TONBRIDGE & MALLING BOROUGH COUNCIL

OVERVIEW AND SCRUTINY REVIEW GROUP

9 September 2014

Report of the Director of Finance and Transformation

1 REVIEW OF CAPITAL RENEWALS PROVISIONS

1.1 Background

1.1.1 Budget provision for the replacement of vehicles, plant and equipment is identified in the Council's Capital Plan. These provisions are collectively referred to as capital renewals and in the seven year period covered by the 2014/15 Capital Plan, average £829,000 per annum. Annual revenue contributions to meet the cost of capital renewals have been temporarily suspended but are scheduled to be reintroduced in the near future. Going forward, changes in the level of provision for capital renewals will have an impact on the Council's revenue savings targets. In general, annual budget provisions for capital renewals are underspent.

1.2 What are capital renewals

1.2.1 Service delivery costs typically include expenditure on staffing and payments to suppliers. These costs are consumed during a financial year and therefore feature in the services' annual revenue budget. Most services also utilise vehicles, plant and equipment either directly (e.g. sports equipment at a leisure centre) or indirectly (personal computers and associated network infrastructure). Vehicles, plant and equipment has a useful life of more than one financial year so it is capitalised (appears as an asset on the Council's balance sheet) and budgeted for within the Capital Plan. In any one year capital renewals will include:

Service / Facility:	Average each year £000's	%	Vehicles, plant and equipment including:
IT	275	33	PCs, servers, network and some software.
Leisure Centres and Golf Course	270	33	All sports equipment, pool equipment, catering equipment, furniture and carpeting.
CCTV, Car Parking & Recycling	110	13	CCTV cameras and monitoring equipment; ticket machines; recycling vehicle, banks and boxes.
Parks & Open Spaces	102	12	Children's outdoor play equipment, benches and picnic tables, security fencing and signage.
Departmental Equipment	72	9	Telephone system, printing equipment, photocopiers but excluding most furniture.
	829	100	

1.3 Capital renewals funding

1.3.1 In 1991 the Council sold its stock of council houses. The sale proceeds enabled all borrowing to be repaid and generated a cash balance (circa £50m) that was set aside in a reserve to meet capital expenditure in the future. Whilst the Council will receive a limited amount of external support in the form of government grants and developer contributions, that reserve (known as the capital reserve) provides the main source of funding for existing schemes and any new schemes that are added to the Capital Plan. The capital reserve also funds capital renewals.

1.3.2 Historically the capital reserve has received an annual top-up from revenue as part of the Council's budget setting process. That top-up was intended to contribute sufficient new funds to meet the cost of replacing existing plant and equipment as it reached the end of its useful life as well as providing money for statutory services e.g. disabled facilities grants. Clearly, replacement of life expired assets such as IT and the equipment used in our leisure facilities and elsewhere is essential to enable the Council to continue to deliver services.

1.3.3 The Council's budget for 2003/04 included revenue provision of £500,000 to meet the cost of capital renewals. In subsequent years that revenue provision was scaled back to ease the pressure on the Council's revenue budget and "buy time" to enable revenue savings to be identified. In 2009/10 no revenue funding was provided for. The report to January 2009 meeting of the then Finance and Property Advisory Board justified the action as follows:

"1.2.4 *The 2008/09 original estimates made provision for a contribution of £450,000 which represents approximately one third of our long term capital renewals and other annually recurring expenditure. The current financial difficulties are unprecedented and caused by a variety of factors which are outside the Council's control. The capital reserve is of sufficient size that in the short term the annual top-up can be temporarily suspended but this is* ***predicated*** *on the following:*

- *that current approved expenditure be examined with a view to budget provision being deleted or scaled back where feasible by some £2.5m,*
- *the totality of new additions to the Capital Plan be limited to a predetermined annual figure of £600,000 (maximum), and*
- *the annual contributions to the capital reserve from revenue are reintroduced within a reasonable time frame and increased over time to a level sufficient to meet capital renewals and other annually recurring expenditure, currently £1.5m.*

1.2.5 *On the assumption that the values identified in paragraph 1.2.4 are accepted then the revenue reserve for capital schemes will continue to be available to support new investment, without recourse to borrowing, throughout the life of the current MTFS.*

1.2.6 *The new additions and annual revenue contribution figures will need to be reviewed on a regular basis and incorporated into the Council's Capital Strategy."*

1.3.4 The Capital Reserve balance has fallen to £7.5m at the start of this financial year (2014/15) and at the present rate of consumption will be exhausted in four years. Annual contributions to the capital reserve to meet the cost of capital renewals are reintroduce in our Medium Term Financial Strategy in 2018/19.

