EASTLEIGH BOROUGH COUNCIL

Capital Strategy Report

2023/24

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Strategic Implications

This report relates to all the objectives in the Council's Corporate Plan 2015-2025 as it supports the Council's ability to fund capital and revenue projects and services. The approach recommended continues to build on the Council's previous success in this respect, by achieving a high level of rewards for residents in terms of service objectives supported by a well-managed financial position, whilst still managing the appropriate level of risk carefully as detailed in the report and appendices.

Background

This strategy gives a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of local public services along with an overview of how associated risk is managed and the implications for future financial sustainability.

Decisions made this year on capital and treasury management will have financial consequences for the Council for many years into the future. They are therefore subject to both a national regulatory framework and to a local policy framework.

Capital Expenditure

Capital expenditure is where the Council spends money on assets, such as property or vehicles, that have a usable life of more than one year. In local government this includes spending on assets owned by the Council, by other bodies, as well as loans and grants to other bodies enabling them to buy or improve assets.

In 2023/24 the Council is planning capital expenditure of £88m as summarised below:

Table 1 – Prudential Indicator - Estimates of Capital Expenditure

Programme Area	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
Climate and Environmental	1,741	16,481	26,886	0	0
Infrastructure	18,255	3,719	2,641	3,300	0
Housing	32,923	24,876	36,665	49,568	59,716
IT	131	100	509	469	0
LACs	3,694	4,625	5,606	975	0
Leisure	310	680	3,352	0	0
Urban Regeneration	1,767	4,572	12,200	4,651	0
Total Capital Expenditure	**58,821**	**55,053**	**87,859**	**58,963**	**59,716**

Governance of Capital Expenditure

The current Community Investment Programme (CIP) is attached at Appendix 1A. The CIP consists of capital schemes identified by councillors and staff as being of benefit to the community. Schemes are approved in year by Cabinet, or if it is a scheme that falls under a Local Area, then approval can be given by the relevant Local Area Committee (LAC).

All projects are monitored by the Project Management Office (PMO), ensuring that projects are initiated in a controlled and planned way and are reported upon regularly.

For each proposed scheme, alignment to Corporate Strategic aims is checked before commitment to spend is made. This is achieved using a Project Initiation Matrix (PIM) to turn a proposal into a clear concept. When the project is authorised, an approved project methodology is used to control and deliver the project and report on progress through to the appropriate Strategic Programme Board. A process map of the project process is shown at Appendix 1B.

For all Strategic Capital Projects, these are monitored through Programme Boards chaired by a member of the Corporate Leadership Board and comprising Councillors, including a member of Cabinet, alongside key members of staff who are involved in the implementation and delivery of capital schemes including a member of the Project Management Office. The aim of Programme Boards is to ensure that schemes are managed efficiently and effectively, whilst considering the Council's priorities and aligning capital expenditure to meet these priorities. For smaller capital spend, these items are monitored either through Local Area Committees or through the Council's regular performance monitoring process.

Financing of Capital Expenditure

All capital expenditure must be financed, either from external sources (Government grants, developers', and other contributions), the Council's own resources (revenue, reserves and capital receipts) or borrowing (borrowing and leasing). The planned financing of Capital Expenditure is as follows:

Table 2 - Capital financing

Financing	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
External sources	7,856	8,600	6,584	0	0
Own resources	11,037	20,933	6,897	2,117	1,716
Borrowing	39,928	25,520	74,378	56,846	58,000
Total	**58,821**	**55,053**	**87,859**	**58,963**	**59,716**

The core financing of capital expenditure continues to be borrowing. The Council continues to borrow under the guidance of CIPFA's Prudential Code for Capital Finance in Local Authorities, which gives the Council the power to borrow.

Borrowing is only a temporary source of finance, since loans and leases must be repaid and this is therefore replaced over time by other sources of finance, usually from revenue, which is known as minimum revenue provision (MRP). Alternatively, proceeds from selling capital assets, known as capital receipts, may be used to repay borrowing. Planned MRP repayments are shown in the table below:

Table 3 – Repayment of borrowing

Repayment of Borrowing	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
MRP	5,141	5,905	6,181	7,076	7,257
Voluntary MRP	1,448	2,000	0	0	0
Total Repayment of Principal	**6,589**	**7,905**	**6,181**	**7,076**	**7,257**

The Council's full MRP Policy is approved by Council as part of the Treasury Management Strategy report. The MRP policy ensures that over the life of any asset the full borrowing is repaid.

Voluntary MRP (VRP) has been charged for the purchase of land used for Nitrate Mitigation. To better reflect the short-term nature of the Nitrate income received for Nitrate Credits, it has been deemed prudent to use the revenue income as it is received from this scheme to repay the borrowing.

