Service Concessions

Report by David Gladwin, Acting Chief Financial Officer

Report for Decision

1 Recommendations

a) Approve implementation of the guidance on Service Concession Arrangements (SCA) as detailed in section 3.1 with effect from 1st April 2023;

b) Note the retrospective benefit of £20.463 million to the end of 2022/23 (section 3.15) and the recurring in year saving of £2.608 million in 2023/24 rising to £3.649 million in 2027/28 recognising that whilst this does not release cash (contractors do not refund any payments), it means that the Council's General Fund Reserve increases;

c) Note that additional costs incurred in years beyond the contract terms of Public Private Partnership (PPP) arrangements can be met from PPP unitary charge budget released (section 3.19);

d) Note that the cost of borrowing to access the retrospective funds released by implementing SCA guidance and also the in-year benefits can be met from surplus cash flows that are routinely placed on short term deposit in accordance with the Councils Treasury Management and Investment Strategy. The cost of this is estimated to be £0.147 million in 2023/24 rising to £0.795 million in 2027/28 (section 3.24); and

e) Approve that the utilisation of retrospective benefits is applied prudently on an equal basis over the term of the existing Medium Term Financial Strategy (MTFS) through to 2027/28 to help delivery of achieving longer term financial sustainability as approved by the Business Transformation Steering Group.

Date: 5 February 2023
Report Contact: David Gladwin, Acting Chief Financial Officer

David.gladwin@midlothian.gov.uk 0131 271 3113

2 Purpose of Report / Executive Summary

2.1 This report is to provide Council with information on the changes permitted to how councils account for the repayment of debt on service concessions and to seek approval to implement the change.

2.2 Reprofiling of debt in relation to PPP and similar contracts would mean a retrospective gain of £20.463 million and an annual benefit of £2.608 million starting in 2023/24 rising to £3.649 million in 2027/28 and profiled annually as shown in the "Total (reduction) / cost" column in appendix B.

2.3 While there will be extra costs after the PPP contracts end these can be managed within budget no longer required to pay for PPP unitary charges.

2.4 As the retrospective benefit is on an accounting basis, in order to use this to spend on real expenditure items, the council will have to fund this. Funding this will result in lost interest from short term deposits from short-term surplus cashflow generated funds and grant receipts in advance, phased depending on the timing of applying retrospection.

2.5 The approach proposed in this paper demonstrates that implementing the service concessions guidance is:

- **Affordable** – Ongoing costs of repaying debt after the end of the PPP contract are affordable from the remaining net PPP budget. Any impact of lost income on deposits can be managed within Loan Charges budgets;
- **Sustainable** – The Loan Charges Budget can be maintained at close to current levels and the generation of the retrospective benefit helps sustain the council budget for a period of time;
- **Prudent** – the approach better matched the costs of repaying debt to the useful lives of assets.

3 Background

3.1 The Scottish Government, through Finance Circular 10/2022 published in September 2022, permitted Councils to apply additional flexibility to the accounting treatment for Service Concession Arrangements in place before 1st April 2022. The statutory guidance applies from financial year 2022 to 2023 but permits retrospective application as an option. The key details of the permitted approach are shown in table 1 below.

Table 1: Details of permitted approach.

Options	To calculate the annual charge for the principal repayments of the debt liability: • Equal instalments of principal; or • The annuity method

Discount Rate	The discount rate to be applied should follow the requirements of the Accounting code. The principal repayments should be discounted using the interest rate implicit in the contract if that rate can be readily determined. If that rate cannot be readily determined, the incremental rate of the local authority should be used.
Applicable Years	Applied in 2022/23 or 2023/24 only. Can be either prospective or retrospective application.
Cumulative Statutory Adjustment	The cumulative statutory adjustment is from the Capital Adjustment Account to the General Fund and is made as at 1st April in the year applied. There is no prior year restatement of statutory adjustments. The SCA liability will continue to be written down by the contractual principal repayments.
Applicable Arrangements	The flexibility must be applied consistently to all SCAs entered prior to 1st April 2022 except for contracts with less than 5 years until completion provided the annual charge is not materially different. A body should separately identify the value of each SCA. If not, the asset and liability must be restated at market values. The flexibility does not apply to leases or any similar arrangement.
Governance	The decision to apply the flexibility must be approved by the Full Council.
Prepayments	Where a prepayment was originally funded from a revenue or capital source, the body may revisit that decision and choose to fund the prepayment from borrowing. Borrowing should be recognised as a loans fund advance.

