membership resources

Briefing 20-69 **July 2020**

APSE Briefing: Public Accounts Committee Report into Local Authority Commercial Activity

All APSE Contacts in England, Northern Ireland, Scotland & Wales

1. Introduction

In recent years local authority investment in commercial activity has increased, in many cases as a direct response to austerity. This commercial activity has been through both income generation from fees and charges, alongside active investments in property and assets. During the COVID-19 health pandemic income from fees and charges, such as leisure membership, car parking and events has suffered dramatic falls and in addition concerns have been raised as to the long-term health of investment decisions; especially in sectors whereby there may be long term issues as to viability such as large office complexes.

In many cases the income from investments has been a welcome additional resource for councils in place of cutting budgets. However, this has not been without criticism, particularly from within Government where concerns have been raised about the risks of commercial exposure.

These concerns have now manifested in a new report from the Public Accounts Committee (PAC) which investigated the issue of commercial investments by local authorities and alongside this they have criticised what they suggest is inaction by MHCLG. In this briefing therefore we consider the findings and recommendations made by the PAC but we also point to the balanced approach to commercial investments and managed risk which most sensible councils have adopted. Notwithstanding the differing legislative frameworks within England, Scotland, Wales and Northern Ireland which relate to powers to charge, trade and make investments the issues raised by the Public Accounts Committee are arguably cross-cutting throughout the UK. This briefing will therefore be of interest, especially for those who have responsibility for delivering commercial strategies.

2. The Findings and recommendations of the Public Accounts Committee

Borrowing purely for yield and out of area investment

First of all, in respect of MHCLG, the PAC suggests that it has been complacent whilst £7.6 billion of 'taxpayers' money' has been placed into risky commercial property investments. The PAC argues that far from the MHCLG response, that borrowing purely for yield is relatively scarce, they point to the recent NAO study which looked at both the growth of commercial property

investments and its concentration of spend in a smaller number of authorities. The PAC also suggested that there was a specific issue with out of area spend stating **"***The NAO's report demonstrates the significance of acquiring property for yield rather than service provision: £2.5 billion of spend in the three years to 2018–19 was on property out of authorities' own areas with 64 authorities incurring this form of spend".*

However, APSE would argue that for many parts of the UK 'out of area' investment is part of a balanced approach to managing risk. In areas of poor returns because of low value should those authorities not be given the opportunities available to authorities in more affluent areas? Furthermore, centring investment in one area opens up the prospect of being subject to localised economic shocks, such as the loss of anchor retailers. In any event whilst some investment may be regarded as purely for yield, many authorities have in turn invested that yield in local developments that might otherwise have been unaffordable, creating much wider social and economic benefits from that yield.

The PAC recommendation on this issue is: -

Recommendation: The Department must be more active in its oversight of the prudential framework and strike a better balance between supporting localism and ensuring that local authorities act within the frameworks that underpin local freedoms. To do this the Department should:

- **communicate publicly the types and scale of commercial activity, including new innovative types of commercial investment, where it has concerns that behaviour is not consistent with the spirit of the prudential framework;**
- **publicly challenge behaviour where it has concerns; and**
- **work with the LGA and other sector bodies to ensure that the Department's concerns are understood and communicated consistently across the sector.**

Extreme debts

The PAC suggests that MHCLG's failure to ensure that 'authorities adhere to the spirit of the framework has led to some authorities taking on extreme levels of debt which is both risky and sends a mixed message to the sector'.

They argue that 'amongst the group of district councils that have been most active in acquiring commercial property the median level of external borrowing as a share of spending power (government grant plus council tax) increased from 3% to 756% from 2015–16 to 2018–19', singling out Spelthorne Borough Council borrowing £1.1 billion against annual core spending power of £11 million.

This ratio of debt to spending power relies upon the debt being serviced by the rental income, and highlights the increased risk in the event of an economic downturn. The PAC does however

acknowledge that guidance from MHCLG and CIPFA makes clear that authorities should not borrow solely to invest for profit and states "In CIPFA's view this activity has traditionally been viewed as unlawful. Nonetheless, the prudential framework, even with the revised investment guidance, has failed to constrain the extreme levels of risk taking by some authorities".