The Council's cumulative outstanding amount of borrowing is measured by the Capital Financing Requirement (CFR). This increases with new borrowing-financed capital expenditure and reduces with MRP and capital receipts used to repay borrowing. The CFR is expected to rise to £574M in 2022/23. Based on current projections for capital expenditure and financing, the Council's estimated CFR is as follows:

Table 4 – Prudential Indicator - Estimates of Capital Financing Requirement

	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
Capital Financing Requirement	556,682	574,297	642,493	692,263	743,006

Asset Management

To ensure that capital assets continue to be of long-term use, the Council has an Asset Management Strategy 2020-2025 that was approved by Cabinet in 2020. This Strategy sets out the key future objectives and how the Council will effectively manage, use and review the assets. An update on progress against the Strategy and a plan for the forthcoming year will be reported to Audit and Resources in March 2023.

When a capital asset is no longer needed, it may be sold so that the proceeds, known as capital receipts, can be spent on new assets, or used to repay borrowing.

The Council is also requesting approval to spend capital receipts 'flexibly' on service transformation projects until 2024/25. Please see appendix 1C

Treasury Management

Treasury Management is concerned with keeping sufficient, but not excessive cash available to meet the Council's spending needs, while managing the risks involved. Surplus cash is invested until required, whilst a shortage of cash will be met by borrowing. The Council is typically cash rich in the short-term as revenue income is received before it is spent, but cash poor in the long-term as capital expenditure is incurred before being financed. The revenue cash surpluses are offset against capital cash shortfalls to reduce overall borrowing, also known as internal borrowing.

The Council's main objectives when borrowing are to achieve a low but certain cost of finance while retaining flexibility should plans change in future. These objectives are often conflicting, and the Council has struck a balance between cheap variable rate short-term loans and long-term fixed rate loans where the future cost is known but higher. The Council continues to weigh up this balance and evaluates the market to maintain affordability, certainty, and flexibility in its borrowing. The Council takes external professional advice on interest rates and Treasury Management from advisors Arlingclose to help inform this Strategy.

The Council does not borrow to invest for the primary purpose of financial return and therefore retains full access to the Public Works Loans Board.

Projected levels of the Council's total outstanding net borrowing are shown below, compared with the CFR. The difference between the two being the level of internal borrowing used by the Council. This represents the use of reserves, working capital and revenue financing to offset the need to borrow.

Table 5 – Prudential Indicator – Gross Borrowing and the Capital Financing Requirement

Gross Borrowing & the Capital Financing Requirement	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
Gross Borrowing	521,648	539,263	607,459	657,229	707,972
CFR	556,682	574,297	642,493	692,263	743,006

Statutory guidance is that gross borrowing should remain below the CFR, except in the short term. Table 5 demonstrates that the Council expects to comply with this in the medium term.

To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes that cash balances are kept to a minimum level of £30M to maintain liquidity at each year end. This benchmark is forecast to be £527M for 2022/23 and is forecast to rise over the following three years as capital expenditure is incurred.

Table 6 – Liability Benchmark

Liability Benchmark	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
Secured Borrowing	521,648	525,000	360,000	350,000	350,000
Liability Benchmark	524,973	527,912	600,124	648,644	693,181
Short Term Borrowing Required	n/a	2,912	250,124	308,644	353,181

The table shows that the Council expects to borrow below its liability benchmark, representing a need to borrow as short-term loans become due for renewal in the future. This strategy should maintain a lower cost of borrowing through the financing of short-term loans but does show the refinancing risk this introduces the Council to. This risk is mitigated by the Council's ongoing access to the PWLB, and the liquid short term local authority to local authority borrowing market, allowing access to refinance borrowing as it becomes repayable.

More detail on the liability benchmark can be found in the Treasury Management Strategy.

The Council is legally obliged to set an affordable borrowing limit each year. In line with statutory guidance, a lower operational boundary for borrowing is also set at £10M below the authorised limit, as a warning level should borrowing begin to approach the limit. As the Council approves capital schemes throughout the year, this limit is updated and reviewed regularly and reported to Cabinet for approval by Council alongside Community Investment Programme approvals.

Table 7 – Prudential Indicator - Authorised limit and Operational Boundary for External Borrowing

Authorised Limit for External Borrowing	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
Borrowing	555,682	573,297	641,493	691,263	742,006
Other Long-Term Liabilities	1,000	1,000	1,000	1,000	1,000
Total Authorised Limit	**556,682**	**574,297**	**642,493**	**692,263**	**743,006**

Operational Boundary for External Borrowing	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
Borrowing	545,682	563,297	631,493	681,263	732,006
Other Long-Term Liabilities	1,000	1,000	1,000	1,000	1,000
Total Operational Boundary	**546,682**	**564,297**	**632,493**	**682,263**	**733,006**

Investments

Treasury Investments arise from receiving cash before it is paid out again. Investments made for service reasons or for financial gain are not generally considered to be treasury investments.

