REPORT TO:	FINANCE AND MANAGEMENT COMMITTEE	AGENDA ITEM:	9(a)
DATE OF MEETING:	13TH JANUARY 2005	CATEGORY: RECOMMENDED	
REPORT FROM:	DIRECTOR OF CORPORATE SERVICES	OPEN	
MEMBERS' CONTACT POINT:	KEVIN STACKHOUSE (595811)	DOC: u/ks/leasing/leasing	
SUBJECT:	FINANCING OF VEHICLES, PLANT, MACHINERY and WHEELED BINS	REF:	
WARD(S) AFFECTED:	ALL	TERMS OF REFERENCE: FM08	

1.0 Recommendations

1.1 That the Council sets up a Renewals Fund for the future replacement of its vehicles, plant, machinery and wheeled bins.

1.2 That the Council transfers £550,000 from the Commutation Reserve to set up the Fund.

1.3 That capital resources are used to finance the Fund in the future, and be identified in the Council's approved capital investment programme.

2.0 Purpose of Report

2.1 To consider options for financing the future purchase and replacement of the Council's fleet of vehicles, plant, machinery and wheeled bins.

3.0 Executive Summary

3.1 Effectively, the report assesses other options available to the Council compared to the current method of leasing. This was undertaken to determine whether there was a more cost-effective method of financing the replacement of the Council's assets, and in particular, to help mitigate the projected medium and longer-term budget deficit on the General Fund.

3.2 The options appraisal was based on an estimated replacement programme over the next 11 years. The analysis concludes that although prudential borrowing could be a cheaper option in some aspects, it would not help to significantly mitigate the projected budget deficit and free up significant revenue resources.

3.3 Using capital finance in the future was therefore considered, as a means of saving the relatively large amount of revenue leasing charges in the General Fund. The report concludes that using a Renewals Fund is the best option.

3.4 In the longer term, this would be more beneficial in cash flow terms, in addition to helping to mitigate the projected budget deficit in the medium term as leasing is wound down.

4.0 Detail

Background

4.1 The Council currently finances the replacement and purchase of vehicles, plant, machinery and wheeled bins through leasing. This method has been used for a number of years.

4.2 The leases are "operational" in nature, in that effectively the Council rents the use of the asset through a financing company. Repairs, maintenance and insurance are the responsibility of the Council, but the asset remains in the ownership of the lessor and returns to them at the end of the leasing period.

4.3 In addition, the Council arranges and undertakes the procurement of assets, including through a tendering process if necessary. Leasing is the method by which the purchase is financed.

4.4 Typically, assets are leased over the following periods:

- Vehicles – 7 years (although revised accounting arrangements will reduce this to a 5-year term from 2005/06).

- Plant, machinery and wheeled bins – 10 years

4.5 At the end of the lease period (called the "primary" period), the asset is either:

- Returned to the lessor – any costs involved are borne by the Council,
- Bought by the Council,
- Sold/scrapped as agreed with the lessor – any net cost is borne by the Council, or
- The lease agreement is extended into a secondary period at a much reduced cost to the Council.

4.6 As can be seen, all the above involve an additional cost to the Council, which is not easy to estimate. It depends on the requirements of the Council in each circumstance and on the condition/future suitability of the asset concerned.

Benefits and Drawbacks of Leasing

4.7 Leasing has been used extensively throughout local government, mainly due to previous limitations on borrowing, together with limited revenue and capital resources. It can have the following benefits:

- It doesn't tie up capital.

- The cost is spread over a number of years.

- Costs of individual leases are fixed and are relatively certain over the terms of the lease.

- It is currently an "off balance sheet" form of capital financing. This means that for local authorities there is no requirement to set-aside provision for repayment in a revenue account.

- It is a tried and tested method that has worked for a number of years.

4.8 However, leasing can also have drawbacks, as follows:

- The lessee doesn't own the asset.

- It is inflexible - once the terms of the lease are agreed, they are extremely difficult and costly to amend if circumstances surrounding the condition or use of the asset change.

- There are hidden costs, for example in penalty payments, especially when the asset is returned in a condition that does not meet the terms of the lease; i.e. is unacceptable to the lessor.

- For administrative reasons, finance is only "drawn down" once per year to cover all items. Where assets are bought and used before this date, this can increase leasing charges.

- Although individual lease charges are fixed, the overall amount can vary from year to year depending on new leases and any existing ones terminating. This makes longer term budgeting more difficult.

- New accounting regulations for leasing could restrict "off balance sheet" transactions which may increase costs in the future.