As APSE and others have observed for some time, those taking a higher risk change the terms of the debate for all authorities but in most cases local authorities have clear parameters in place for their investment risk, and the appetite for risk should be established early on in the investment strategy, with the support of elected members.

Minimum Revenue Provision

Minimum Revenue Provision (MRP) is **where the local authority under prudential borrowing requirements must set aside money each year to repay the debt.** This means that borrowing is reflected in current spending and prevents the costs of borrowing falling wholly on future council tax payers. The PAC states that 'The NAO found some instances where local authorities were still not making MRP on their commercial property acquisitions. Richard Watts, Chair of the Local Government Association Resources Board told us that not applying MRP "strays very close to breaching" the requirements on authorities'.

The PAC therefore makes two recommendations on this point:

Recommendation: ***For its future oversight of the prudential framework the Department*** **needs to develop, and rapidly deploy, interventions that target extreme risk taking. These should be used as part of a wider package of measures to limit non-compliance with the framework, regardless of scale.**

Recommendation: The Department should undertake a review of the MRP guidance and consider whether its statutory basis should be strengthened and how to require local authorities to improve the clarity and transparency in relation to commercial property purchases.

Actions to Address Risky and Non-compliant Behaviour

The PAC acknowledges that MHCLG has amended its guidance in response to the rapid growth on commercial property and borrowing levels but suggests that this work is too little and too late, noting that the initial calls for changes were made in November 2016 but subsequent guidance was not operational until 2018-2019. Which is after significant further spending identified by the NAO. They state that "HM Treasury is consulting on prohibiting loans purely for yield and investments outside an Authorities area. The consultation also proposes that authorities have to provide more detail, including on potential commercial investment, on their borrowing and investment activities in their annual returns to the Public Works Loan Board (PWLB)". Reference is also made to the efficacy of the 1% increase in the cost of new PWLB loans

in October 2019. In addition to this HM Treasury's decision to bring the PWLB back in house they suggest will enable departments to access more accurate and timely information about loans.

On this issue APSE would argue that the 1% rise was something of a blunt instrument. In many areas local authorities had already developed advanced plans for redevelopments, such as shopping centres abandoned by developers, where to save local High Streets and Town Centres, local councils had stepped in, not motivated by solely a return on investment, but by acting as stewards of local place, and making active and necessary interventions to improve local economic activity and community well-being. The 1% increase therefore arguably stymied the 'good' and the 'bad' in investment terms which makes for a poor policy decision by HM Treasury.

The PAC suggest that the need for a hard intervention (in the form of the rate raise) highlights the failure of the soft intervention (the guidance). It therefore makes the following recommendation.

Recommendation: The Department should take steps to ensure that future interventions are more timely and effective and subject to rigorous post-implementation review to ensure lessons are learnt.

The prudential framework has been impaired by the emergence of new forms of behaviour in the sector, and now requires fundamental review.

The PAC highlights that MHCLG state that 'authorities have "managed, as it were, to escape" from the affordability constraint that is critical to the prudential framework. We are particularly concerned to hear that this undermines the Department's statutory backstop powers to intervene in relation to borrowing by individual councils. They go on to highlight new forms of investment such as renewable energy schemes, including 'solar bonds', that they suggest there needs to be a better understanding of. Again, they make a recommendation that points towards further interventions: -

Recommendation: ***Working with CIPFA and sector stakeholder bodies, the Department should undertake a thorough review of the prudential framework, that addresses the issues we have identified. The Department should publicly report within the next 12 months. This review should incorporate the recommendations relating to challenging behaviour in the sector, designing effective interventions and improving the data held by the Department set out elsewhere in this report.***

However, APSE is mindful that whilst any new behaviours or forms of investment should be thoroughly assessed, we would not want this to signal a slowing down of the innovative forms of new investment, particularly in the area of green investments. So far over 280 local authorities have declared Climate Emergencies, which need to be translated into action plans, these plans will inevitably need new forms of investment to transform and decarbonise services and local areas.