1.4 How capital renewal provisions are determined

1.4.1 Budget provisions for capital renewals in the current and next four years of the Capital Plan are summarised in the table below.

2014-15 Capital Plan - Capital Renewals Provisions	**2014/15 £000**	**2015/16 £000**	**2016/17 £000**	**2017/18 £000**	**2018/19 £000**
Planning, Housing & Environmental Health Services	33	183	46	35	35
Street Scene & Leisure Services	403	400	385	591	475
Corporate Services	350	468	332	347	275
Total	786	1,051	763	973	785

Approximately 95% of these provisions are supported by detailed schedules of equipment. An extract from the Street Scene and Leisure schedule is provided at **[Annex 1]**. The remaining provision, approximately £50,000 per annum, is based on historic expenditure patterns and relates to the replacement of CCTV equipment and recycling boxes / banks.

1.4.2 In general, the detailed schedules incorporate a separate entry for each item of equipment and record the purchase price and date when last purchased. Service managers will provide an estimate of the useful life of the equipment which is used to predict when budget provision will be required for future replacements.

1.4.3 The schedules cover the same 10 year period used in the Council's Medium Term Financial Strategy (MTFS). To simplify the calculations involved a common price base is used throughout the schedules (mid-current financial year). Global provisions for inflation in future years are determined when the estimates are incorporated into the Capital Plan and MTFS.

1.4.4 As part of the budget setting process the schedules are updated each autumn. The update incorporates any equipment replaced in the preceding 12 months and any unspent provision relating to the previous financial year is brought forward. The schedules are also amended for any additions and deletions. Service managers are asked to review the updated schedules and confirm that the estimates of useful life are reasonable.

1.4.5 The schedules will evolve over time. Whilst equipment replacements are usually on a like for like basis technological advances / market trends and changes in service delivery methods mean that isn't always the case. New items will also arise from capital refurbishment / enhancements schemes.

1.5 Budget performance

1.5.1 A small proportion of equipment will be covered by four / five year maintenance agreements (e.g. leisure centre fitness equipment). Such equipment will be replaced as the maintenance agreement expires. The certainty over the replacement date ensures budget provision for replacement is allocated to the correct financial year. However, the majority of equipment will be replaced when a service manager considers it appropriate (the item has failed, is near to failure or deemed no longer safe). The accuracy of budget provisions for such equipment is largely dependent on the initial assessment of useful life. Those useful life assessments are generally pessimistic. Equipment invariably lasts longer than anticipated and as a consequence budgets are underspent.

1.5.2 An analysis of actual spend vs budget over the last four years is provided at **[Annex 2]** and summarised below.

Capital Renewals	**2010/11**		**2011/12**		**2012/13**		**2013/14**	
	£000	**%**	**£000**	**%**	**£000**	**%**	**£000**	**%**
Budget	1,486	100	910	100	1,205	100	864	100
Actual spend	1,016	68	559	61	955	79	430	50
Underspend	470	32	351	39	250	21	434	50

The average underspend over the four years is £376,000 or 34% of budget. As outlined in section 1.3 above, capital renewals are currently funded from the capital reserve. This underspending means the reserve balance is higher than it would have been had spending been in-line with budget, in other words, the Council is better off. In the future capital renewals will be met from revenue and therefore features in our revenue projections or MTFS. The MTFS is constructed using estimates (budget provision) based on current prices uplifted for the inflation in the future years. Inaccuracy in budget provision will inevitably impact on the level of savings predicted by the MTFS.