Current Leasing Costs

4.9 The Council currently incurs around **£286,000 per year** in leasing charges and this is summarised in the following table.

Asset	**Annual Cost (£)**
Vehicles	180,200
Plant and Machinery	41,600
Wheeled Bins	64,600
Total	**286,400**

4.10 In addition, the Council is also committed to increasing this amount from 2005/06 by around £15,000. This is mainly to finance the purchase of wheeled bins to extend the composting scheme in the District. This would take the annual amount to just over **£300,000**.

Why Review Leasing

4.11 Members will be aware of the projected general fund budget deficit in future years. Due to the magnitude of annual leasing charges as highlighted above, together with a potential requirement to make efficiency savings in financing and procurement as indicated in the Gershon Report, a review of leasing as the adopted financing method has been undertaken.

The Scope of the Review

4.12 The other options available in addition to leasing are:

- to borrow,
- to purchase assets outright each year using capital resources, or
- to operate a Renewals Fund.

4.13 This is the scope of the following options appraisal, i.e. to determine the best financing method for purchasing/replacing the council's **current** fleet of vehicles, plant and equipment, etc. for **current** services.

Contract Hire

4.14 This is not considered as part of the options appraisal. Contract Hire is the alternative to purchasing, servicing and managing vehicles and plant "in-house." Whether this is a better alternative in meeting the Council's wider requirements would need to come from a more fundamental review of the Council's fleet/transport service.

Projected Replacement Programme

4.15 Before determining the best financing method, a review was undertaken to determine what are the future requirements for vehicles and plant, etc. The main basis for this is the dates when a current lease expires, i.e. it is assumed that this is the date that triggers the replacement of that particular asset.

4.16 Therefore, this replacement programme only covers those items that are currently leased. Other smaller items of plant and equipment on the Council's overall inventory are not included as they are usually replaced from within other revenue budgets.

4.17 In addition, known commitments, in particular relating to wheeled bins over the next 2 years has also been included. Any further replacements would need to be subject to the service development process to obtain additional funding in accordance with the Council's financial strategy.

4.18 In total, the indicative **rolling** programme over the next 11 years is summarised in **Appendix 1.** The main assumptions regarding price increases, etc. are also shown.

4.19 Effectively, the Council will need to finance an estimated capital investment of around **£2.8m** over the next 11 years. This is to replace its major items of vehicles, plant and machinery that would normally be leased.

4.20 It should be noted that any replacement programme is only a plan and would over 11 years be subject to change. For example, planned replacements may not occur as per the schedule, some could be earlier, some assets may last longer.

4.21 However, it is considered that this indicative programme provides a good basis on which to undertake the relevant financial appraisal.

The Initial Options Appraisal – Leasing v Borrowing

4.22 Members will be aware that under the Prudential Code for Capital Finance, the Council does have some degree of flexibility to borrow outside Government allocations. The main caveat is that the Council is required to demonstrate that the cost of any borrowing is prudent, affordable and sustainable.

4.23 Current research indicates that there is some evidence of authorities that have or are considering, using prudential borrowing as an alternative to leasing.

4.24 The appraisal was undertaken using the Net Present Value (NPV) methodology. This compares costs where the various cash flows occur over different time periods. It uses a discount rate (3.5%) to calculate the present value of the costs and produces a NPV. In this case, the best option is that showing the lowest NPV.

4.25 The NPV effectively takes into account the future value of money; i.e. £1 today will be worth less in say 10 years. This does not have any real effect in the short term, but is more of a guide to values in the longer term.

Assumptions

4.26 To test which is the best financing method between leasing and borrowing, the estimated replacement values for 2004/05 were used (as shown in **Appendix 1**). This is the **capital** value of assets for which new leases will need to be arranged in March 2005 (around £290,000 in total). The other main assumptions are shown in the table below.

