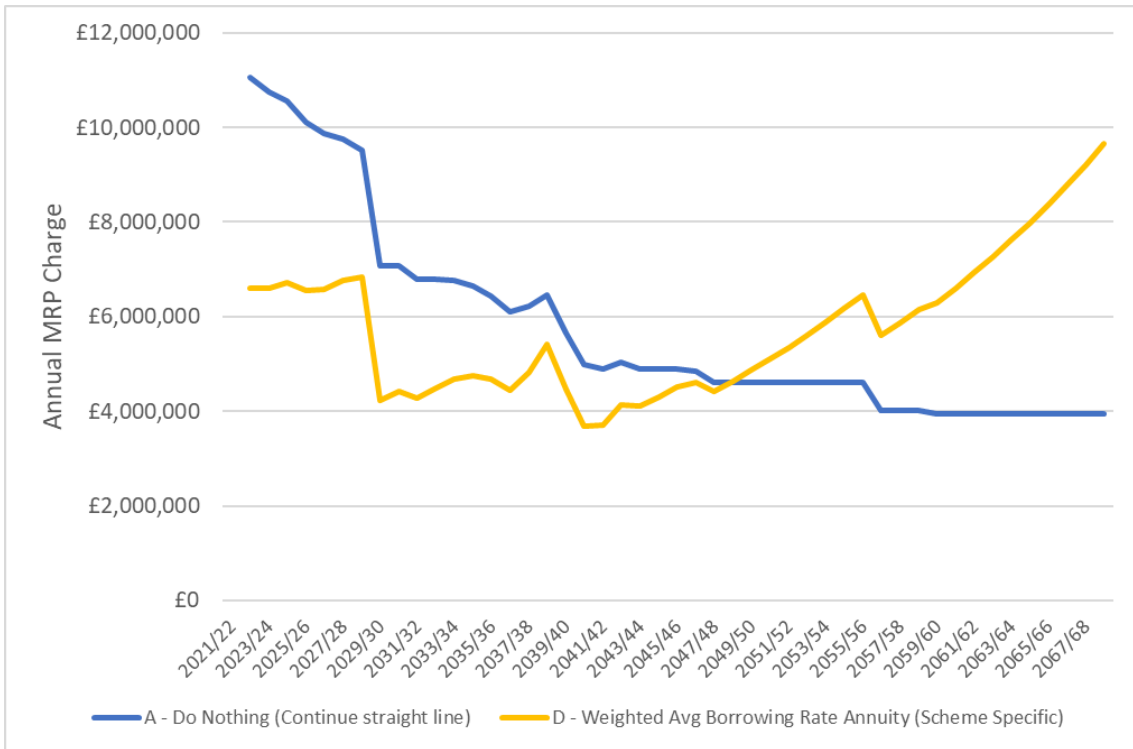
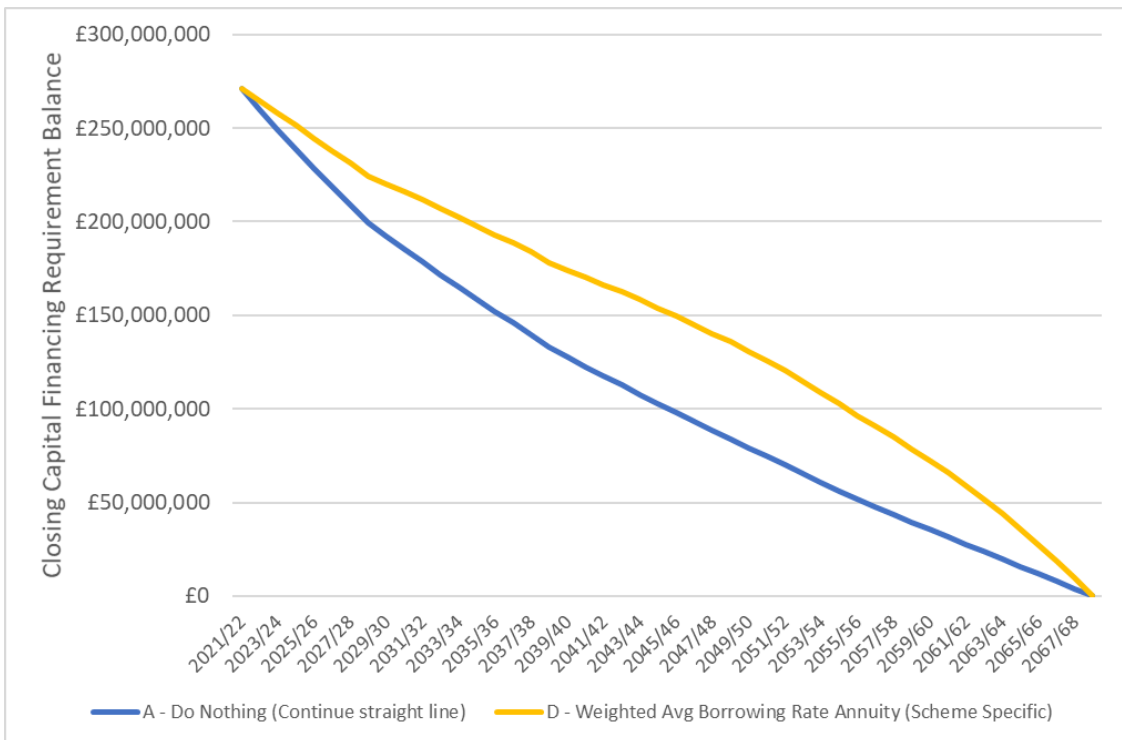


Chart 3 shows the closing CFR balance (supported and unsupported debt elements) for Options D compared to Option A. This is to demonstrate that the CFR will be cleared over the same period compared to Option A.

Chart 3 : Closing CFR Balances (Supported Borrowing plus Unsupported Borrowing) - Option A vs Option D



All graphs and calculations are taken from the closing position at 31st March 2022 and therefore future prudential borrowing decisions will increase the MRP charge from those detailed in this report.

The revised MRP Policy Statement attached to this report for approval has been drafted adopting Option D methodology.