



A Review of the Revised Penny Rate Product during 2010/2011

**A paper for Belfast City Council from the Institute of
Revenues Rating and Valuation**

January 2011

INTRODUCTION

This brief report was commissioned because of the need for Belfast City Council to have an initial validation of the revised actual Penny Rate Product for 2010/11 and the estimated Penny Rate Product for 2011/12. There are no formal terms of reference due to the urgency of the request. The Institute of Revenues, Rating and Valuation (IRRV) issues this document on a "pro bono" basis as part of its on going relationship with the Council.

The Importance of the PRP

LPS undertakes the calculation of the PRP and notifies the Northern Ireland Local Authorities of the estimated penny rate product for the upcoming financial year. There are two calculations - the estimated PRP (EPP), which enables local authorities to set the rate poundage in line with their budgetary requirements and the actual PRP (APP), which reflects the annual outturn and determines the final distribution of the income.

These calculations and the data that is used to reach the appropriate figures are critical to the financial processes of local government in Northern Ireland. It is, therefore, essential that any forecasts that inform these calculations are as accurate as possible.

Operational Arrangements

Historically the EPP was calculated in October of each year, in respect of the following financial year. Two calculations are prepared – one for the District Councils and one for General Grant purposes for use by the Local Government Division (LGD).

As a result of the growing awareness of the importance of the rate income to local authorities there has been a concern at the inaccuracy of the EPP as notified in advance of the financial year. This inaccuracy can result in a higher than necessary rate poundage being set or alternatively reducing the amount of money available to finance spending plans.

It is noted that in an attempt to improve the predictive accuracy of the EPP, the LPS has been working more closely with the BCC and the other Councils in Northern Ireland over the past 3 years. In particular a significant factor in this work has been the dialogue with the representatives from the Association of Local Government Finance Officers (ALGFO) and the Society of Local Authority Chief Executives (SOLACE).

As a result of the work with ALGFO the LPS undertook to provide three estimates for the upcoming year. This was a significant step in the improved liaison with local authorities. The first estimate is provided in early October , the second early November and the final in mid-December.

Following the issue of the October estimate LPS met with the Councils to discuss the EPP and provide details of the assumptions underpinning the calculation. The discussions were also an opportunity for Councils to question any aspect of the estimate and provide local knowledge on anything that may impact during the life of the estimate.

It appears that the EPP now includes more current information about the losses on collection and cost of collection and whilst local authorities are made aware of the assumptions it is critical that the accuracy of the information that leads to those assumptions is rigorously challenged both within LPS and externally by the NI Councils.

Whilst the cost of collection ought to be based on reliable data the same cannot always be said of the losses on collection. As an example of our concern we mention two specific losses.

- The figures relating to irrecoverable sums are always difficult to estimate. Not only are we in uncertain economic times there is the added problem of the large amount of debt both domestic and non domestic. The question that needs to be asked is, how much is truly recoverable? The debt needs to be analysed in terms of its age and status in order to properly estimate the collectable yield.
- The amount lost due to vacancies net of empty property rate, here the question is simple, are the figures a true measure of vacant property and empty rate levied or is there an administrative issue to be faced in terms of the quality of information held in the database.

Whilst local authorities are encouraged by LPS to scrutinise and challenge the key elements of the estimate the question that must be asked is, do they have the knowledge and the information available to them to drill down into the detailed elements of the calculation – the answer to this question must be no.

Councils are provided with a number of working spreadsheets to assist their understanding of the process and allow them to if they so wish tweak the estimate. The spreadsheets are intended to replicate the assumptions made so calculations are transparent to Councils. Spreadsheets are provided for EPP for future years, in-year and APP outturn and arising from recent discussions with Councils the LPS now provides quarterly updates of the Rateable Value base.

BASIS OF ESTIMATED PRP

We have been informed by LPS that the data for estimates is based on: -

1. The rateable valuations report produced by the LPS at 30th November The report is a summary of the Net Annual Values (NAV's) of the individual properties, and
2. The Domestic Capital Value as shown in the list at 30th September;
3. Losses on collection are based on the actuals for previous years.

In our view the "estimated" PRP is not truly an estimate – it is simply a figure based on the values in the valuation list at a point in time and takes only limited account of potential changes to the tax base in the year for which the "estimate" is provided. We believe this is a major deficiency and results in a significant flaw in the financial planning process for local authorities..

