### Pool Rate Calculation

### Summary

1. This paper considers the methodology for calculating the assumed interest rate (i.e. the pool rate) used to determine the debt financing element of the revenue settlement. The pool rate of interest has continued to increase when general interest rates have remained stable or have decreased. It appears this is as a result of adjusting the pool rate by reversing unsupported borrowing out of the calculation. This paper reviews this established practice, and considers whether an alternative methodology is required.

### Views sought

2. Members are asked to note this paper and provide their thoughts on the current method of calculating the pool rate. Members are also invited to consider whether a change in methodology is required.

### Background

3. The Partnership Council introduced a pool rate of interest for Welsh local authorities for the 2000-01 Settlement. The method used is similar to that used by the Department of Communities and Local Government (DCLG), except that:

   - a full set of Welsh local authority data is used;
   - information on non-Public Works Loan Board (non-PWLB) debt is one year more recent than in the DCLG model; and
   - unsupported borrowing is reversed out of the calculation.

4. The pool rate is calculated on the basis of:

   - the latest available information about the outstanding PWLB and non-PWLB long term and short term Local Authority debt;
   - the average interest rates associated with that debt; and
   - the assumption that net new borrowing is derived from supported borrowing totals.

5. As indicated above, from 2010-11 onwards, the pool rate of interest used to determine the debt financing element of the revenue settlement, has unsupported borrowing reversed out of total outstanding debt. In a 2009 DSG Paper (Paper 27), it was suggested the pool rate of interest was lower than what it should be, when considering unsupported borrowing had increased considerably since 2004-05, leading to an increased proportion of outstanding debt being taken out at lower interest rates.

6. It was subsequently agreed by DSG members that unsupported borrowing should be reversed out of the pool-rate model.

7. In order to do this, information on the amount of new unsupported borrowing in each year since prudential borrowing was introduced was required, which was readily available. Information on the interest rate and residual maturities for unsupported borrowing for each year was also required to reverse unsupported borrowing out of

the calculation. Following conversations with the PWLB, it was established that this information didn't exist, but it could be proxied. The amounts of all new borrowing by UK local authorities from the PWLB and corresponding interest rates were therefore used to derive notional residual maturities for unsupported borrowing of Welsh Local Authorities. This assumed that Welsh debt financed by unsupported borrowing assumes the same residual maturity profile as all UK local authority borrowing. The notional amount outstanding at the end of the financial year, and the average rate of interest, were reversed out of the pool rate calculation for use in the revenue settlement.

8. This practice of adjusting the pool rate has continued since 2010-11.

## Analysis

9. As the assumptions outlined in paragraph 7 assign unsupported borrowing a lower rate of interest, reversing this debt out of the calculation reduces the amount of outstanding debt and therefore pushes the pool rate of interest higher. This is demonstrated in the table and chart below, which compare the adjusted pool rate of interest (used in the revenue settlements) with the unadjusted rate.

