Agenda Item 5

Service Concession Arrangements

Falkirk Council

Title:	**Service Concession Arrangements**
Meeting:	**Falkirk Council**
Date:	**23 February 2023**
Submitted By:	**Director of Transformation, Communities & Corporate Services**

1. Purpose of Report

1.1 The purpose of this report is to provide Members with information on the changes permitted to how councils account for the repayment of debt on Services Concession Arrangements (SCA). This paper will:

- Explain the principles behind the implementation of the SCA guidance;
- Detail the financial implications of this guidance;
- Consider how benefits flowing from SCAs could be used prudently and effectively to support the Council to reach a financially sustainable position.

1.2 This report is for noting with a proposal for the implementation of the change to come as part of the March Budget Report.

1.3 This report relates to the Financial Sustainability enabler within the Council Plan.

2. Recommendations

2.1 **Council is invited to:**

(1) note the contents of this report; and

(2) note that the March Budget Report will include proposals for the implementation and use of Service Concession Arrangements.

3. Climate Change Impacts

3.1 There is no climate change impact arising from the recommendations in this report. The issue of Service Concession Arrangements (SCA) is a technical accounting matter which will be further considered alongside the Council budget. The wider revenue and capital budgets support spend across the Council, and this spend does have a wide ranging and varied impact on climate change.

4. Background

4.1 As part of the Spending Review in May 2022, the Scottish Government announced that the implementation of Service Concessions Guidance was accessible to councils. The Financial Strategy report presented to Council in September 2022 introduced the issue of SCAs and noted that detailed calculations would be required on receipt of the final guidance on Service Concessions. The Strategy also noted that implementation of the revised SCA guidance would require full Council approval.

4.2 SCAs will be different for all Councils and will depend on the relevant contracts that each Council have in place. For Falkirk Council there are two contracts in the scope of this guidance, both in respect of secondary schools – Class 98 and the Non-Profit Distributing Organisation (NPDO) contracts. The Class 98 contract is a 25-year contract and covers the following five schools – Bo'ness Academy, Braes High School, Graeme High School, Larbert High School and the former Carrongrange School. The NPDO contract is a 30-year contract which covers Denny High School, Falkirk High School, Grangemouth High School and St Mungos High School. These contracts financed the building of the schools and the provision of ongoing services within these schools.

4.3 In each of the contracts, the Contractor built the schools and the Council agreed to make an annual payment, called the Unitary Charge Payment. The Unitary Charge Payment comprises three elements:

- Principal repayment of debt (for the building costs)
- Interest payments
- Payment for services

4.4 The annual unitary charge for the Class 98 contract is approximately £13.7m and for the NPDO contract it is approximately £15.5m.

4.5 For the NPDO contract only, the Council made a revenue prepayment of £24m at the start of the contract. The purpose of that prepayment was to reduce the ongoing unitary charge payments. Within the guidance, this element is treated in a different way to the unitary charge payments.

4.6 The total long-term debt liability (i.e. the Council's payment for the assets) to be repaid by the Council is as follows:

Contract	Debt Liability £'m
Class 98	62.889
NPDO	113.320
Total	**176.209**

4.7 Under the current arrangements, the repayment of debt is paid over the life of the two contracts. However, at the end of the contract period, the assets are still expected to have a remaining useful life.

4.8 Under the terms of the Class 98 contract, the Council has the option to purchase the schools at the end of the contract and provision of £5m has been set aside to enable this, as the preferred option for the Council. A report will be brought back to the Education, Children and Young People's Executive in June 2023 on this issue. The purchase of the schools would be due to happen in 2025. Under the terms of the NPDO contract, the schools will transfer to Council ownership in 2039/40.

4.9 The Scottish Government and CoSLA have been working for some time on revisions to the accounting treatment of the assets, to account for the cost of the assets over the life of the asset as opposed to the life of the contract. This would be in line with the accounting treatment of all other capital spend.

4.10 A briefing session was held for Members on 6 February 2023 to go through the SCA work, with a slide pack sent round all Members.

5. Considerations

5.1 Service Concession Arrangements – Revised Guidance

5.1.1 The revised SCA guidance allows councils to account for the long-term liability of the school assets over their expected useful life, rather than over the contract term. In effect, the benefit from the SCA is achieved by better matching the debt costs of the secondary schools to the expected useful lives of the schools and, therefore, repaying the debt across a longer period of time. For Falkirk Council it is considered appropriate to estimate a useful life for these assets of 40 years.