The Council's policy on treasury investments is to prioritise security and liquidity over yield, focusing on minimising risk rather than maximising returns. Cash that is likely to be spent in the near term is invested securely, for example with the Government, other local authorities, or high-quality banks, to minimise the risk of loss. As can be seen below, to ensure liquidity during a volatile economic period, additional funds were being held short term. It is forecast that underlying investment levels will reduce in the future.

Money that will be held longer term is invested more widely, to balance the risk of loss against the risk of receiving returns below inflation. Both near-term and longer-term investments may be held in pooled funds. In this instance an external Fund Manager makes decisions on which particular investments to buy and the Council may request its money back at short notice.

Table 8 - Treasury management investments

Treasury Investments	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
Near-term Investments	37,500	20,000	20,000	20,000	20,000
Longer-term Investments	10,760	10,000	10,000	10,000	10,000
Total	**48,260**	**30,000**	**30,000**	**30,000**	**30,000**

The effective management and control of risk are prime objectives of the Council's treasury management activities. The Treasury Management Strategy sets out various indicators and limits to constrain the risk of unexpected losses and details the extent to which financial derivatives may be used to manage treasury risks.

The Council delegates responsibility for the monitoring and scrutiny of its Treasury Management practices and activity to the Treasury Management Review Group (TMRG), which includes Councillors and the Chief Financial Officer, and delegates responsibility for the implementation and administration of Treasury Management policies, strategies, and practices to the Council's Chief Financial Officer. The Council also employs an external advisor, Arlingclose, to provide advice on how the Council can manage its investment and borrowing portfolio.

Investments for service purposes are where the Council may choose to assist local public services by making loans to, or purchasing shares in, local service providers, or businesses to promote economic growth, or to help enable Council objectives externally, such as by lending money to a housing developer to provide additional housing that would not be provided by the open market. Considering the public service objective, the Council is willing to take more risk than with treasury investments. However, it still plans for such investments to break-even or generate a profit after all costs.

Decisions on service investments are made by the relevant Service Director in consultation with the Chief Financial Officer and must meet the criteria limits laid down in the Investment Strategy. Most loans and shares are capital expenditure and investments and purchases will therefore be approved as part of the CIP.

Cabinet are requested to recommend that Council approve the Investment Strategy which is contained within the separate Investment Strategy report.

Investment Governance

With central government financial support for local public services declining, the Council has made investments in property and housing to meet corporate objectives for Regeneration, Economic, Environment, Service Delivery and Housing Development and achievement of income to support efficiencies, to enable it to continue to provide high quality local services.

Due to the nature of these transactions, there is a higher risk, bringing with it a higher return. To mitigate the risk, the Council has developed a governance structure to allow it to carry out additional due diligence on these investments.

For instance, for the purchase of commercial property, the first element that is looked at is tenant covenant strength which is the ability of the tenant to pay the rent. This includes, but is not limited to, credit checks on potential tenants, meetings with the senior management of potential tenants of large value transactions and a detailed review of their accounting statements.

Similarly with a housing scheme, the Council will look at things such as underlying land values, to determine, should there be complications with the scheme, whether the Council would still be able to sell or develop the land in a different way to achieve the same objectives. For example, with the One Horton Heath development, there are options both to sell land parcels to developers, and to self-deliver the site, to ensure financial flexibility on the scheme, whilst continuing to deliver desired outcomes.

In addition to security of the investment, is the financial business case. The Council borrows for property and housing investments; therefore, the Council ensures that the income from the tenants is more than the borrowing costs and repayment of borrowing (MRP) applicable to the investment, or similarly the sale of the completed assets will be higher than the capital outlay.

To make the financial business case as resilient and low risk as possible, the Council adds in three additional costs to assets it will keep in its portfolio, an interest rate adjustment, a void adjustment, and a maintenance adjustment. As the Council borrows at a variable rate for its commercial activity, the Council charges an interest adjustment on each property. This is where, although the Council predominantly borrows at cheaper variable rates, any financial business case is charged at higher long-term rates. This ensures should interest rates rise in the future, the Council has factored in the risk of higher future borrowing costs. An interest rate reserve is held to mitigate against future rate rises affecting the Councils ability to provide services.

The Council also charges a void adjustment to each business case. This reserves a percentage of the income so that with commercial property, when the initial lease period expires, the Council has enough funds set aside to cover the loss of income and void costs such as Business Rates or Council Tax for up to 12 months should a tenant decide not to renew a lease, leaving the Council having to find a new tenant. For housing developments, this is an allowance to cover the possibility of a void period between tenancy agreements. This adjustment is transferred to the property or housing reserve, an earmarked reserve used to ensure a future loss of tenant does not affect the Councils ability to provide services.

