REPORT TO: **SPECIAL MEETING OF MORAY COUNCIL ON 1 MARCH 2023**

SUBJECT: **ACCOUNTING FOR SERVICE CONCESSIONS**

BY: **DEPUTE CHIEF EXECUTIVE (ECONOMY, ENVIRONMENT AND FINANCE)**

1. REASON FOR REPORT

1.1 To provide Council with information on the changes permitted to how local authorities account for the repayment of debt on service concession arrangements and request approval of the Council revising its methodology for accounting accordingly.

1.2 This report is submitted to Committee in terms of section (II) (23) relating to the approval of the annual estimates of revenue expenditure.

2. RECOMMENDATION

2.1 It is recommended that Council approves:

(i) the implementation of the option in the guidance on service concessions to revise the accounting methodology as detailed in section 4, resulting in recurring savings of £1.2 million and a retrospective benefit of £11.2 million be approved; and

(ii) the saving from the retrospective benefit be ear-marked for loans charges associated with school new build / refurbishments as set out in paragraph 4.9.

3. BACKGROUND

3.1 Service concessions are contractual agreements to receive services, where responsibility for making available the property, plant and equipment needed to provide those services lies with the contractor. The Council is deemed to control the services that are provided under the schemes, and as ownership of the property, plant and equipment will pass to the Council at the end of the contract for no additional charge, the Council carries the assets used under the contracts on its Balance Sheet. It also has a long-term liability (debt) reflecting the obligation to make payment for the service concessions.

3.2 A unitary charge is paid in respect of each service concession, split into three elements for accounting purposes: payment for services, repayment of debt and interest payable. The element relating to the repayment of debt is used to reduce the long-term liability in the balance sheet.

3.3 The Council has two service concessions: the Elgin Academy/Keith Primary School Public Private Partnership (PPP) and Elgin High School Design, Build, Finance, Maintain (DBFM) scheme. In 2011/12 the Council entered into a 30 year PPP contract for the construction, maintenance and operation of two schools in Keith and Elgin. The contractor took on the obligation to construct the schools and maintain them in a minimum acceptable condition. The annual unitary charge payment in 2021/22 was £5.170m. This increases annually by inflation. In 2017/18 the Council entered into a 25 years DBFM contract for the construction, maintenance and operation of a new school in Elgin. The contractor took on the obligation to construct the school and maintain it in a minimum acceptable condition. The annual unitary charge in 2021/22 was £2.545m. This increases annually by inflation.

3.4 The Council added assets of £45.1 million to its balance sheet in respect of the PPP. After taking into account capital contributions made by the Council a long term liability (debt) of £39.9 million was created. For the DBFM scheme the value of assets added to the balance sheet was £26.2 million, and a long term liability of £25.3 million was created. As at 31 March 2022 the total long term liability for both schemes is £51.3 million.

3.5 The accounting regulations followed to date oblige the Council to reduce the liability related to the assets over the life of the contracts (30 years and 25 years). By the end of this term, the debt outstanding would be nil and the assets will be transferred to the Council's ownership, with a remaining useful life (of 20 and 25 years respectively).

4. SERVICE CONCESSION GUIDANCE

4.1 The Scottish Government gave local authorities three options for accounting for the capital element of service concessions to revenue, set out in Finance Circular 10/2022, published in September 2022.   The options are to continue to expense the long-term liability over the life of the service concession contract; to expense the liability over the expected life of the assets, or to account on a depreciation basis. Any change to the accounting method must be approved by Council in a report setting out the reason for the change. The report must make explicit that this change is prudent, sustainable and affordable over the life of the asset. The second option mirrors the rules for loans fund charges on assets funded from borrowing and is considered to be prudent, sustainable and affordable for the reasons set out below.

4.2 It should be noted that none of the options change the amount that the Council is obliged to pay contractors under the terms of the contract or the timescale over which these payments are made. The guidance relates to purely to the method of accounting for the service concessions.

4.3 The recommended change is considered to be prudent as it spreads the charge to the Council's annual expenditure over the life of the asset, in accordance with standard accountancy practice. Spreading the charge over a lesser period could be argued to be excessively prudent and to penalise today's Council Tax payers to the benefit of Council Tax payers in the future. It is more affordable in the short term to spread the cost over the longer period, as the annual cost is reduced. It is sustainable as the overall cost to the Council remains the same, albeit that cost is recognised over a longer period.