5.1.2 The revised guidance also allows councils to decide on their preferred approach to making debt repayments – the equal instalments of principle (EIP) method or an annuity method.

5.1.3 This does not change what the Council pays the contractors in cash every year or the timing of those payments. This is simply about the accounting transactions to pay for the assets. The change is a technical accounting change which changes how the repayment of the debt is accounted for in the Council's Revenue Budget. It is worth emphasising that the use of SCAs does not alter the contracts for the schools in any way; the terms of the contract remain as originally agreed.

5.1.4 Councils can only apply this change in 2022/23 or 2023/24. However, councils are allowed to apply this change in accounting treatment retrospectively. This means the Council can compare the payments made to date under the current arrangements and the payments that would have been made using the new guidance. This creates a technical overpayment in the accounts with too much having been charged to the revenue account in previous years to pay for the assets. This is referred to as the Retrospective Adjustment.

5.1.5 The revised arrangements do not release cash, i.e. the contractor does not repay any of the technical overpayment. However, the Council's reserves will be increased by the overpayment element. To actually spend these reserves will require borrowing to obtain the cash. There are costs associated with this. The borrowing and associated costs are set out in section 5.6 of this paper.

5.2 Calculation of the Financial Benefit

5.2.1 The calculations required for this exercise are complex and rely on the original contracts as the starting point. The Council's Treasury Advisors, Link Asset Services, were commissioned to carry out the calculations on behalf of the Council. The basis of the calculations prepared is:

- The useful life of the assets should be based on 40 years
- The calculation of the debt repayment will be based on the annuity method.

5.2.2 The annuity basis is considered the best method to represent the use of the assets over their useful lives and this method is used as standard practice in most PPP arrangements. The use of the annuity basis is therefore considered appropriate for the Council's SCAs.

5.2.3 There are two elements to the calculations completed by Link:

- The Retrospective Adjustment; and
- Future benefits

5.2.4 Each of these areas is outlined in the following sections.

5.3 Retrospective Adjustment

5.3.1 Link have calculated the following retrospective adjustment for the Council:

	Retrospective Adjustment £'m
Debt Repaid up to 31 March 2023 based on contract duration	100.351
Revised Calculation of Debt based on useful life of assets (40 years)	29.396
Overpayment up to 31 March 2023	**70.955**

5.3.2 The technical overpayment of £70.955m is the Retrospective Adjustment and this can be taken as a financial benefit and transferred to the Council's reserves.

5.3.3 The overpayment of £70.955m is made up of three different elements:

	Retrospective Adjustment £'m
Class 98 Unitary Charge	35.045
NPDO Unitary Charge	14.769
NPDO Revenue Prepayment	21.141
	70.955

5.3.4 It is important to understand that each of these areas is distinct and the guidance allows the Council to pick one, two, three or none of these options. The Council can only take the benefit of the overpayment if it is approved by Council.

5.3.5 Officers intend to seek Council approval to take all three of the above options as a benefit. This recommendation is reflective of the unprecedented financial challenge facing the Council and the prevailing fiscal uncertainties in the economy. By taking all three options, the Council is not obliged to use all three, but it does ensure that they are available should they be required.

5.4 Future Benefit

5.4.1 In addition to the retrospective gain, there will be benefits through adjustments to the repayments in the coming years. These benefits are added to the Retrospective Adjustment, to give a total overall potential benefit. See summary table at paragraph 5.5.1.

5.5 Repayment

5.5.1 Extending the asset lives will result in repayments being due after the end of the contractual periods. The current and proposed repayment position is summarised in the following table with tables showing the breakdown by contract included in Appendix 1.

	Current Repayment £m	Revised Repayment £m	(Reduction) /Cost £m	NPV at 3.5% £m
Pre 2023/24	100.351	29.396	(70.955)	(70.955)
2023/24	8.290	3.078	(5.212)	(5.036)
Years 1 – 5	19.715	14.702	(5.013)	(4.802)
Years 6 – 10	15.209	25.278	10.069	7.590
Years 11 – 25	32.645	99.249	66.604	34.452
Years 26 – 40	-	4.506	4.506	1.761
	176.209	**176.209**	**-**	**(36.900)**

5.5.2 It is important to note that the Council does not repay any more debt than originally planned. The amount paid at the end of the SCA will be the same as that set out in the original contracts.

5.5.3 The costs of lengthening the repayment period will potentially result in additional revenue budget pressure from year four onwards. Finance officers will look to smooth the additional repayments out as far as possible to help manage the budget process. The Council is not paying the contractor for longer or paying the contractor more.