3.2 Accounting for service Concessions refers to how the Council accounts for PPP's and similar contracts. There are four separate contractual arrangements that apply in Midlothian:

- Dalkeith Schools Campus – 30 year PPP contract for the provision and facilities management of schools ending in 2034;
- Midlothian Schools Ltd - 30 year PPP contract for the provision and facilities management of Stobhill, Gorebridge, Tynewater, Moorfoot, Loanhead and St Margaret's, Lawfield and Strathesk Primary Schools ending in 2037;
- Newbattle Community Campus – 25 year not for profit distributing model contract for the provision and lifecycle maintenance of the campus ending in 2043;
- Residual Waste Treatment Plant, Millerhill – 26 year design, build, finance and maintain (DBFM) contract jointly procured by Midlothian and the City of Edinburgh Council ending in 2044.

3.3 The Council engaged Link Asset Services to support detailed work in this area and received a final report on Friday 3rd February. Engagement with Members took place at a Council briefing on Wednesday 8th February and was discussed further at the Business Transformation Steering Group (BTSG) on Thursday 9th February. Engagement with Audit Scotland, the Council's newly appointed auditor, has also commenced. Implementation of this financial flexibility is dependent on approval of full Council.

3.4 Contractors built and sourced the finance for the assets described in section 3.2 above and the Council agreed to make annual contract payments for the duration of each contract (a unitary charge payment).

3.5 For accounting purposes the value of each asset was added to the Council's Balance Sheet with a corresponding long-term debt liability. On an annual basis the unitary charge payment is split into three elements: payments for services, repayment of debt and interest payable.

3.6 The element relating to repayment of debt is used to reduce the long-term debt liability in the Balance Sheet. In effect, the accounting regulations that Councils have followed to date mean that Councils are paying for assets over the life of PPP contracts and at the end point of contracts the outstanding debt in the Balance Sheet will be nil but assets will have some remaining useful life.

Service Concessions Guidance

3.7 At the end of the term of PPP contracts the ownership of assets transfers to the Council, or is shared between the City of Edinburgh Council and Midlothian for the Waste Plant. All assets are subject to a defined repairs and maintenance regime and are anticipated to be in a good condition when they transfer back to the Councils. In other words the date the assets transfer back to the Councils does not equate to the end of their useful lives.

3.8 The new Service Concessions guidance referred to in section 3.1 affords councils the ability to account for the debt repayment element for these assets over their expected useful lives rather than the PPP / DBFM contract term. This is illustrated in Table 2 below.

Table 2: Comparison of PPP contract term against asset useful lives.

PPP Scheme	PPP contract term	Estimated Useful Asset Life
Dalkeith Schools Campus	30 years	50 years
Midlothian Schools	30 years	60 years
Newbattle Community Campus	25 years	50 years
Residual Waste Treatment Plant	26 years	26 years

3.9 The benefits from using these assets are gained over their expected useful lives and it would be more appropriate to account for the repayment of the original debt liability on this basis. This is consistent with the existing accounting treatment of all other non-current assets and the estimated useful lives illustrated in table 2 for each class of asset are consistent with current accounting arrangements.

3.10 This does not change what the Council pays to contractors every year. This is simply about the accounting transactions to pay for the assets. Neither does it change the term over which we pay the contractors, it is just how the repayment of debt is accounted for in the Council's Revenue budget.

3.11 Councils are allowed to apply this change in accounting treatment retrospectively. This means that the accounting presentation can change to reflect entries consistent with paying for assets over their useful lives rather than the contract. This creates an overpayment in the Council's accounts at 1st April 2023, with repayments of debt having been paid over the original contract term rather than the asset life (ie) too much having been charged to the General Fund to pay for the assets.

