National Audit Office

A Review from the NAO: Learning from Commercial Activity in Local Government Over the Last Decade

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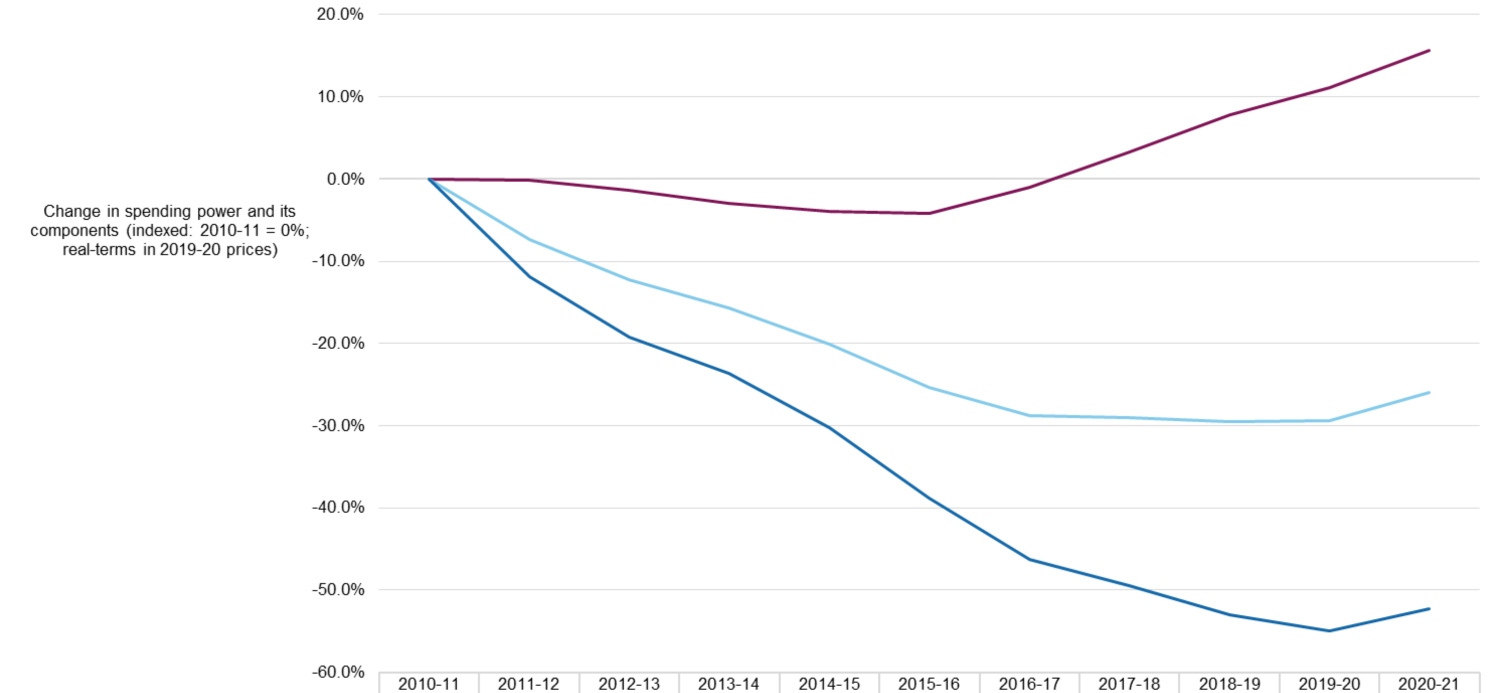
What I intend to cover today

- The landscape of the last decade: outlining the financial sustainability of local government
- Emerging trends and patterns around local authority commercial investments
- Commercialisation and the ‘Levelling Up’ agenda
- Future challenges: the importance of good governance to managing risk