5.5.4 As the contract periods come to an end, officers will review the future savings that flow from this and consider these alongside the repayment of debt to help even out the repayments and ensure a prudent approach is taken.

5.5.5 Using the Retrospective Adjustment will impact on the Council's Capital Financing Requirement (CFR). Funding the CFR is considered as part of the Council's Annual Treasury Management Strategy which will be presented to Executive in April 2023 before approval by Council.

5.6 Costs Linked to Using the Retrospective Adjustment

5.6.1 The Financial Strategy presented to Members in September 2022 noted that this is a technical accounting adjustment, as opposed to a cash benefit. To use the Retrospective Adjustment to support the Council's budget, and to ultimately pay for expenditure, the Council will have to access cash, i.e. borrow funds. A different form of borrowing will be required depending on whether the arrangement relates to the prepayment or the unitary charge related benefits.

Borrowing for the Prepayment Retrospective Adjustment

5.6.2 The guidance sets out that the Council must treat the borrowing related to the prepayment in the same way as any other capital investment. This is called a loans fund advance. The total interest associated with this advance will depend on the interest rates each year until the end of the period. Based on current estimates, the borrowing of £21.141m for the prepayment will result in total interest charges of £16.5m until the advance is fully paid in 2052/53.

Borrowing for the Unitary Charge Retrospective Adjustment

5.6.3 Borrowing costs for the Unitary Charge elements depend on how and when the Council decides to use the retrospective benefit. These two decisions will impact on the Councils' internal cash balances. If, for example, the Council decided to use £10m in a year, it may be the case that there are sufficient cash balances to cover this cost – this would effectively be internal borrowing. However, if there are insufficient cash balances, the Council may have to borrow externally. These decisions would be taken as part of the operational day to day treasury management activities already undertaken by the Council.

5.6.4 The Council earns interest on its internal cash balances. For example, if £10m of Retrospective Adjustment was taken through cash balances, the interest lost to the Council in 2023/24 would be £0.450m, based on a base rate of 4.5% (this is what base rate is expected to peak at during 2023/24). There is currently little difference between long term and short-term rates for borrowing.

5.7 Use of the SCA Benefits

5.7.1 The Scottish Government guidance on SCAs focussed on the options available for calculation of the benefits. It does not provide guidance on the application of the benefits, beyond the accounting treatment. As noted in the Financial Strategy report in September 2022, the option to use SCAs is very welcome and is going to be essential to allow the Council to set a balanced budget for 2023/24. However, the use of SCAs is effectively the use of a reserve, funded through borrowing. It is not a sustainable way to balance the budget.

5.7.2 In December 2022, the Budget Report to Council noted a financial gap of approximately £67m for the next four years (15% of the 2022/23 budget). At the time of writing, the Budget Report to Council in March is expected to reduce this gap to approximately £62m. The scale of the financial gap remains a huge challenge. SCAs do not reduce the size of the gap. They do however provide an opportunity to re-profile the timing of the gap, albeit this does come at a cost, as previously set out.

	2023/24 £'m	2024/25 £'m	2025/26 £'m	2026/27 £'m	Total £'m
Financial Gap	24.4	20.4	9.2	8.2	**62.2**

5.7.3 SCAs should be considered as an opportunity to buy some time during which the Council can redesign services to deliver recurring savings. The services delivered by the Council must be affordable on an annual basis from available funding, not through technical accounting adjustments.

5.7.4 To take the above issues into account, a number of principles are proposed for the future use of SCAs:

- The use of SCAs should be considered a 'last resort' as they do not address the underlying budget deficit of the Council but instead allow some reprofiling of the budget gap, in effect buying some time to address the underlying issues. Focus must therefore be on the identification and approval of recurring savings.

- As far as possible, the use of SCAs must be matched with the equivalent quantum of savings having been identified over the period of the Financial Strategy.

- Should recurring savings be identified and approved as early as possible, there is an opportunity to better use SCAs to facilitate future investment or targeting support to address need. This depends on identification and approval of savings, and the Council must continue to work towards this.