The Council also has a similar maintenance reserve, where, depending on the age and condition of the building, between 5% and 10% of all income is reserved each year to cover future maintenance works to the buildings. This Maintenance Reserve can then be used to fund the Repairs and Renewals Programme managed by the Property Services Team. For Housing schemes, this will again be transferred to a similar Housing Reserve.

In the case of affordable housing assets being transferred to the Housing Revenue Account (HRA) in the future, arrangements will be put in place within the HRA to cover these elements.

Decisions on property purchases are also subject to additional levels of officer scrutiny, through meetings between members of the Corporate Leadership Board, Asset Management, Project Delivery, Strategic Housing, Development Management, Legal Services and Financial Services. The aim of these meetings is to scrutinise the due diligence that has been carried out, and to scrutinise financial business cases to ensure potential purchases are sound and will deliver against Council priorities.

For Housing schemes, there is a board structure in place, consisting of an Operational Housing board for staff to scrutinise and plan potential schemes, before being raised to the Corporate Housing Board, which has councillor attendance, for final scrutiny.

In addition to internal scrutiny, the use of external advisers is utilised at all stages where appropriate.

After all due diligence has been completed, property purchases are then treated as capital expenditure, and will therefore be put forward for approval as part of the capital programme.

Table 9 – Prudential Indicator – Estimates of net income from commercial and service investments compared to budgeted net revenue stream

Income from non-treasury investments to net revenue stream	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
Income/Savings generated by schemes funded by borrowing	18,240	19,459	20,452	22,573	23,579
Proportion of net revenue stream	**146%**	**156%**	**168%**	**214%**	**238%**

Further information on investments is covered in more detail within the Investment Strategy.

Revenue Budget Implications

Although capital expenditure is not charged directly to the Revenue Budget, interest payable on loans and MRP are charged to revenue, offset by any investment income receivable. The net annual charge is known as financing costs; this is compared to the net revenue stream i.e., the amount of revenue spend funded by Council Tax, Business Rates and general Government Grants.

Table 10 – Prudential Indicator - Proportion of financing costs to net revenue stream

Financing costs compared to net revenue stream	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
Financing Costs (Less VRP)	9,660	13,405	21,167	23,499	20,561
Proportion of net revenue stream	**77%**	**108%**	**174%**	**223%**	**208%**

Whilst the table above shows that the Council is forecast to spend more on financing costs than on revenue spend net of financing costs by the end of the forecast period, what it does not show is the annual surplus that these investments have bought into the Council to spend on services.

Table 11 - Revenue Surplus from Capital Financing

Financing costs compared to income generated	2021/22 Actual £'000	2022/23 Forecast £'000	2023/24 Budget £'000	2024/25 Budget £'000	2025/26 Budget £'000
Financing Costs (Less VRP)	9,660	13,405	21,167	23,499	20,561
Income/Savings generated by schemes funded by borrowing	18,240	19,459	20,452	22,573	23,579
Annual Surplus	**8,580**	**6,054**	**(715)**	**(926)**	**3,018**

Further details on the revenue implications of capital expenditure will be discussed in the 2023/24 Revenue Budget.

Due to the very long-term nature of capital expenditure and financing, the Revenue Budget implications of expenditure incurred in the next few years will extend for up to 50 years into the future. The CFO is satisfied that the proposed capital programme is prudent, affordable and sustainable. The process of effectively managing assets through monitoring approved business plans and utilising earmarked reserves where appropriate mitigates impacts of economic viability and is integral to the ongoing success of this Strategy.

Knowledge and Skills

The Council employs qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. The team includes:

- A Finance Team with five CIPFA qualified accountants, all with over ten years of experience in Local Government accounting, one CIMA and one ACCA qualified Accountant.

- An Asset Management Team including a number of Chartered Surveyors with over 10 years' experience who are members of the Royal Institution of Chartered Surveyors (RICS), two of which are RICS Registered Valuers. They are regulated by their professional body (RICS) and comply with the RICS rules in relation to conduct and Continuing Professional Development.

- A Legal Team with 3 qualified solicitors, 2 Chartered Legal Executives, a barrister (unregistered), a trainee Legal Executive and a Trainee Solicitor. This includes 3 with over 10 years in Local Government; 4 with significant property and related commercial transaction knowledge; 4 with extensive planning experience and 3 with substantial regulatory and governance background.

Where Council staff do not have the knowledge and skills required, use is made of external advisers and consultants that are specialists in their field. The Council currently employs Arlingclose Limited as Treasury Management Advisers and takes advice from external property and legal advisors where appropriate. This approach is often more cost effective than employing such staff directly and ensures that the Council has access to knowledge and skills commensurate with its risk appetite.

Further details on officer's skills and knowledge, as well as external advisers can be found in the Investment Strategy report.