Context | Ongoing financial pressure

Government-funded spending power has reduced by more than 50% since 2010/11



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Council tax	0.0%	-0.2%	-1.4%	-3.0%	-3.9%	-4.2%	-1.0%	3.3%	7.9%	11.1%	15.6%
Spending power	0.0%	-7.4%	-12.3%	-15.7%	-20.1%	-25.4%	-28.8%	-29.0%	-29.5%	-29.4%	-26.0%
Government funded spending power	0.0%	-11.9%	-19.2%	-23.7%	-30.3%	-38.8%	-46.3%	-49.5%	-53.0%	-55.0%	-52.3%

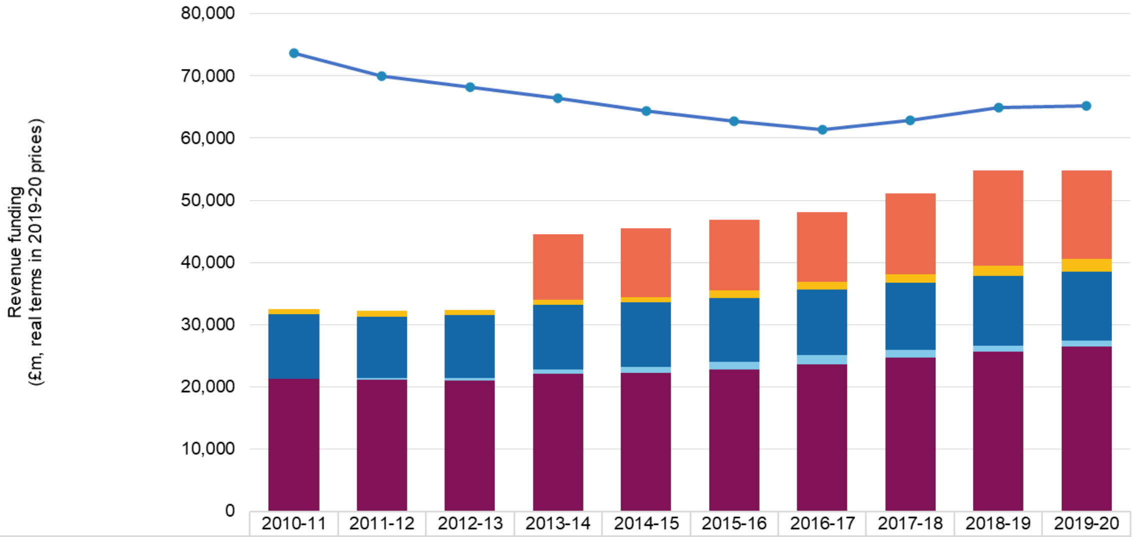
Year

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

- The sector has been **financially stretched** for over a decade with funding cuts since 2010, though we have seen an uptick in spending power in recent years
- Increasing importance of council tax and move to local business rates retention means councils **more dependent on local tax revenues**
- This creates **differential yields** across different places not necessarily correlated with need, and **volatility over time** with the economic cycle

Outcomes | Financial sensitivity to local economy

Income linked to local economies, such as council tax and business rates, has become more prominent as a share of funding since 2010/11



