

TORBAY COUNCIL

Report No: **Env/60/04**

Title: Review of the Method of Funding Fleet Purchases

To: Executive on 7th December 2004

1. Purpose

- 1.1 To determine the method of financing the acquisition of new and replacement vehicles and items of plant and machinery.

2. Relationship to Corporate Priorities

- 2.1 Vehicles supplied by fleet management are used in the delivery of all the Council's priorities.

3. Recommendation(s)

- 3.1 That Torbay Council utilises the option under the new Prudential Framework, to borrow money directly or to take up finance leases to fund the capital purchase of vehicles and items of plant and machinery where it is beneficial to do so.

4. Reason for Recommendation(s)

- 4.1 Having carried out a financial assessment of the various methods of financing the purchase of vehicles and items of plant and machinery it is considered that using the freedom to borrow available to Councils under the new Prudential Framework will give the benefit of reduced costs and greater flexibility in the procurement process and also produce overall service improvements.

5. Key Risks associated with the Recommendation(s)

- 5.1 For a number of years the Council have used operating leases as the method of financing the purchase of most vehicles and larger items of plant and machinery. An operating lease is a contract between a lessor and a lessee for the hire of a specific asset. The lessor retains the ownership of the asset but the right of use is given to the lessee for an agreed period of time in return for a series of rentals, which includes an interest charge, paid by the lessee to the lessor. An operating lease will not run for the full life of the asset and the lessor takes the residual risk. In all the existing operating lease agreements the lease rentals are fixed for the primary period, the lessee retains the risks associated with costs of financing and changes in interest rates. It is also a requirement of an operating lease that the lessee takes the risk of what the asset will be worth (residual value) after the primary period has ended. However, a leasing company would take into account changes in interest rates, or fluctuations in residual values, when entering into new leasing agreements.
- 5.2 The key risks associated with the recommendation to borrow directly to fund fleet purchases is changes in interest rates within the Council's Borrowing portfolio and to fluctuations in the residual values of assets purchased.
- 5.3 It is considered that these are Intermediate risks within the Council's Risk Matrix.
- 5.4 All the other risks associated with operating vehicles financed through operating leases are currently borne by the Council and therefore there would be no change under the recommendation.

5.5

Likelihood	6	6	12	18	24
	5	5	10	15	20
	4	4	8	12	16
	3	3	6	X 9	12
	2	2	4	6	8
	1	1	2	3	4
		1	2	3	4
		Impact			

Low risk

Intermediate risk

High risk

The "x" in the above matrix denotes where the author has assessed the level of final risk to fall

6. Alternative Options (if any)

6.1 Carry on using operating leases to acquire vehicles and items of plant as described in paragraph 5.1 above. The use of operating leases has certain advantages and disadvantages.

6.1.1 Advantages

- Certainty - once the lease has been signed, the Council has certainty over a large element of the cost of using the asset over the initial pre-determined period (primary period). This degree of certainty enables the lessee to cost and budget for the provision of the asset more accurately.
- No Capital Investment – the ownership of the asset remains with the lessor so there is no call on the capital resources of the Council.
- Residual Value Risk – providing the asset is held for the full term of the lease then the Council is relieved of any residual value risk.

6.1.2 Disadvantages

- Inflexibility – once an operating lease has been agreed it can be very difficult to end the lease, it can be done but the penalties for early termination are very costly. Assets like vehicles are normally leased over a 5, 7 or 8 year period, over these timescales services needs and technology will change. Most operating leases provide for the rights in the lease to be transferred, by agreement with the lessor, but not the obligations.
- Return Conditions – over the last few years return conditions have proved to be one of the major problems associated with operating leases. Examples of these problems are excess mileage, the cost of returning the asset to a location specified in the lease at the expiry of the agreement, the cost of an engineering inspection and the condition of the vehicle when returned must be reasonable (subject to fair wear and tear). This places the onus on the Council to ensure that the asset is in a good condition at the expiry date. Over the past years leasing companies have generally been looking more closely at the definition of reasonable and the cost of this return condition has increased. All of these return conditions can individually or collectively add to the overall cost of a lease and present a large cost at the end of the agreement.
- Secondary Periods – the Council is usually required to inform the lessor, three months before the expiry date of the agreement, whether it intends to return the asset or carry on into a secondary period. The lessor can offer revised terms; the revised secondary rentals are at the discretion of the lessor and are usually based on the current market

value of the asset. Secondary agreements have been used and have proved to be more expensive than originally expected.

- Administration – these costs can be high and are due to the initial costs of market testing to obtain competitive quotes from leasing companies, entering into the lease agreement, the recording of lease agreements and paying lease rentals, dealing with termination and return conditions and secondary rental period if required.