3.12 Whilst this does not release cash (contractors do not refund any payments), it means that the Council's General Fund Reserve Balance increases by reversing the overpayments made to 1st April 2023, with an equal and opposite adjustment made to the Capital Adjustment Account which is an unusable reserve.

Financial Implications of Implementing new guidance

3.13 As noted in section 3.8 the Service Concession guidance allows the debt repayments to be better aligned to the expected useful life of the assets. It also allows Councils to decide on their preferred approach to make debt repayments. The options available are to make debt repayments using either equal instalments of principal (EIP) or an annuity method.

3.14 This report adopts the latter, calculation of debt repayment on the annuity basis as it best represents the consumption of assets over their useful lives. The annuity method is used as standard practice in most PPP arrangements. Calculation of the debt liability repayments using the annuity method is considered a prudent approach as it reflects the time value of money as well as providing a charge that is better matched to how the benefits from using the assets are consumed over their useful lives – it reflects that fact that an asset's deterioration is slower in the early years of life and accelerates towards the latter years. As a comparison, had these assets been provided at the time of construction through the Council's General Services Capital Plan, debt repayments would have been calculated on an annuity basis consistent with the current approved methodology for repayment of all loans fund advances made to fund General Services Capital Plan assets.

3.15 By implementing the new Service Concession guidance section 3.11 notes that there will be a retrospective gain to the Council. After full review of guidance and detailed analysis of contract conditions, calculations have been finalised and the retrospective benefit to the end of 2022/23 is £20.463 million. This is shown in detail at appendix B.

3.16 The new profile of repayments means that the council will have over-paid debt to the value of £20.463 million to the end of 2022/23. This can be taken as a financial benefit and transferred to the General Fund Reserve. The increase in the Council's General Fund Reserve can be used over time to support implementation of the MTFS to contribute to achieving a position where annual council expenditure and annual income are in equilibrium thus demonstrating ongoing financially sustainability.

3.17 In addition, there will be a £2.608 million in-year benefit from 2023/24 rising gradually to £3.439 million by 2027/28. Full in-year impacts are shown in the “Total (reduction) / cost” column in appendix B. These in-year figures are reflected in the latest projections of budget gaps as shown in the Medium Term Financial Strategy report at agenda item 8.7 today.

Repayment over a longer term

3.18 As a result of lengthening the repayment periods by aligning these to asset lives there will be an extra cost for each year from the end of the PPP contract to the end of the asset life. This is shown in detail at Appendix B in the “Total (reduction) / cost” column. The first year of additional cost is in 2043/44 and totals £74.431 million through to 2067/68 when all assets will be fully accounted for.

3.19 Taking into account an estimate for inflation over the remaining years and reducing the PPP unitary charge budget by the level playing field support which will no longer be provided by the Scottish Government at the end of 2033/34, it is anticipated that an annual net budget (after deduction of Level Playing Field Support) in excess of £18 million will be available.

3.20 It is suggested that this PPP unitary charge budget that will no longer be required to fund PPP unitary charge payments be used to fund the additional annual payments that arise from 2043/44 from lengthening the repayment period.

3.21 It is also appropriate to consider the time value of money. Modelled at 3.5%, table 3 shows the overall Net Present Value (NPV) of moving from the current repayment methodology to the revised repayment methodology. This highlights an NPV saving of £36.584 million over the period to which the last PPP asset will be fully accounted for.

Table 3: NPV impact of recommendation

Year	Total (reduction) / cost £000	NPV £000
Pre 2023/24	(20,463)	(20,380)
Yrs 2 to 5	(11,636)	(10,293)
Yrs 6 to 10	(20,167)	(15,254)
Yrs 11 to 25	(12,811)	(9,757)
Yrs 26 to 40	43,263	14,237
Yrs 41+	21,814	4,863
Total Saving	**0**	**(36,584)**

Costs linked to using the retrospective benefit

3.22 As noted in section 3.12 this is not a cash benefit, but an accounting benefit. Using the retrospective benefit to support the MTFS and ultimately to pay for council expenditure then it is necessary to access funds. There are two options, to borrow or to use an element of cash balances.