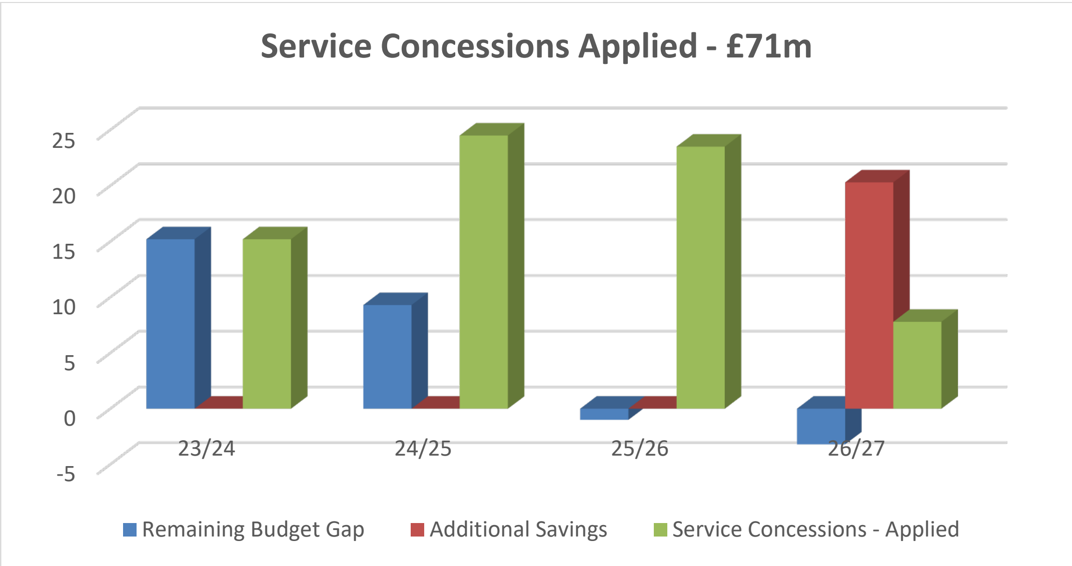
5.7.5 SCAs must be applied prudently to avoid the risk of a 'financial cliff edge' in future years. A series of charts have been prepared to demonstrate how SCAs could be applied.

Example 1 SCAs used to bridge remaining gaps:

	2023/24 £'m	2024/25 £'m	2025/26 £'m	2026/27 £'m	Total £'m
Financial Gap	24.4	20.4	9.2	8.2	**62.2**
Council Tax – 5% per annum*	(1.4)	(1.4)	(1.4)	(1.4)	**(5.6)**
Savings Identified	(7.8)	(9.7)	(8.8)	(10.0)	**(36.3)**
Remaining Gap	**15.2**	**9.3**	**(1.0)**	**(3.2)**	**20.4**

* 3% is already built into the opening gap

5.7.6 The chart below assumes that Members agree to an annual 5% increase in council tax and that all savings identified are approved, leaving the remaining gap to be filled by SCAs.



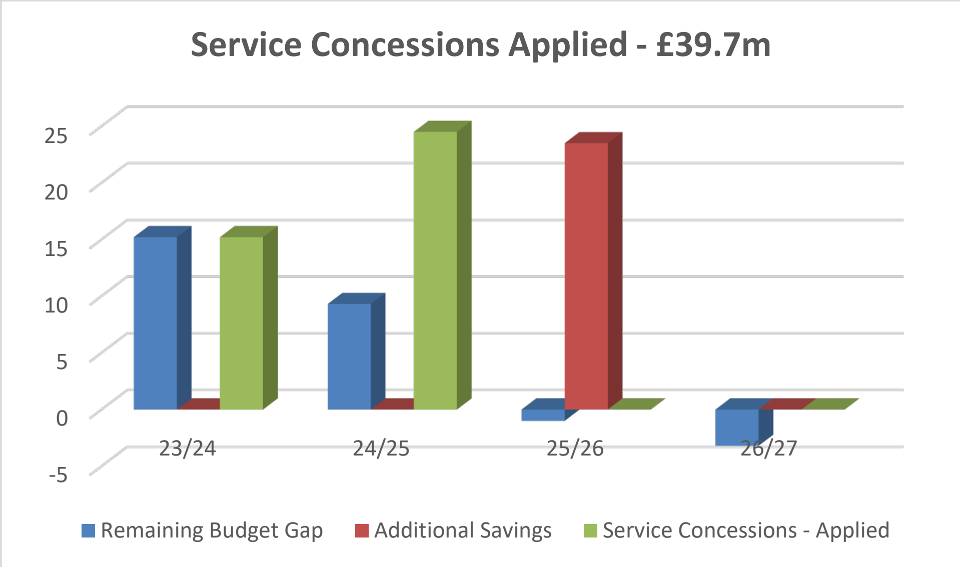
5.7.7 In example 1, SCAs used would applied as follows:

	Previous Year £m	Current Year Gap £m	Total £m
2023/24	-	15.2	**15.2**
2024/25	15.2	9.2	**24.5**
2025/26	24.5	(1.0)	**23.5**
2026/27	23.5	(3.2)	**7.8**
			71.0

5.7.8 In this scenario, there would be insufficient Retrospective Adjustment to fully cover the 2026/27 financial year and therefore £12.5m of savings would still be required. The £7.8m of SCAs used in 2026/27 would be added to any financial gap in 2027/28.