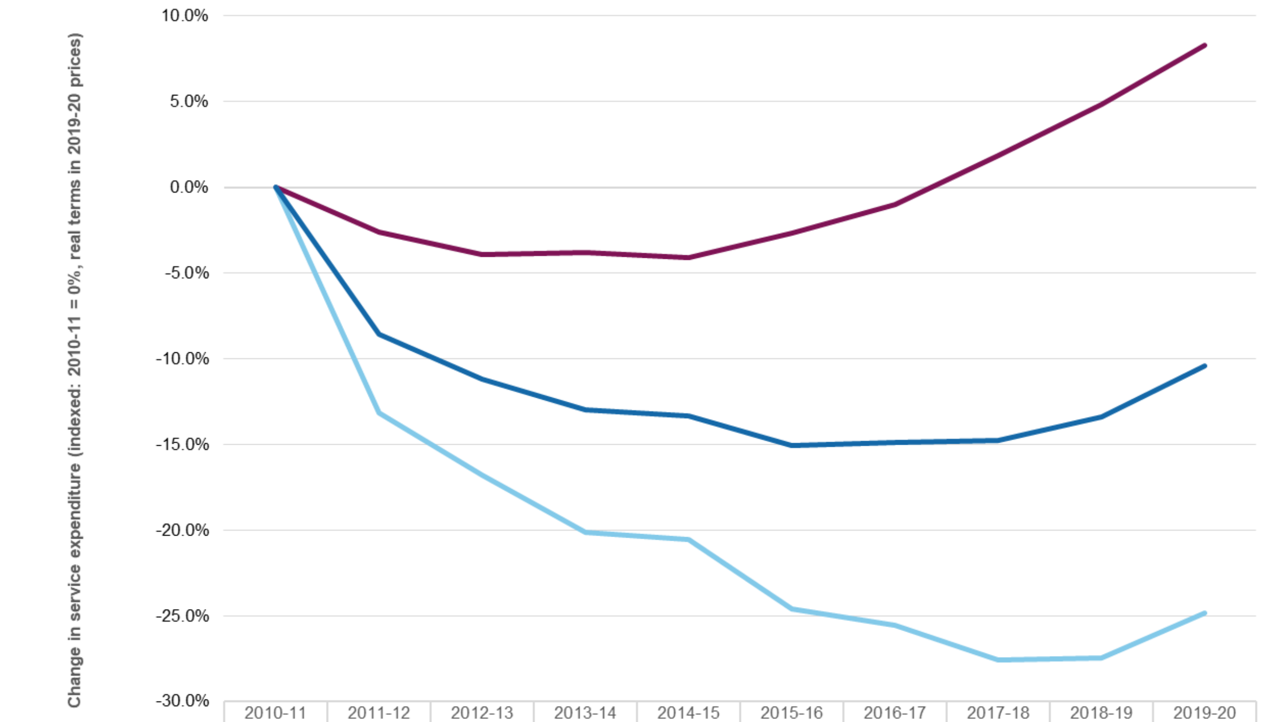
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Locally retained business rates	0	0	0	10,530	11,015	11,440	11,106	13,050	15,259	14,207
Commercial income & Community Infrastructure Levy	877	996	915	906	875	1,100	1,299	1,370	1,691	2,014
Sales, fees and charges	10,408	9,888	10,091	10,355	10,285	10,313	10,516	10,790	11,133	11,139
New Homes Bonus	0	228	448	740	967	1,209	1,528	1,267	962	905
Council tax	21,278	21,130	20,954	22,043	22,288	22,819	23,590	24,645	25,727	26,500
Overall change in these income sources since 2010-11	0.0%	-1.0%	-0.5%	36.9%	39.5%	44.0%	47.5%	57.0%	68.2%	68.2%
Overall change in these income sources since 2010-11, excl. locally retained business rates	0.0%	-1.0%	-0.5%	4.5%	5.7%	8.8%	13.4%	16.9%	21.3%	24.5%
Total of these income sources, NHS transfers and direct government funding (excl. public health)	73,650	69,983	68,151	66,354	64,422	62,760	61,327	62,918	64,846	65,243

Year

- Government made a range of policy changes to incentivise local authorities to support business growth, housebuilding and development
- Authorities have grown local non-tax income in response to funding pressures
- Ultimately, the share of local authority income that is sensitive to economic conditions rose from 44% to 84% by the end of March 2020
- Just in time for the pandemic, and now the cost of living crisis…

Context | Less room for manoeuvre

Even with more money raised from service users through sales, fees and charges, overall service spending has fallen by 10% in real terms



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Social care	0.0%	-2.6%	-4.0%	-3.8%	-4.1%	-2.7%	-1.0%	1.9%	4.8%	8.3%
Non social care	0.0%	-13.1%	-16.8%	-20.1%	-20.5%	-24.6%	-25.6%	-27.6%	-27.5%	-24.8%
All services	0.0%	-8.6%	-11.2%	-13.0%	-13.4%	-15.1%	-14.9%	-14.7%	-13.4%	-10.4%
Social care (£m)	29,747	28,960	28,570	28,609	28,532	28,946	29,439	30,306	31,180	32,204
Non social care (£m)	38,508	33,449	32,045	30,768	30,599	29,026	28,663	27,883	27,936	28,944
All services (£m)	68,256	62,409	60,615	59,377	59,131	57,972	58,102	58,188	59,117	61,148