3.23 Midlothian's TMIS supports the cash backing of reserves and it is also common to see short dated cash deposits shaped around cash flow. This is particularly the case when actual capital expenditure occurs later than planned or grants are received in advance. It therefore seems a sensible approach to access funds to support application of retrospective benefits from cash balances as required. It is therefore proposed that the application of the retrospective and in-year benefits be funded by surplus funds as required.

3.24 There will be a cost of utlilising these funds equating to income foregone on cash deposits. The annual values of these will depend on the profile of applying retrospection. For illustrative purposes table 4 below shows this cost based on an equal split of applying retrospection over a five year period along with accessing in-year benefits.

Table 4 – Costs of accessing the benefits of SCAs.

Financial Year	Retrospective Debt Overcharged £000	Use of Retrospective Debt Overcharged £000	Use of in-year Benefit £000	Interest Foregone £000	Net (saving) / cost to General Fund £000
Pre 2023/24	20,463				
2023/24		(4,093)	(2,608)	147	(6,554)
2024/25		(4,093)	(2,796)	342	(6,547)
2025/26		(4,093)	(3,005)	439	(6,659)
2026/27		(4,093)	(3,227)	609	(6,711)
2027/28		(4,091)	(3,459)	795	(6,755)
Total	**20,463**	**(20,463)**	**(15,095)**	**2,332**	**(33,226)**

3.25 It can be seen from table 4 that interest forgone thus resulting in an increase to the loan charges budget in 23/24 is £0.147 million rising to £0.795 million in 2027/28. By which time all retrospective savings are applied and the ongoing impact will solely relate to use of in-year benefit. Additional loan charges costs are dwarfed by savings from implementation of revised SCA guidance.

Use of Service Concessions Benefit

3.26 It would be prudent and also good fiscal sense to use the retrospective benefits in a staggered way over the period of the current MTFS to smooth pressures that may come from current areas of financial pressure like pay and inflation and also to allow time and investment to support the transformational change that is essential in delivering ongoing financial sustainability for the council. Table 4 above models application on an equal basis over years 2023/24 to 2027/28.

3.27 Should members approve the recommendations in this report consideration can be given to implementation as part of the MTFS report at agenda item 8.7 of today's agenda.

3.28 Members are advised that the Acting Chief Financial Officer, in his capacity as section 95 officer, confirms that the proposals set out in this report, including longer-term budgeting plans for longer-term increased costs, is consistent with the requirements for the proposal to be prudent, sustainable and affordable.

4 Report Implications (Resource, Digital and Risk)

Resource

4.1 The financial outlook remains challenging for the term of this Council and the recommendation of the External Auditor is "*as a matter of urgency, officers and elected members need to work together to develop and agree the medium term financial strategy and progress the Council's transformation plans*".

4.2 Implementation of revised SCA guidance increases the General fund reserve on 1st April 2023 by the retrospective element of £20.463 million and provides in-year savings through to 2042/43.

4.3 Prudent application of retrospective savings can contribute to the overarching goal of ongoing financial sustainability for the Council.

Digital

4.4 The adoption of digital solutions is a central strand of the Medium Term Financial Strategy. One-off areas of investment in digital transformation could be funded from savings generated by approval of this report.

Risk

4.5 The following key risks and issues are highlighted in the context of the MTFS:

- Uncertainly over the Scottish Government's and Council's financial position;
- The economic outlook and decision by Scottish Government on future years grant settlements and grant distribution;
- The risk to service provision and service users associated with a continued decline in available resources to fund services;
- Future years Public Sector pay policy and current and future year pay award settlements;
- Actual school rolls varying from those provided for in the budget;
- The impact of the wider economic climate on range of factors including: inflation, interest rates, employment, tax and income levels and service demands;

- Cost pressures, particularly demographic demand, exceeding budget estimates;
- The reform of public services and the implications for the National Care Service (Scotland) Bill;
- The impact of Universal Credit, and potential pension changes;
- The costs of implementation of national policies varying from the resources provided by Government;
- Potential liabilities arising from historic child abuse;
- Unplanned capital investment requirements and the associated cost; and
- Ability to continue to meet the expectations of our communities within a period of fiscal constraint.