Economically, Northern Ireland is a rapidly expanding area and there has been considerable growth in both domestic and non-domestic development, which has not taken in to account in the "estimate". Critically though with the downturn in the economy the pace of new build will, inevitably, slow down and this has to be reflected when calculating the EPP. The concept in LPS that the calculation of EPP is essentially a mechanical exercise has to be done away with and they need to understand the impact on the local authority financial process if their estimates are wildly incorrect.

In addition, and critically, the calculation appears to take little account of possible reductions in rateable value that will result from the appeals process. This is evidenced by a number of large reductions that have occurred in the current financial year and which are retrospective. Such reductions have a negative impact on the final outcome of the PRP and this is exacerbated by the fact that there is no formal procedure in place to ensure that local authorities have prior warning of such changes

LPS responsibility for the Penny Rate Product

There appears to be no specific responsibility on LPS to provide local authorities with an estimated penny rate product although the regulations do state how it is to be calculated. In relation to the actual Penny Rate Product Regulation 3 (5) does specify that this has to be calculated and District Councils notified of under or overpayments.

The variances from the estimated to the actual penny rate product over the last few years, including a significant negative variance being notified to BCC clearly makes a nonsense of financial planning so far as local authorities are concerned and it is our view that the LPS should have a statutory responsibility for:

- Undertaking the calculation of the estimated penny rate product, and
- Notifying local authorities of any changes that will impact on the penny rate product during the course of the financial year.

Had the LPS had a statutory responsibility for reviewing the estimate and keeping the local authorities informed of possible changes during previous financial years the

potential for such high variances would have been recognised and the local authorities would have had an early indication of possible problems.

This responsibility, however, goes further than simply notifying Councils – the estimate has to be as accurate as possible taking account of all possible changes. This has clearly not been the case in the current financial year where BCC has been notified of a short fall of £660,000, only to be told four months later that this shortfall was in the region of £3.6m. This shows a disregard for the problems incurred by poor estimates and clearly raises the issue of the reliability of the estimating process.

Developing the calculation of the Estimated PRP

It is clear that a better methodology for calculation of the estimated PRP has to be agreed if the estimate is to more closely match the final out-turn.

An estimate should be precisely that and should take as its starting point the actual values shown in the valuation list and should then take account of potential increases in rateable value, particularly new build, during the year of estimate and should also identify potential reductions by way of demolitions, hereditaments taken out of rating and reductions in value. In addition account has to be taken of estimated losses on collection including allowances and voids.

It is our view that the electronic estimating model currently used by LPS should be scrutinized to ensure that it is fit for purpose and to ensure that all factors can be taken in to account. Such a model could then be used for the final out-turn calculation and for undertaking “what if” calculations.

The forecasting model

In order to ensure that any model created for the accurate forecasting of the Penny Rate Product (PRP) is rigorous and fit for purpose it would be desirable to carry out a detailed analysis of the elements that make up the calculation of the actual PRP calculation.

The most effective approach would be to concentrate on the actual outturn of the financial year in question and to apply the results to the actual financial year. For the analysis to be effective there must be a root and branch study of each element of the calculation. This would be based upon the actual figures in the calculation and the origination of those figures.

The significant elements are: -

- The effective value of the tax base
- The initial debit drawn from the tax base
- The losses on collection
- The cost of collection
- The value of rate rebates awarded

The verification of these elements must include reconciliation to the original source of the data. For example, the rateable value provided from the source valuation records must be the value used for the initial debit and any changes to that value must be in accord with the movement in the valuation list. These values must include those in respect of properties owned by the Housing Executive.

The losses on collection should be provable to the accounting records and the original source of the loss. The cost of collection must be verifiable to properly audited sources. The value of the rebates should reconcile to the returns used for subsidy purposes and the prime accounting records. This value should then be used to calculate the appropriate percentage.

Each of the elements must be subjected to a rigorous risk assessment that must be made available to the local authorities.

MAXIMISATION OF INCOME

In order to maximise rate income it is essential that all properties be brought in to the rating list in a timely and efficient manner. This depends to a great extent on the liaison arrangements between local authorities and the LPS and the efficiency with which LPS deals with the assessments once it is in receipt of the appropriate information to enable the billing to be undertaken. Assessments not included within the financial year impact on the level of the APP.

The Revised EPP

The reasons for the reduced EPP appear to be –

- Reduction in overall rate income £1.1m
- Allowances £0.86m
- Increase in write-offs £3.1m
- Increase in 3 month period of vacancy £0.5m

In the short term little can be done about these items other than to

- Closely question LPS as to the reasons for the reduction in overall rate income and to determine if there are any outstanding new or altered properties that need to be brought in to the valuation list before the 31st March 2011.
- Obtain a detailed breakdown of the write-offs and the reasons for them.
- Obtain detailed reasons why there has been a considerable increase in the 3 month vacancy rate
- Obtain a detailed analysis of the reasons for the increases in the Allowances.