Year

- Social care budgets are under **increasing strain** with an ageing population and growing demand amongst those of working age, coupled with significant increases in the costs of children's care
- Recent announcements and events show **little prospect** of the financial demands on councils changing
- Council spending on social care **has risen** and has **grown as a proportion of spending power:** now up to c80% on average for social care authorities
- With significant reductions in discretionary service spend having already taken place, **LAs have less headroom** to offset new financial pressures

Responses | What is commercialisation?

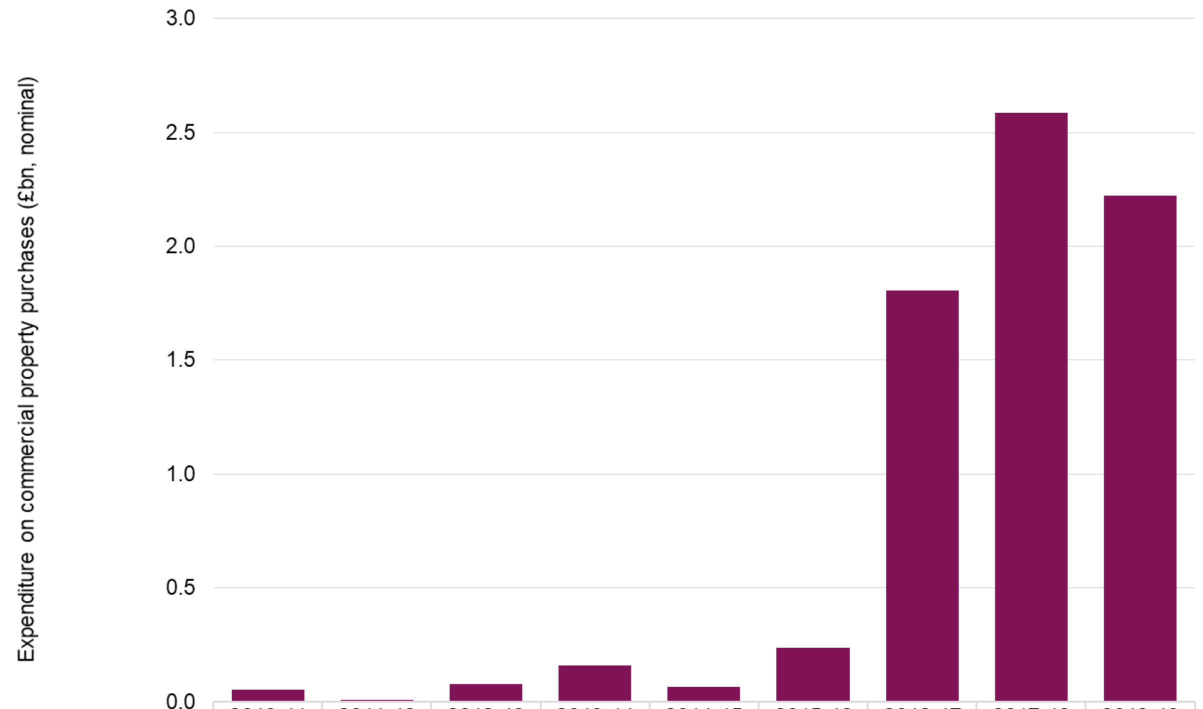
Being commercial is much more than commercial investment…

Adopting a commercial mindset	E.g. procurement, efficiency, leveraging assets
Rethinking fees and charges	New / higher / more intelligently set to help maximise income and support policy goals (behaviour change)
Trading	Selling services – eg back office, school supplies / school improvement, leisure, waste collection
Strategic asset management	Review charges, change use, transfer, sell
Miscellaneous	Advertising, sponsorship, events, filming
Housing companies	Buy and/or develop – outside the HRA
Property investment	Asset classes? In/out of borough? Link to local regeneration
Digital	A newer area, harnessing the power of data and data assets