Access to the data to carry out oversight responsibilities

The PAC stated that it recommended "in 2016 that the Department improve the data it holds on local authority commercial investment activity. The Department did take steps to improve the data it has access to, but these changes have not added much clarity, and the new data the Department acquired is already outdated. The Department needs to improve the data it has access to on local authority investment activity and the associated risks, so it can assess the exposure to risk of local government investment in individual sectors. It also needs better data to ensure framework compliance".

Whilst this recommendation seems sensible, as the recent COVID pandemic has highlighted, the data on investment and risk is very much dependent on prevailing economic conditions, therefore in terms of using this data to assess risk it would potentially only serve as a litmus test. Ultimately the local authority, under the current framework remains responsible for any losses and of course Government has confirmed its unwillingness to compensate investment losses as a result of commercially driven investment decisions – taking a markedly different approach to compensating losses incurred from fees and charges, as part of the financial package to councils in responding to COVID-19 pressures. This recommendation also therefore raises the question as to what actions would be taken if the Government ultimately believed an authority was acting outside of the framework. On the one hand councils have been encouraged to raise more of their own finances and on the other it appears as if the PAC would seek to limit that by more central interventions.

A 'serious' data review in relation to local authority commercial investment

As part of the MHCLG response to the PAC it undertook to take a serious data review on commercial investment however the PAC suggests that this should be expanded to include new forms of investment such as renewables and include other matters such as local authority trading companies to explore "the potential scale and direction of travel of this activity which can then trigger further investigation if required".

The PAC recommends: -

Recommendation: ***The Department should write to the Committee by September 2020 setting out its approach and timescale for improving its data on council commercial activity, and how this relates to its broader review of the prudential framework. The Department should also set out how it intends to use its improved data following the data reviews to strengthen framework compliance. The data review should address the concerns we have raised relating to data on new forms of commercial activity, and on the use of data to assess framework compliance.***

APSE would argue that whilst data can be of great importance as a performance assessment and indeed compliance tool, this of itself, does not address the underlying issue which is that

commercial activity has been a necessity in responding to austerity over the past decade. In any event councils have always had the ability to raise income from statutory and non-statutory fees and charges, alongside broader powers to act commercially which stretch back decades. It is vitally important that the spectre of some out of kilter behaviours does not then translate into curtailing the freedoms and flexibilities that councils need in order to operate effectively.

External audit

The committee suggest that changes to external audit could be used to improve assurances about related local authority commercial investment activity. However, they warn that this will 'not be a silver bullet'. The PAC highlights that in the Department's (MHCLG's) Post Implementation Review of its recent guidance changes concluded that audit "should not be viewed as a strategy for mitigating risk within the system" and they state that therefore "it is unlikely to inform decision making when authorities are developing their commercial strategies". The PAC also suggests that whilst the forthcoming publication of the Redmond Review by MHCLG will be welcome, alongside assurances that this will then allow consideration of what changes should be made to the local audit framework, the PAC makes the point that this will not be a substitute for scrutiny in real time.

APSE has also argued that local scrutiny, and testing the appetite for risk, should be a consideration at the start of developing commercial strategies and not an afterthought. Whilst audit has a place in the process of accountability, efficient scrutiny measures should also be in place at a local level. That being said, with growing experience in commercialisation matters, many councils have adopted and developed effective schemes of delegation to enable quicker decision making (for example in property purchases) but, alongside this, transparent reporting and scrutiny requirements of their commercial strategies.

The PAC therefore makes two recommendations on the issue of external audit: -

Recommendation: As part of its review of the prudential framework, the Department should consider a wider package of changes, rather than relying primarily on (post-Redmond) external audit to address failings in the local governance of commercial investment activities.

Recommendation: The Department should write to the Committee within three months of the publication of the Redmond Review setting out its response to the review, including not only how the Department intends to strengthen local audit but also how this will support improved governance of commercial investment activity.