Example 2 SCAs used to bridge first 2 year remaining gaps

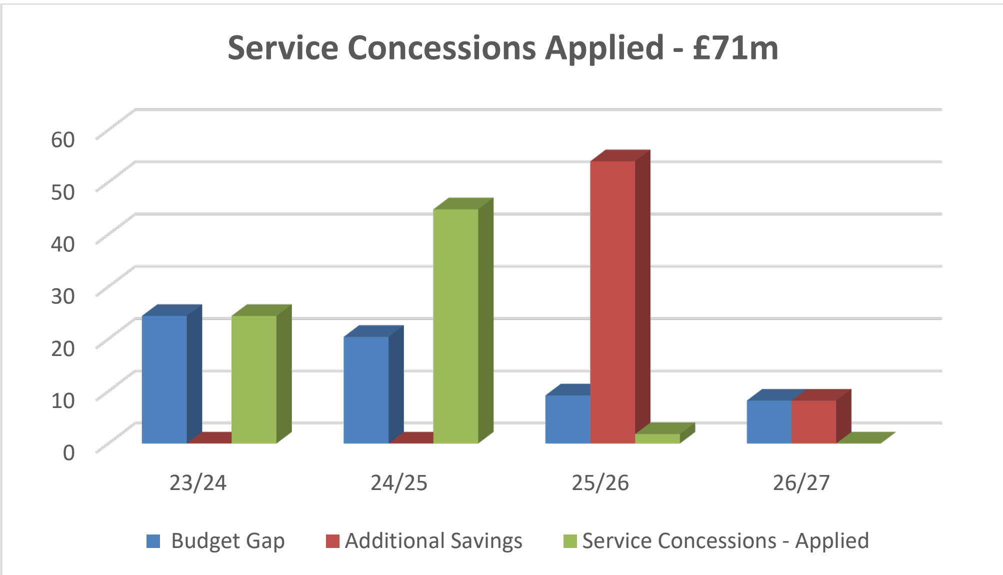
5.7.9 The chart below assumes that Members agree to an annual 5% increase in council tax and that all savings identified are approved, leaving the remaining gap to be filled by SCAs. It also assumes that services identify, and Members approve sufficient recurring savings to balance the position in 2025/26 without the need to use SCAs.



5.7.10 In example 2, £15.2m would be required to balance the position in 2023/24. If no further recurring savings are found, £15.2m would be required for 2024/25 plus the projected gap of £9.3m, leaving a requirement of £24.5m in 2024/25. This illustrates the cumulative nature of using SCAs without continuing to identify/approve further savings.

Example 3 SCAs used to bridge first 2 year total gaps

5.7.11 The chart below assumes that Members agree to an annual 3% increase in council tax and do not approve any savings in years 2023/24 and 2024/25.



5.7.12 In example 3, the Council would use £24.4m of SCAs in 2023/24. In 2024/25, the Council would need to use £24.4m again and a further £20.4m. For 2023/24 and 2024/25, total SCAs used would be 69.2m, leaving £1.8m available for 2025/26.

5.7.13 The chart above demonstrates the financial cliff edge that the Council would create, with savings of £54m required to balance the position in 2025/26. This illustrates the important of applying SCAs with prudence, ensuring that there is priority given to the development and approval of recurring savings.

5.8 Proposed Use of SCAs

5.8.1 A final proposal for the use of SCAs will be presented to Members as part of the Budget Report on 1 March 2023. That report will recommend the use of SCAs to allow the Council to set a balanced budget for 2023/24. Based on current estimates, Council may be asked to approve the use of £15.2m of SCAs in 2023/24.

5.8.2 Council should note that recent advice from our Treasury Advisors is that the prepayment element must be taken in the year in which it is agreed. Given the prepayment element is not required until 2023/24, Council may be asked to defer consideration of this element until during the 2023/24 financial year. However, this will not impact on the quantum of benefits available or their potential use.