Responses | Commercial property

But many of the headlines on commercialisation have focussed on commercial investment, rightly so…

Commercial property purchases by English local authorities, 2010/11 to 2018/19



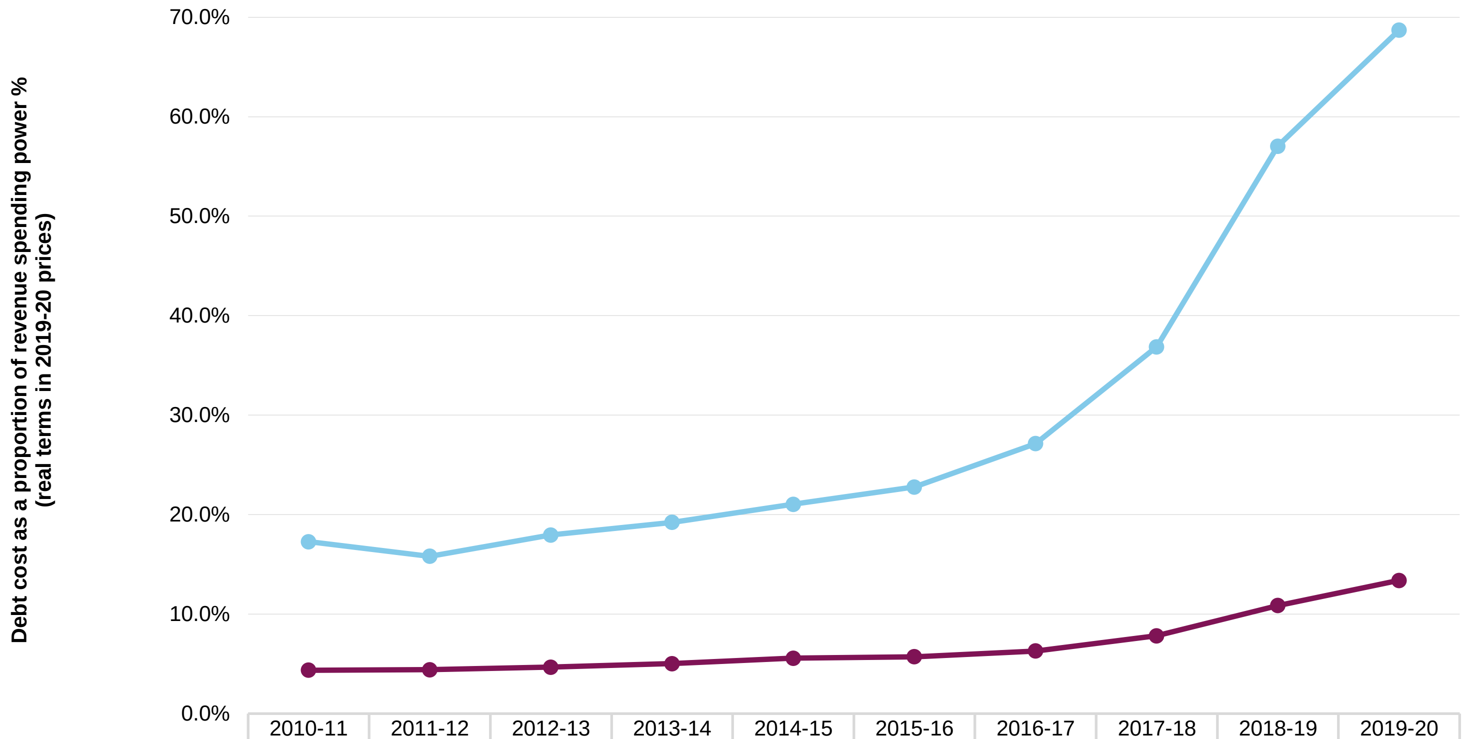
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Spend on acquistions (£bn)	0.1	0.0	0.1	0.2	0.1	0.2	1.8	2.6	2.2
Local authorities active in year (count)	11	14	18	28	30	41	83	107	107