Local governance arrangements are not robust enough

A final perspective of the PAC is that '**Local governance arrangement are not robust enough with some authorities' commercial investments not being properly transparent or subject to adequate scrutiny and challenge'**. As previously raised by the PAC (in May 2019) they are

concerned about weak arrangements for the management of risk. They point out that 'commercial sensitivity is not an adequate excuse for concealing risk and uncertainty'. They highlight that written evidence as part of their inquiry stated that there is limited reporting to members, and decision-making can be taken by very small groups. Some local capital strategies still do not, it is argued, contain the level of transparency encouraged by the Department.

Again, on this point, APSE has always been mindful through its commercialisation network to ensure that transparency and scrutiny has to be part of any council commercialisation strategy, however, this too has to be carefully managed. Undermining for example an intended property purchase by making this public knowledge could not only flag the potential investment to rival investors but could also drive up the price through generating competition. There are nuances as to how investments need to operate to secure better outcomes. Therefore, a mature outlook on scrutiny and governance matters should be agreed at the start of any commercial strategy but also regularly reviewed, so any gaps in accountability can be properly addressed.

The PAC recommendations on this matter are: -

Recommendation: ***The Department should:***

- ***work with LGA to disseminate good practice about transparent and inclusive decision making;***
- ***following discussion with the sector, set clear expectations about the details required in capital strategies not only about planned investments but also previous investments including their performance against expectations, financing costs, the scale of contingency reserves, and their contribution to service budgets; and***
- ***work with relevant partners to support local arrangements for scrutiny and challenge of council investments.***

3. APSE concluding comments

Whilst the PAC intervention in the debate on council commercialisation matters raises some interesting factors, and is worthy of further consideration, this comes at a time when council exposure to commercial risk is once again in the headlines. As a result of COVID-19 there has been seismic changes in behaviour through both Government restrictions, such as social distancing, but also potential longer-term changes, such as the growth in online shopping and home-working; which of course has implications for both retail and office developments as investments, and how such assets may need to be re-purposed in the near future.

A further consideration is that, in responding to the financial pressures placed on councils as a result of the health pandemic, the spotlight on losses of income has exposed the reliance that councils have had to develop to ameliorate the impact of austerity. Councils have lost money from income from fees and charges (which will be partially compensated by Government – see APSE Briefing 20-63) but Government has also made it clear it will not be compensating councils for any losses of investment income. This underpins the semi-autonomous nature of councils'

investments; it is they who will lose out from poor investment decisions and they therefore have a vested interest in appropriate management of risk. That is not to suggest that Government (nor the PAC) should not take an interest in ensuring that risks are well managed and due regard is given to governance and accountability, since losses will ultimately impact on the financial security of councils, and local tax-payers. However, in the vast majority of cases, with the support of experienced and highly professional teams within local authorities, this management of risk is well-balanced and proportionate.

It is important to remember in all of this that informed elected councillors are involved in decision-making, providing democratic accountability for those investment decisions. It would be wrong therefore to end up with an overly burdensome reporting regime against an ever-tightening framework or code of practice which undermines the democratic accountability of councils. Many local authority leaders have made a conscious effort to be more commercially minded, as a deliberate strategy, to offset the impact of council budget reductions, in order to save both services and jobs in their local area.

APSE would therefore support overarching efforts to ensure governance and accountability measures are strengthened and that 'outliers' in terms of the balance of risk on investments, are properly managed and if needed appropriate actions could be taken. However, now more than ever, when councils are already suffering financial hardships as a result of COVID-19 it is also important that we do not use the proverbial sledgehammer to crack a nut. The vast majority of councils are following the spirit and intention of the existing codes of practice alongside their own scrutiny and governance processes as well as having due regard to their own financial standing orders. Any future actions and changes must therefore be proportionate to the problem in hand, and not applied as a brake across all investment activity.

Mo Baines

APSE Head of Communication and Coordination

Email: mbaines@apse.org.uk