Financing Period	• To reflect asset lives under revised accounting arrangements from next year and the Council's Depreciation policy: ➢ Vehicles – 5 years ➢ Plant, Machinery and Wheeled Bins – 10 years
Leasing Rate	• The prevailing financial market rates as at September 2004
Borrowing Rate	• Government (PWLB) rates as at September 2004
Principal Repaid	• On maturity of the loan
Leasing	• After the primary period there are 2 options of either: ➢ Purchase the asset, or ➢ Extend the Lease into a Secondary period

4.27 The detailed workings are shown in **Appendix 2.**

4.28 A summary of the estimated costs over the associated 5 and 10 year periods, are shown in the following table.

Prudential Borrowing

	Vehicles (5 years) £	Plant and Machinery (10 years) £	Wheeled Bins (10 years) £
	66,478	85,813	164,775
Leasing			
Primary Period	54,147	90,964	146,793
Then Purchase (Option 1)	59,325	97,021	156,965
Or Extend Lease (Option 2)	64,945	106,957	175,081

Vehicles

4.29 Leasing appears to be the most favorable option, but less so if the lease is extended.

Plant and Machinery

4.30 Borrowing appears the better option; in particular compared to the leasing options after the primary period.

Wheeled Bins

4.31 Leasing appears to be the best option in the primary period, but becomes less attractive with options 1 and in particular, number 2.

Which is the Best Option?

4.32 Arguably, this part of the appraisal is inconclusive, as relatively there is little to choose between leasing and borrowing costs. Leasing rates do tend to follow borrowing rates and either may be better at any particular time.

4.33 One of the issues associated with leasing is that it depends what decision is made after the primary period, and this is not easily predicted as previously highlighted. In comparison, borrowing incurs no additional costs after it is repaid and the Council owns the asset.

4.34 Consequently, it has the option of keeping the asset (at no extra financing cost) or selling/scrapping it for a residual value. However, borrowing could incur a "provision for set-aside" in the General Fund, depending on the level of its overall Capital Financing Requirement.

4.35 Although borrowing may be less costly overall, it would still be an on-going cost in the Council's General Fund. This would not help to significantly reduce the projected revenue budget deficit.

4.36 This leads onto the option of purchasing assets outright using capital resources.

Capitalising the Purchase of Assets

4.37 Using this option, each year the Council would need to earmark the relevant financing in its capital programme to replace assets. Effectively, this would need to be the "first call" on capital resources.

4.38 The indicative replacement programme shown in **Appendix 1** requires an investment of £2.8m over the next 11 years. This equates to an average of around £250,000 per year.

4.39 However, within this, the replacement programme is very volatile. For example, in 2005/06 projected requirements are relatively small. However, between 2007 and 2009, projected replacements are more significant.

4.40 Given these amounts, the Council may find it extremely difficult to finance replacements in those years from its projected capital resources. Earmarking £250,000 per year may also be difficult, as an adequate reserve may not have been set-aside to cover the peak years.

A Renewals Fund

4.41 This is a fairly common method of replacing vehicles and plant, etc. Its main benefit is that it helps to smooth out the peaks and troughs of the replacement programme.

4.42 In addition, it can bring a degree of flexibility to the programme in that it allows for changes from year to year as long as the overall balance of the fund over the planning period is not compromised. For example, some replacements can be brought forward, whilst others can be put back depending on condition of assets and the requirements of the service.

4.43 However, a renewals fund needs to be established and resources set-aside to do this. In addition, it requires to be "topped up" on a regular basis. To illustrate this, **Appendix 3** sets out a profiled renewals fund based on the indicative replacement programme from Appendix 2.

4.44 This shows that an amount of £550,000 would be required to establish the Fund (Year 1) topped up by between £225,000 and £250,000 per year for 10 years. Together, this finances the £2.8m rolling programme.

4.45 The annual top up would need to be found from the Council's capital resources. It is unlikely that this amount could be found from within current revenue resources.

Comparison to Leasing

4.46 At current rates and within current budgets, the Council would continue to incur around £300,000 per year to meet this replacement programme. This would total in excess of £3.3m over 11 years. In cash terms, this is around **£1/2m more** than the capital financing option, i.e. the £2.8m capital value. This is illustrated in **Appendix 4.**

Financing the Renewals Fund

4.47 The Fund would operate as an earmarked capital reserve. The initial 550,000 could be set-aside from next year's available capital resources. However, this may significantly reduce resources for other investment opportunities.

4.48 Another option would be to redirect other reserves available to the Council, in particular the present reserve earmarked for "commutation." This is no longer required for this purpose and totals around £960,000.

4.49 The on-going amount, initially of £225,000 per year, could be found by redirecting current repayments on covenant agreements as they fall out. This would provide nearly ½ of the required amount to 2009/10 and all of the annual contribution form 2010/11 onwards as the largest covenants are repaid.

4.50 The remaining £125,000 per year required would then be the "first call" on future capital investment programmes to 2009/10. Effectively, this would need to come from capital receipts.