Year

- LAs spent £6.6bn in three years - **14.4 times more than the previous three years**
- Bulk of activity by a relatively small group of LAs, but proportion growing
- **District councils** spent more than other types of authority
- Regionally, authorities in the **south east** accounted for over half of all acquisitions
- **Full effect of the pandemic on property income not yet known**

Outcomes | Increasing risk for some

Debt costs in English district councils as a percentage of spending power, 2010/11 to 2019/20



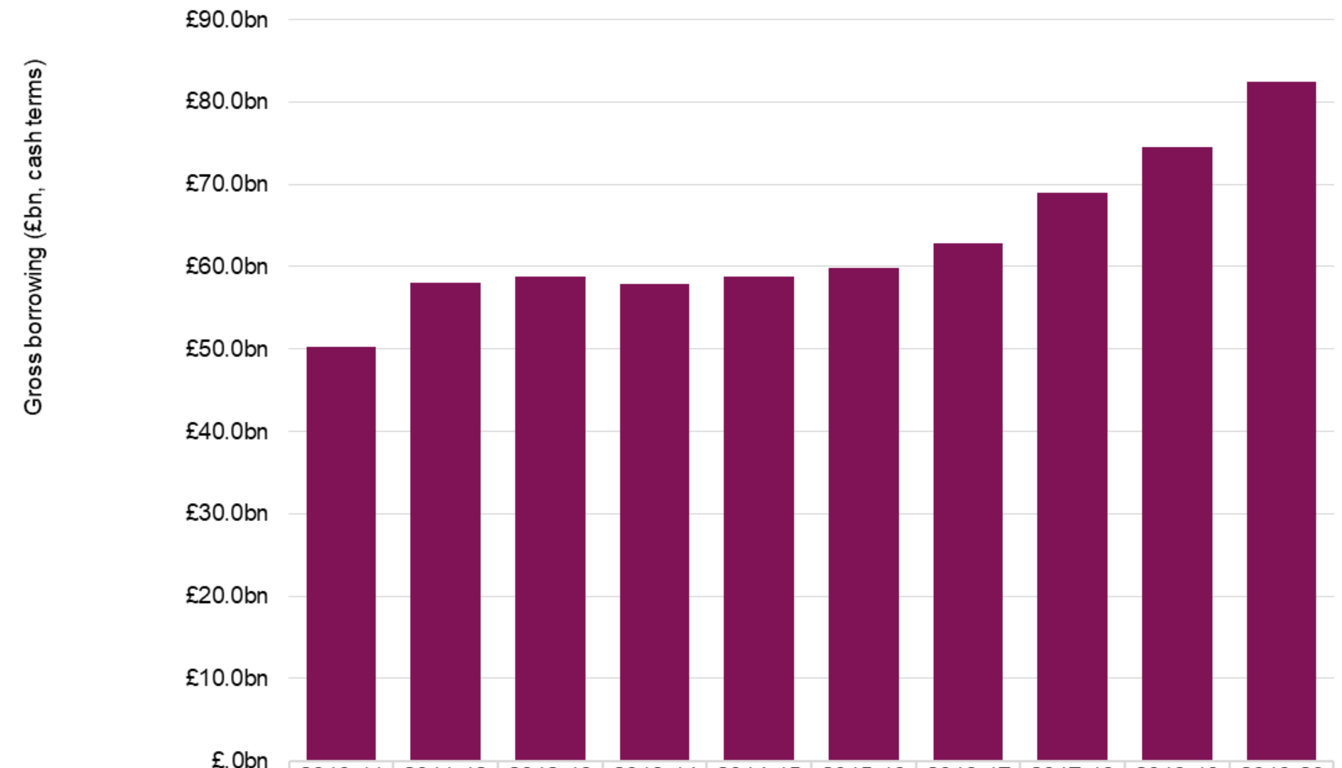
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
All districts debt cost as % of spending power	4.4%	4.4%	4.7%	5.0%	5.6%	5.7%	6.3%	7.8%	10.9%	13.4%
Top 20 districts in each year as % of spending power	17.3%	15.8%	17.9%	19.2%	21.0%	22.8%	27.1%	36.9%	57.0%	68.7%
Single tier and county council social care spend as % of spending power	52.3%	54.9%	57.1%	59.5%	62.7%	68.3%	72.8%	74.9%	77.3%	79.7%