Cost of Collection

The cost of collecting rates incurred by the LPS is apportioned between the local authorities in Northern Ireland on the basis set out below

The LPS calculates the cost of collection for each local authority in Northern Ireland in accordance with the Rates Regulations (Northern Ireland). This is determined by assessing the net cost of levying rates during the year including such proportion as the Department considers appropriate in relation to costs incurred including expenses incurred by way of superannuation and of compensation for loss of office or loss of diminution of emoluments, but not including any allowances made to owners under Articles 20 or 21;

Calculation of the Cost of Collection

The cost of collection determined by the Department is then apportioned in accordance with the Rates Regulations (Northern Ireland) 2007, which state that: -

4. -(1) *When in accordance with paragraph 4(1) of Schedule 1, the cost of collection for any district has been ascertained, the cost of collection of NAV rates for the district shall be determined in accordance with sub-paragraphs (2) and (3).*

(2) *The cost of collection of NAV rates for a district for any year shall be the proper proportion of the total cost of collection for that year of rates for the district.*

(3) *The proper proportion of the total cost of collection for any year is the proportion which the aggregate rateable NAV of hereditaments or any parts of any hereditaments in the NAV list in the district bears to the rateable NAV of hereditaments or any parts of any hereditaments in the NAV list and the total rateable / capital value of hereditaments or any parts of any hereditaments in the capital value list of the district. .*

BCC has no control over the cost of collection incurred by LPS on its behalf and, more importantly, they do not have an understanding as to how the total cost is calculated as no detailed information is provided by LPS. As a result it is impossible for BCC to form a view as to the effectiveness and efficiency of the collection process towards which they are contributing a significant amount.

We would recommend that it is essential that BCC request a detailed analysis of the calculation of the Cost of Collection

Losses on Collection

Forecasting losses on collection

The wording defining "loss on collection" we believe is inadequate and gives carte blanche to LPS to write off balances for any reason. The items that can be treated as losses should be clearly defined together with the criteria for write off so that local authorities are assured that amounts are being written off correctly. As part of the notification process BCC should be provided with a detailed breakdown of losses.

The treatment of irrecoverable debts should be transparent particularly as arrears have risen considerably over the past four years and this will invariably impact on the amount of debt to be written off in the future, which will, in turn, ultimately impact on the penny rate product.

There is a strong case for LPS to liaise with BCC during the course of the financial year over the likely level of write offs. 2010 / 11 is a case in point where it is possible that one of the reasons for the decline in the EPP is the level of write-offs.

CONCLUSIONS

The approach to the delivery of the EPP and APP has improved over the last two years. The liaison with the local authorities is becoming more data driven and should, therefore, lead to more resilient estimates,

The operative word here being 'should' but this has clearly proved not to be the case in relation to the revised estimate of the EPP. This appears to be the result –

- Firstly, a reducing tax base that was not recognised when the original EPP was undertaken. We would argue that this should have been identified had the calculation of the EPP been approached in a scientific and logical manner and had it been constructed properly and the potential for significant increases and / or reductions identified.
- Secondly, an increase in write offs particularly bankruptcies. We would argue that these should have come as no surprise to LPS and should have been taken in to account in the original EPP as the information was largely available to them.

The model used by LPS has to be properly structured and fit for purpose, however, the model is only **as good as the data fed into it and the forecasts made in relation to that data. It is absolutely essential that the information provided to the Operational Finance Team within LPS is accurate and appropriate** - and it would appear that there is a serious fault inherent in the process because of the continuing inaccuracy of the EPP in respect of BCC.

Next Steps

Given the lateness in the financial year that this shortfall has come to light it may well be too late for BCC to take corrective action on expenditure and will have to meet this from balances but the following actions should be taken -

- Ask LPS what is in the pipeline for new / increased assessments – LPS should be required to ensure that these are inserted in the valuation list before the end of March 2011.
- Ask LPS what is included in write offs – and asked to provide a detailed list of all write – offs..
- Hold detailed discussions with LPS on the EPP for 2011/12 and question them closely on the constituent elements of the EPP.
- Ask LPS what is included in the cost of collection by providing a detailed financial analysis.
- Seek to agree with LPS that an independent audit is taken of the EPP methodology.

The Institute would welcome the opportunity to carry out further work in this area.

David Magor and Patrick Doherty

Institute of Revenues Rating and Valuation