4.51 The Council has in recent years generated useable capital receipts well in excess of £100,000 per year. Current projections show that this should continue to be the case but clearly this cannot be guaranteed. However, with additional receipts now available to the Council from the transitional pooling arrangements, this may help to reduce this risk further.

Potential Drawbacks of a Renewals Fund

4.52 Apart from ensuring that adequate capital receipts are earned and earmarked to 2009/10 as highlighted above, other issues are as follows.

- Some deposit interest may be lost, in particular on the initial £550,000 if part of the commutation reserve is used. This money is effectively in the Council's bank, although it is likely that it would be utilised in the future in any case. In addition, this amount effectively covers the first 3 years replacements so would not be fully spent at the outset.

- The main cost is not readily measurable, in that it is (to use the jargon) an "opportunity cost." This means that in providing the initial funding and on-going top ups, the Council is fore going capital investment opportunities in other areas.

- It is a longer-term investment with pay back over a number of years. In addition, until around 2014, the Council would still be paying for existing leases, albeit at a reducing and much lower cost.

- Depending on actual replacements, the Fund may need a further one-off top up every 10 years or so.

So what are the benefits?

4.53 Besides savings on cash paid out over the longer term, the main benefit is that the General Fund would eventually be saving around £286,000 per year from leasing charges. This is incremental, and would be fairly significant on a cumulative basis over the longer term. An analysis is shown in the following table.

Analysis of Leasing Charges Falling Out
(if not renewed)

Year	Annual Amount (£'000)	Cumulative Amount (£'000)	Cumulative Savings on Budget (£'000)
2005/06	27	27	27
2006/07	13	40	67
2007/08	46	86	153
2008/09	83	169	**322**
2009/10	60	229	551
2010/11	23	252	803
2011/12	1	253	1,056
2012/13	16	269	1,325
2013/14	6	275	1,600
2014/15	11	286	1,886

4.54 The budget savings are assuming that around £286,000 would be rolled forward on an annual basis in the Council's financial projections. Effectively, the end column in the above table identifies the cumulative savings available compared to that included in the current budget.

4.55 For example, compared to current projections for leasing, the Council could save around £322,000 by 2008/09 if leasing was wound down.

4.56 Clearly, this would considerably help to reduce the overall projected deficit on the General Fund. However, it would be prudent to earmark a relatively small proportion of this to meet any termination costs when current leases expire.

Other Benefits Compared to Leasing

4.57 The report previously highlighted some of the potential drawbacks of leasing. A renewals fund would be more beneficial in that:

- The Council would own assets and would benefit directly from any residual value.
- There are no "hidden" costs associated with leases expiring.
- There is more flexibility on when actual replacements are made, both in the year and between years, as long as the overall programme and balance on the Fund is not compromised.

Renewals Fund - Risk Analysis

4.58 It has previously been noted that the Renewals Fund is dependent to some extent on future capital resources that are not guaranteed. In addition, it has been identified that the Fund may need a further top-up every 10 years. Furthermore, regulations could change around procurement and financing of assets.

4.59 To reduce these risks, the Council has the following options.

- To use savings from future covenant repayments as they are repaid.

- To set-aside the remainder of the Commutation Reserve as a contingency.

- To set-aside additional capital receipts in any year that are exceptionally high, for example, utilising the extra receipts from the transitional pooling arrangements.

- Borrowing could be utilised, in particular to finance the more expensive assets. However, this would again put pressure on the General Fund.

- To utilise assets as long as possible. The replacement programme assumes that each vehicle is replaced every 5 years. On average, vehicles may have a useful life longer than this.

5.0 Financial Implications

5.1 As detailed in the report.

6.0 Corporate Implications

6.1 None Directly.

7.0 Community Implications

7.1 None Directly.

8.0 Conclusions

8.1 Leasing has worked for a number of years, but it is a fairly significant cost in the Council's General Fund. It appears that there is little to choose between leasing and prudential borrowing. Although in some aspects borrowing may be cheaper, it would not save significant amounts in the General Fund.

8.2 The review effectively recommends setting up a Renewals Fund to replace the Council's vehicles, plant and machinery in the future. This would entail using reserves to set up the Fund and using future capital resources to maintain it, to meet the Council's replacement programme.

8.3 Using reserves and capital resources does forego potential investment opportunities elsewhere. However, in the longer-term, there are overall cash flow savings.

8.4 In addition, any drawbacks need to be balanced against, that by moving away from leasing, this would produce fairly significant on-going savings in the General Fund. This would help to mitigate the projected budget deficit in the medium term.

9.0 Background Papers

9.1 None