4.6 Developing a MTFS is important and can support the mitigation of a number of these risks by setting out the key assumptions on which forward plans are based. The consequences of the challenging grant settlement parameters mean that it is also necessary to bring forward measures to secure financial balance over the period covered by the Medium Term Financial Strategy.

4.7 The risk of not having in place a balanced MTFS is the potential elimination of available reserves, which in turn would severely limit the Council's ability to deal with unforeseen or unplanned events and also the imposition of significant cuts at short notice with limited opportunity for consultation.

4.8 Approval of this report makes available sums that can be applied to not only contribute to ongoing financial stability but can be used to mitigate manifestation of any risks identified at section 4.4 above.

Ensuring Equalities

4.9 The strategic plan and associated MTFS together with the resource allocation measures which will support financial sustainability will, as far as the constraint on resources allow, be developed within the context of the Council's priorities, ensuring as far as possible that resources are directed towards the key priorities of reducing inequalities in learning, health and economic circumstance outcomes.

4.10 The Strategic Plan and associated MTFS will continue, as far as is possible, to reflect Midlothian Council's commitment to the ethos of the Equality Act 2010 with careful consideration of the interests of the most vulnerable in our communities through the preparation of equality impact assessments.

4.11 In addition, the Strategic Plan will underline the Council's commitment in its Equality Plan to tackle inequality and promote inclusion within the limitations of the resources available. It will also allow the Council to plan and deliver services which meet the needs of our diverse communities and respond to the changes ahead.

Additional Report Implications

See Appendix A

Appendices

APPENDIX A – Report Implications
APPENDIX B – Total Proposed rescheduling model

Appendix A

A.1 Key Priorities within the Single Midlothian Plan

The Strategic Plan and associated Medium Term Financial Strategy facilitates decisions on how Council allocates and uses its available resources and as such has fundamental implications for delivery of the key priorities in the Single Midlothian Plan. It helps ensure that resources are available to continue to delivery key priorities.

A.2 Key Drivers for Change

Key drivers addressed in this report:

☒ Holistic Working
☒ Hub and Spoke
☒ Modern
☒ Sustainable
☒ Transformational
☒ Preventative
☒ Asset-based
☒ Continuous Improvement
☒ One size fits one
☐ None of the above

A.3 Key Delivery Streams

Key delivery streams addressed in this report:

☒ One Council Working with you, for you
☒ Preventative and Sustainable
☒ Efficient and Modern
☒ Innovative and Ambitious
☐ None of the above

A.4 Delivering Best Value

The report does not directly impact on delivering Best Value.

A.5 Involving Communities and Other Stakeholders

The development of the Strategic Plan and associated Medium Term Financial Strategy provides for public engagement.

In addition, there has been and will continue to be, engagement with the recognised Trade Unions on the Council's financial position and the development of the Strategic Plan and associated Medium Term Financial Strategy.

A.6 Impact on Performance and Outcomes

The Strategic Plan and associated Medium Term Financial Strategy facilitates decisions on how the Council allocates and uses its available resources and as such has fundamental implications for service performance and outcomes. The financial consequences of the pandemic have impacted on the availability and allocation of resources in pursuit of key outcomes as set out in the Single Midlothian Plan for both the immediate and longer term and therefore the ability of the Council to continue to deliver services in a financial sustainable manner.

A.7 Adopting a Preventative Approach
An effective Strategic plan supported by a Medium Term Financial Strategy will support the prioritisation of resources to support prevention activities.

A.8 Supporting Sustainable Development
There are no direct sustainability issues arising from this report and we will work to mitigate any sustainability issues which arise as a consequence of the Strategic Plan and associated Medium Term Financial Strategy.