5.8.3 Members should note that the use of SCAs to reach a balanced budget position does not address the underlying budget deficit of the Council but instead allows some reprofiling of the budget gap, in effect buying some time to address the underlying issues. Focus must therefore be on the identification and approval of recurring savings.

5.8.4 There is an opportunity to use SCAs for investment in future years but only if the Council achieves financial sustainability on a recurring and sustainable basis.

5.9 Next Steps

5.9.1 Approval to implement the changes to SCAs will be included as a recommendation in the March Budget Report. The March Budget Report will also set out the proposed level of application of SCAs in 2023/24.

5.9.2 The Councils Annual Treasury Management Strategy will consider any impact on the Council’s prudential indicators and Capital Financing Requirement (the Council’s underlying need to borrow). This will be presented to Executive in April 2023 before approval by Council.

5.9.3 The applicable accounting policies will be updated in the Council’s Annual Accounts from financial year 2023/24 onwards.

6. Consultation

6.1 SCAs have been discussed at the Financial Strategy Group and a briefing session was held for all Members on 6 February 2023.

7. Implications

Financial

7.1 The financial implications are set out in the body of the report.

Resources

7.3 There are no additional resources required arising from the recommendations in this report. Link Asset Services, the Council's Treasury Advisors were appointed to undertake the specialist calculations required for this report.

Legal

7.4 There are no legal implications arising from the recommendations in this report.

Risk

7.5 The main risks associated with the recommendations have been set out in the body of the report. There is a requirement to ensure that a prudent approach is taken to the use of SCAs, including the smoothing of repayments moving forward. This work will be picked up as part of the refresh of the Financial Strategy.

Equalities

7.6 There are no equality issues that arise from the recommendations in this report.

Sustainability/Environmental Impact

7.7 There are no sustainability or environmental issues that arise from the recommendations in this report.

8. Conclusions

8.1 The guidance to change how SCAs are accounted for provides a welcome opportunity for the Council to recognise substantial financial benefits. These benefits can be used to support the Council to achieve financial sustainability, a key enabler within the Council Plan. This report emphasises that SCAs do not reduce the budget gap, but they can be used to reprofile the budget gap, buying time to support service change, transformation and savings delivery.

8.2 It is important that Members understand that there are risks around the use of SCAs and that a prudent and sustainable approach is required. That means that Council must continue to focus on the identification of recurring savings to balance the financial gap. That approach could potentially result in SCAs becoming available for future investment.

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Date: 15 February 2023

Appendices

Appendix 1 – Current and proposed repayment profiles

List of Background Papers:

The following papers were relied on in the preparation of this report in terms of the Local Government (Scotland) Act 1973:

Link Asset Services Report on Service Concession Arrangements

Appendix 1

Current and proposed repayment profiles

The Council's Treasury Advisors, Link Asset Services, have prepared the following calculations for the repayment of Service Concession Arrangements:

	Class 98 (£62.889m)				NPDO (£89.320m)				Revenue Prepayment £24m			
	Current position	Principal repayments based on simple 40 year annuity			Current position	Principal repayments based on simple 40 year annuity			Current position	Principal repayments based on simple 40 year annuity		
PPP principal repayments	**Current £000**	**Revised £000**	**(Reduct) /cost £000**	**NPV 3.5% £000**	**Current £000**	**Revised £000**	**(Reduct) /cost £000**	**NPV 3.5% £000**	**Current £000**	**Revised £000**	**(Reduct) /cost £000**	**NPV 3.5% £000**
pre 2023/24	48,156	13,111	(35,045)	(35,045)	28,195	13,426	(14,769)	(14,769)		21,141	(21,141)	(21,141)
2023/24	5,911	1,358	(4,553)	(4,399)	2,379	1,383	(996)	(963)		(337)	337	326
Yrs 2 to 5	8,823	6,755	(2,068)	(2,194)	10,892	6,412	(4,480)	(3,966)		(1,535)	1,535	1,359
Yrs 6 to 10		12,428	12,428	9,394	15,209	10,433	(4,776)	(3,635)		(2,417)	2,417	1,831
Yrs 11 to 25		29,237	29,237	17,894	32,645	57,666	25,022	10,143		(12,346)	12,346	6,504
Yrs 26 to 40										(4,506)	4,506	1,761
Total	**62,889**	**62,889**		**(14,349)**	**89,320**	**89,320**		**(13,191)**				**(9,360)**