4.4 The loans charges for each year – principal and interest - may be calculated either in equal annual principal repayments with interest payments decreasing over time as the principal is reduced or by the annuity method, whereby the total capital plus interest remain constant, with in a lower principal repayment in the early years, increasing as time elapses. The annuity method is the preferred option, matching the Council's approach for loans fund charges on assets funded from borrowing that were acquired in the same financial years as the service concession arrangements. This is considered a prudent approach as it provides a charge that is better matched to how the benefits of the asset are consumed over its useful life – an asset's deterioration is slower in the earlier years of life and accelerates in later years – and is more affordable in earlier years.

4.5 Under this approach, the charge to revenue would be lower than the unitary charge paid to the operator during the period of the contract, but charges to revenue would continue beyond the contract term for the asset life. The total overall charges over the lives of the asset will be the same. Recurring savings of £1.2 million would be generated during the remaining period of the service concession contracts – in 2024/25 the annual charge would have been £2.317 million and will be £1.149 million under the new method. This saving is one of the financial flexibilities afforded by Scottish Government to assist local authorities. The saving is a key component of the draft budget presented to this meeting of Council.

4.6 As a result of lengthening the repayment period to align with the useful life of the asset there will be an additional cost to revenue each year after the end of the PPP and DBFM contracts until the end of the useful life of the buildings.

4.7 The guidance allows gives Councils the option to calculate the revised charge retrospectively and adjust the revenue account as if the asset life method had always been used. While this does not release cash (the contractors do not pay us money back), it means that the Council's General Fund balance can be increased by reversing part of the charge that has been made to date (this sits in an unusable reserve, the Capital Adjustment Account). This will result in a credit to the General Fund of £11.2 million.

4.8 The Council has submitted a bid to the third phase of the Scottish Government Learning Estate Investment Programme (LEIP). Under LEIP the Council would receive revenue funding on completion of the funded schools, on condition of them meeting certain targets for performance, but would have to finance the capital cost. It is proposed to take the retrospective benefit of £11.2 million in full in 2023/24 and to ear-mark this sum to fund the increase in loans charges for any of the projects associated with the LEIP 3 funding bid or for future loans costs of replacement schools if the LEIP 3 bid is unsuccessful. It is considered prudent to make budgetary provision for these costs to ensure that the LEIP bid is affordable and to otherwise facilitate improvement of the learning estate.

5. SUMMARY OF IMPLICATIONS

(a) Corporate Plan and 10 Year Plan (Local Outcomes Improvement Plan (LOIP))

Financial planning is integral to the Council's overall planning processes and allows the Council to direct resources to its agreed priorities which include financial sustainability.

(b) Policy and Legal

There are no policy or legal implications arising directly from this report.

(c) Financial implications

Changing the basis on which service concessions are accounted for will generate recurring annual savings of £1.2 million and a one-off retrospective saving of £11.2 million. These savings will be matched by future charges after the contract end dates which can be met from existing budgets. The proposed approach is considered prudent as it better matches the costs to the useful life of the assets. It is also sustainable and affordable as the overall cost of repaying debt remains the same. Ear-marking the retrospective saving is prudent as it ensures affordability of further improvement to the learning estate.

(d) Risk Implications

There are no risk implications arising directly from this report. However, if the recommendations of the report are not approved there is a heightened financial risk to the Council of being unable to balance its budget in 2024/25.

(e) Staffing Implications

There are no risk implications arising directly from this report.

(f) Property

There are no property implications arising directly from this report.

(g) Equalities/Socio Economic Impact

No equalities implications arise directly from this report.

(h) Climate Change and Biodiversity Impacts

No climate change and biodiversity impacts arise directly from this report.

(i) Consultations

The Council engaged with its Treasury Management advisers in the preparation of this report. The Chief Financial Officer has been consulted and comments incorporated into the report.

6. CONCLUSION

6.1 Exercising the option to account for service concessions over the life of the asset rather than the life of the contract delivers annual revenue savings of £1.2 million. Re-profiling the debt in relation to the PPP/DBFM schemes would mean a retrospective gain of £11.2 million (section 4.5).

6.2 The annual saving is a key component of the draft budget presented to this meeting of the Council, reducing the budget shortfall in 2023/24 and future years.

6.3 The retrospective benefit should be ear-marked to facilitate investment in the learning estate.

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Background Papers:	
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