Year

- Dramatic change among a small group, who are now very highly leveraged in relation to the size of their core activities
- These levels of activity increase risks for the authorities in question, and raise questions for the whole sector

Outcomes | Rising borrowing with less set aside

Gross borrowing and minimum revenue provision (MRP), English local authorities 2010/11 to 2019/20



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Gross borrowing at 31 March	£50.2bn	£58.1bn	£58.8bn	£57.9bn	£58.7bn	£59.8bn	£62.9bn	£69.0bn	£74.5bn	£82.4bn
Minumum Revenue Provision	£2.0bn	£2.1bn	£2.2bn	£2.1bn	£2.0bn	£1.7bn	£1.4bn	£1.2bn	£1.4bn	£1.5bn

Year

- Much of the new commercial property investment is **funded by borrowing** (although not the only reason for rise)
- Most LA borrowing is **long-term maturity loans**, so it is prudent to set aside money for repayment (MRP)
- In 2020 we reported some LAs were **not making sufficient MRP** provision in relation to borrowing associated with investment properties, contrary to guidance (though change starts earlier, so not all about commercial)
- Ultimately, between 2013/14 and 2019/20, stock of borrowing rose by **42%**, while level of MRP set aside each year fell by **30%**

Levelling Up | Initial thoughts

- Largely remains a **policy theme rather than an implemented programme** – but a focus on regional (in)equality seems here to stay, whatever party is in government (cf Gordon Brown's A New Britain report for the Labour party and Kier Starmer's proposed 'Take Back Control' bill)
- Continued discussion on the Government's **Levelling Up Bill – now being brought back to Parliament** after housing and planning proposals were amended following in-Party tussles
- In any case, levelling up is less about immediate income generation and more about driving economic growth, supported by individual fund allocations, largely for capital investment - the Levelling Up Fund (which itself brought together several different funding pots (the Local Growth Fund, the Getting Britain Building Fund, the DfT Pinch Point funding, and the Towns Fund), the Community Ownership Fund, the Community Renewal Fund, and now the UK Shared Prosperity Fund - rather than fundamental changes to formula funding, or providing statutory powers to raise new funds.
- In terms of commercialisation, council investment funded by borrowing can **no longer be primarily for financial return, nor in advance of need** – therefore (borrowing for) investment must be for local regeneration purposes, which tends to signal market failure and low market rents and returns. But lenders are less willing to lend in areas of low commercial returns. It also limits smaller authorities' ability to spread risk across geographic areas with stronger growth prospects.
- Under **devolution arrangements** (eg Mayoral Combined Authorities) there have been some moves towards raising money, but these have largely been for capital (eg transport) rather than for service delivery (though we may see a new 'tourism tax' in some places). Instead, we see a focus on mayor's 'soft power' to convene others and act as a voice for the region to drive inward commercial investment.

Checks and balances| Effective commercialisation strategy requires good governance and assurance

- Our 2019 report on local authority governance found that:
  - Good governance is **key to ensuring financial control,** and **local checks and balances need to be effective**
  - There is a sizeable group of authorities (c30%) with **multiple governance** issues
  - **Risk profiles have increased** in many authorities, in part due to commercial investments and ventures
- Redmond review into external audit, 2020:
  - Noted both commercial property and wholly-owned companies as potential risks to authorities' financial sustainability
  - Local audit market is very fragile, with concerns about the supply of appropriately experienced and qualified local authority auditors – to review increasingly complex structures and transactions
- As at 30 November 2022, only 12% of local government bodies' 2021/22 audit opinions have been given. Although slightly higher than last year's 9%, the 2021/22 publishing date is two months later than the 30 September target for delivery of 2020/21 opinions.