Comparison of Pool Rate adjusted and unadjusted for unsupported borrowing

|  | 2008-09 | 2009-10 | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 | 2015-16 | 2016-17 | 2017-18 |
|---|---|---|---|---|---|---|---|---|---|---|
| Pool Rate of interest (%) adjusted for unsupported borrowing |  |  | 5.7 | 5.8 | 5.8 | 5.9 | 6.1 | 5.9 | 6.1 | 6.3 |
| Pool Rate of interest (%) unadjusted for unsupported borrowing | 5.7 | 5.6 | 5.5 | 5.5 | 5.4 | 5.4 | 5.4 | 5.1 | 5.1 | 5.0 |
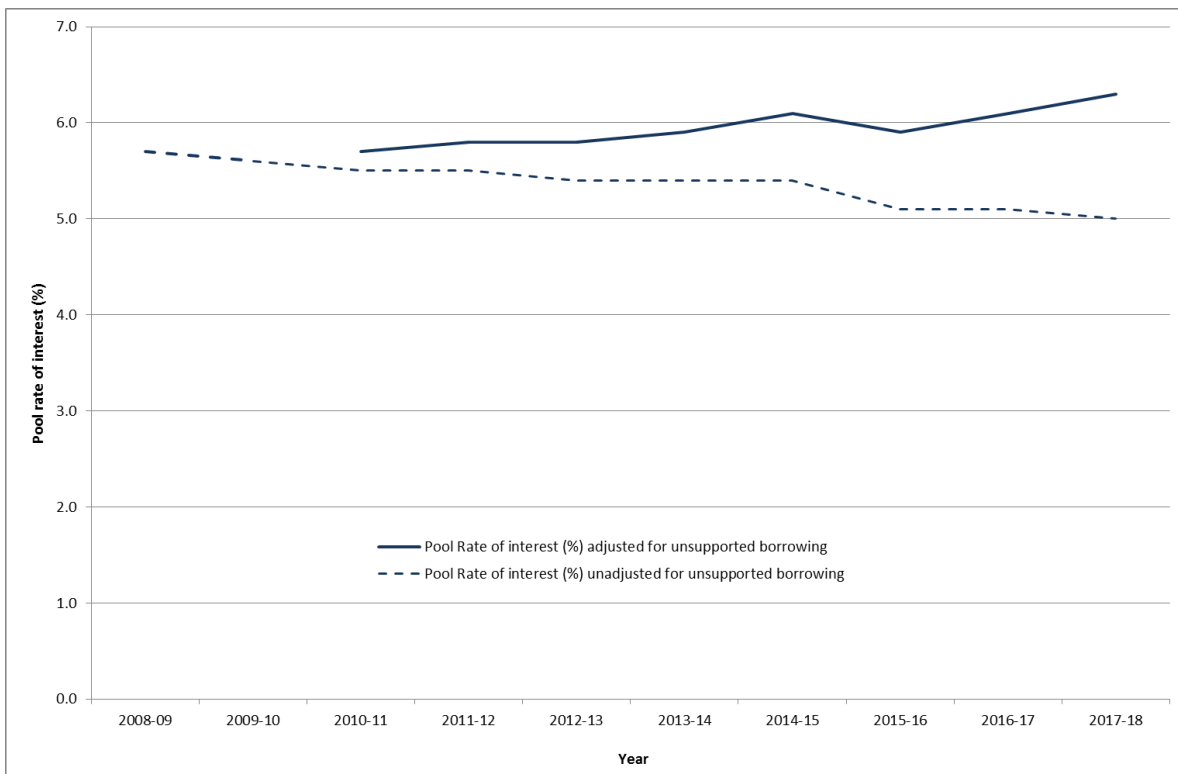


10. Further analysis has pinpointed the reason for the interest rate at which the unsupported borrowing is reversed out being so low, as being down to the assumed interest rate that is built in to the model (i.e. the interest rates corresponding to the amounts of all new borrowing by UK local authorities – provided by the PWLB).

11. The table below shows a time series of the interest rates used as a proxy for reversing out the unsupported borrowing and the impact of this on the PWLB interest rate:

| | 04-05 | 05-06 | 06-07 | 07-08 | 08-09 | 09-10 | 10-11 | 11-12 | 12-13 | 13-14 | 14-15 | 15-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Average interest rate built in to the model** | 4.69 | 4.19 | 4.29 | 4.55 | 3.37 | 3.25 | 3.26 | 3.2 | 3.07 | 3.38 | 3.38 | 2.49 |
| **Resultant average interest rate at which unsupported borrowing is reversed out** | 4.69 | 4.35 | 4.32 | 4.43 | 4.15 | 3.99 | 3.84 | 3.72 | 3.60 | 3.56 | 3.54 | 3.40 |
| **PWLB Interest Rate** | | | | | 5.70 | 5.70 | 5.65 | 5.60 | 5.53 | 5.52 | 5.37 | 5.19 |
| **PWLB Interest rate with unsupported borrowing reversed out** | | | | | 5.99 | 6.13 | 6.26 | 6.44 | 6.64 | 7.03 | 7.18 | 7.47 |

12. There is a question as to whether this interest rate used as part of the calculation to reverse out unsupported borrowing is the most suitable for this purpose. Thoughts would be welcomed as to whether an alternative interest rate could be used.

**Conclusion**

13. DSG Members are asked to discuss the current methodology for calculating the pool rate of interest, and whether the most suitable proxy is used as part of the process of reversing unsupported borrowing out of the model.

**Local Government Finance Policy**
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