1.5.3 The significance of this issue was recognised by Management Team autumn 2010 and two actions taken. Firstly, service managers were tasked to undertake a detailed review of their renewals provisions during 2011 and requested to "*ensure that the replacement cost and the asset life in particular are reasonable. The schedules should also be amended for any items that no longer require replacement in the future or new additions arising from current or recently completed capital plan schemes* ". Secondly, Management Team introduced a savings target (adjustment) to moderate the level of budget provision for capital renewals. A target of 10% was applied to service summaries (i.e. globally rather than to each specific item of equipment). The target was applied in setting the revised estimates for 2011/12.

1.5.4 The review by service managers in 2011/12 had limited impact on the overall level of renewals provisions. The exercise was repeated in 2012/13 and again had limited impact. To avoid over budgeting for renewals the savings target (adjustment) was increased to 20% for the revised 2012/13 estimates. It is evident from the table at paragraph 1.5.2 that there is scope to refine the renewals estimates and or savings target still further.

1.6 Options for the future

1.6.1 Four options have been identified and the advantages / disadvantages associated with each are as follows:

1. Do Nothing.

Advantages:
- No further consideration required.

Disadvantages:
- Fails to address the issue of over budgeting.
- Revenue savings targets likely to be overstated.
- Perpetuates inaccuracy in the level and timing of individual renewals provisions.
- No incentive for service managers to improve budget accuracy in the future.

2. Invite service managers to undertake another review of asset life.

Advantages:
- Reduces over budgeting.
- Reduces likelihood of revenue savings targets being overstated.
- Engages service managers in the process.
- Greater accuracy over the level and timing of provision for each item of renewals

Disadvantages:
- Previous reviews had limited impact on the level of over budgeting.

3. Increase the global savings target from say 20% to 25%.

Advantages:
- Reduces over budgeting.
- Reduces likelihood of revenue savings targets being overstated.

Disadvantages:
- Perpetuates inaccuracy in the level and timing of individual renewals provisions.
- No incentive for service managers to improve budget accuracy in the future.

4. Increase the asset life for each item of vehicles, plant and equipment in the schedules by a predetermined amount e.g. 25% and subject the result to review and confirmation by service managers. The current global savings target of 20% will be eliminated at the same time.

Advantages:
- Reduces over budgeting.
- Reduces likelihood of revenue savings targets being overstated.
- Engages service managers in the process.
- Greater accuracy over the level and timing of provision for each item of renewals.

Disadvantages:
- Increased risk that some items of vehicles, plant and equipment may fail earlier than predicted by the schedules.

1.7 Conclusions and issues for discussion

1.7.1 Only options 3 and 4 above are likely to have a significant impact on the level of over budgeting outlined at paragraph 1.5.2. Either option is expected to yield a reduction in capital renewals budget provisions of 5%. A 5% budget reduction equates to approximately £41,000 per annum and, if introduced, could contribute to one of the savings targets set out in the MTFS.

1.7.2 Under Option 4, the asset life for each piece of vehicles, plant and equipment is increased which increases the risk that an item may fail ahead of schedule. That risk exists at present and is addressed in a very practical way. If an item of equipment fails early and is critical to service delivery then service managers are invited to progress an immediate replacement. This approach will be perpetuated whichever option is adopted.

1.7.3 Approximately 1/3rd of the value of capital renewals is attributed to vehicles, plant and equipment owned by the Council but used on a daily basis by the Tonbridge and Malling Leisure Trust. The legal agreement with the Trust provides for an annual review of the capital renewals schedules. That review is due to commence in the near future and will be influenced by Member's consideration of this matter. Option 4 is not precluded by the agreement but in common with all other service areas the amendment to asset lives will be subject to discussion and agreement with the relevant service manager. Asset lives will revert to current or some agreed alternative if a service manager believes current life plus 25% is inappropriate (e.g. adverse impact on income).

1.7.4 Achieving a 25% reduction in renewals provision is considered deliverable. A higher figure may be justified based on recent experience. However, there are a number of one-off factors that contribute to the underspend identified in paragraph 1.5.2. The level of budget provision and spend against budget will be subject to continuous review and further adjustment to budgets will be made in the future if appropriate.

1.7.5 A separate exercise will be undertaken for non-scheduled equipment (CCTV and recycling boxes / banks) which are covered by general provisions.

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