Capital framework | Codes and Guidance

Document	Purpose/recent changes
Statutory Guidance on Local Government **Investments** (DLUHC)	Originally about treasury management investments but expanded to cover other non-financial assets that the organisation holds to generate a profit, eg investment property. **Authorities must not borrow more than or in advance of their needs purely in order generate profit** – and must explain decisions and approach to managing the risks. New requirement to prepare an **Annual Investment Strategy**, including measures of risk exposure from investment decisions. Where an LA is or plans to become dependent on profit generating investment activity, **risks and contingency plans must be disclosed.**
Statutory Guidance on **Minimum Revenue Provision** (DLUHC)	Authorities have **a duty to make 'prudent' MRP** in respect of capital financing. Change overall definition to **cover capital spending without direct service benefits**, ie commercial investments. Statement that authorities cannot use depreciation method to calculate MRP on borrowing to fund commercial investments. **Government continues to keep MRP under review**, so be aware of possible future changes.
The **Prudential** Code for Capital Finance in Local Authorities (CIPFA)	To ensure LA capital expenditure plans are "**affordable, prudent and sustainable**". Includes commercial investments in the LA's capital strategy, including risk appetite and proportionality with respect to overall resources.
Treasury Management in the Public Services: Code of Practice (CIPFA)	To ensure good TM practice. The **principle of control of risk/optimising returns** to be applied across **all** investment activities, including commercial investments. New section covers non-traditional TM - such **investment decisions should be explicit**, the **additional risks set out clearly**, and the **impact on financial sustainability identified and reported**.

Access to borrowing | Recent changes to PWLB

- **1% rise** in PWLB rates in October 2019, due to concerns about the level of new borrowing
- **Reversed** in November 2020, alongside **changes to PWLB lending terms**
- **Now, to borrow from PWLB:**
  - LAs must submit **three-year capital plans** with spending categorised into acceptable categories or clearly identified as otherwise
  - s151 to **assure HMT** the authority is not buying or refinancing investments assets primarily for yield, and that its capital plans are current
  - **Any investment asset** bought primarily for yield after 26 November 2020 will result in the authority not being able to access the PWLB in that financial year or being able to use the PWLB to refinance this transaction at any point in the future
  - If a local authority is planning to acquire investment assets bought primarily for yield **in any of the following three years**, the authority will be unable to borrow from the PWLB to finance **any** expenditure in its capital plan
- DLUHC will **review local authority capital plans** for compliance with PWLB lending terms
- HMT reserves the right to take action if it has concerns **at any date**

Capital framework | Changes made

DLUHC changes to legal enforcement:

- Has reviewed the statutory powers for capping borrowing and considering their use “to protect local financial sustainability”
- Work to clarify the regulations (secondary legislation) relating to MRP

Changes to codes and guidance:

- DLUHC will ‘further clarify’ the MRP guidance
- CIPFA consulting on revised Prudential and Treasury Management Codes:
  - Clear statements that “An authority must not borrow to invest primarily for financial return”
  - Also messages that commercial investment risks should be proportionate to financial capacity

DLUHC plans to be more active:

- “developing an analytical process to pre-emptively identify risks in the sector”
- “communicating earlier with local authorities when we become aware of certain activities”
- reviewing “the current governance and skills landscape” for borrowing and investment

Commercial investments | Final thoughts

- All commercial investment needs to be set in the wider context of the authority's risk management approach, current risk profile, and risk appetite
- Can you fund or finance investment without PWLB borrowing?
- Does the viability of your project depend on a particular approach to MRP?
- Is your MRP policy secure against different interpretations and forthcoming changes?
- Are you confident in the skills and experience within your organisation or that you otherwise access?
- Can you put in place appropriate arrangements for governance, transparency and challenge that will stand up to scrutiny in the event of failure?

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