6.2 Contract Hire – another expression for an operating lease, usually for vehicles, where the supplier carries the residual risk and the rentals usually include maintenance of the vehicle. There have been only a few examples of this type of agreement over the last 10 years.

7. Background

7.1 The Operational Services Division will need to acquire over £4m of new or replacement vehicles and items of plant and machinery over the next four years. These vehicles are used in the delivery of various services provided by the Council including road sweepers, refuse collection vehicles, welfare buses, small vans, lorries, gritting vehicles and tractors. The cost of acquisition is currently charged to service budgets via an inclusive hire charge.

7.2 For a number of years the Council has used operating leases as the methods of financing the purchase of most new and replacement vehicles. The main reason for this was due to the Local Authorities (Capital Finance) Regulations. These regulations imposed tight controls over local authority borrowing. Borrowing allocations were scarce and spending capital resources on replacing vehicles was not a priority. Under an operating lease the lessee does not end up owning the asset so they did not impact on the capital controls imposed by the government.

7.3 Report F/9/03 described to members the new Prudential Framework. This allows Councils to borrow money to fund capital projects provided it is “affordable” without government support. Borrowing to buy vehicles would be “Unsupported” and the Executive recommended that “a cautious approach be taken to the use of “unsupported borrowing” and that consideration be given initially to the potential for funding capital schemes which will generate sustainable revenue budget savings in the future”.

7.4 The Capital Plan Budget (2004/05 – 2007/08) – Annual Review reported to Executive on 16th February 2004 proposed that consideration could be given to approving some “unsupported borrowing” where it is more economic than other forms of financing such as operating leases. This could produce revenue benefit to the Council as opposed to increasing the burden on Council Tax.

7.5 Having compared the costs and benefits of borrowing directly to fund the acquisition of vehicles and items of plant and machinery to the cost and benefits of operating leases, see appendix 1, it is considered that borrowing directly has the following advantages.

- Produce an overall net revenue saving.
- Increase the flexibility of the procurement process for service users.
- Improve overall service to customers.
- Reduce the risk of unknown costs occurring at the end of the life of the asset.
- Reduce time spent in lease administration.

7.6 It is recommended that the option to borrow through the Council’s Treasury Management function or take up other forms of finance such as HP be considered as an alternative to operating leases where it is beneficial to do so.

- 7.7 Provision for the estimated annual requirements for vehicle and equipment purchases for the next three years will be included as part of the Capital Plan Budget (2005/06 – 2008/09) – Annual Review reported to Executive in February 2005.

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IMPLICATIONS, CONSULTATION AND OTHER INFORMATION

Part 1

These sections may have been completed by the Report author but must have been agreed by the named officers in the Legal, Finance, Human Resources and Property Divisions.

Does the proposal have implications for the following issues? If "Yes" - give details. <i>delete as appropriate</i>		Name of responsible officer
Legal	Not at this stage	
Financial – Revenue	Covered in the body of the report	R. Thorpe
Financial – Capital Plan	Covered in the body of the report	L. Royce
Human resources	No	
Property	No	

Part 2

The author of the report must complete these sections.

Could this proposal realistically be achieved in a manner that would more effectively: <i>delete as appropriate</i>		
(i)	promote environmental sustainability?	No
(ii)	reduce crime and disorder?	No
(iii)	promote good community relations?	No
(iv)	promote equality of opportunity on grounds of race, gender, disability, age, sexual orientation, religion or belief?	No
(v)	reduce (or eliminate) unlawful discrimination (including indirect discrimination)?	No

If the answer to any of the above questions is "Yes" the author must have addressed the relevant issue/s in the main report and have included a full justification and, where appropriate, an impact assessment.

Part 3

The author of the report must complete this section.

	<i>delete as appropriate</i>	If "Yes", give details
Does the proposal have implications for any other Directorates?	Yes	Improve the overall provision of services, reduce revenue costs and increase flexibility.

Part 4

Is this proposal in accordance with (i.e. not contrary to) the Council's budget or its Policy Framework?	<i>delete as appropriate</i>
	Yes
1.	If "No" - give details of the nature and extent of consultation with stakeholders and the relevant overview and scrutiny body.
2.	If "Yes" - details and outcome of consultation, if appropriate.

Part 5

Is the proposal a Key Decision in relation to an Executive function? (i.e. would generate expenditure or savings in excess of £100,000 or 20% of an approved budget OR affect more than 2,000 residents of the Borough.)	<i>delete as appropriate</i>	If "Yes" - give Reference Number
	No	

Part 6

Wards

Not applicable

Appendices

Appendix 1 Financial Assessment of funding vehicle and plant and machinery purchases under prudential borrowing rules

Documents available in Members' Room

None

Background Papers:

The following documents/files were used to compile this report:

Report F/9/03