AUDIT & RESOURCES

Tuesday 22 January 2019

CABINET

Thursday 31 January 2019

CAPITAL STRATEGY

Report of the Chief Financial Officer

RECOMMENDATION TO AUDIT & RESOURCES COMMITTEE

It is recommended that the Audit & Resources Committee considers the Capital Strategy and makes any recommendations for amendments to Cabinet for their consideration.

RECOMMENDATIONS TO CABINET

It is recommended that Cabinet:

(1) recommend to Council to approve the Capital Strategy;

(2) recommend to Council to approve the Treasury Management Strategy in Appendix B and

(3) recommend to Council to approve the Investment Strategy in Appendix C and

(4) recommend to Council to approve the changes to the Prudential Indicators in Appendix B1/B2, and

(5) recommend to Council to approve the changes to the MRP Statement in Appendix B3;

Summary

This Capital Strategy sets out the long term context in which capital expenditure decisions are made and gives due consideration to both the risk and reward of these decisions and the impact on the achievement of priority objectives.

<u>Statutory Power</u>
Section 15 of the Local Government Act 2003.
Section 151 of the Local Government Act 1972.

Sections 21(1A) & 21(1B) of the Local Government Act 2003.
Local Authorities (Functions and Responsibilities) (England) Regulations 2000 [SI 2000/2853 as amended].
SI 2008/414- Local Authorities (Capital Finance and Accounting) (Amendment) (England) (No 2) Regulations 2008

Strategic Implications

1. This report relates to all of 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 strong financial position, whilst still managing the appropriate level of risk carefully as detailed in the report and appendices.

Background

2. This Strategy is a new report for 2019/20, giving a high level overview of how capital expenditure, financing and treasury management activity contribute to the provision of local services along with an overview of how associated risk is managed and the implications for future financial sustainability.

Capital Expenditure

3. 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. The Council has some limited discretion on what counts as capital expenditure, for example, the Council can choose not to capitalise spend under the value of £10k, and instead charge these as a revenue cost in year.

4. In 2019/20 the Council is planning capital expenditure of £77m as summarised below:

Prudential Indicator 1: Estimates of Capital Expenditure

Programme Area	2017/18 actual £'000	2018/19 forecast £'000	2019/20 budget £'000	2020/21 budget £'000	2021/22 budget £'000
Infrastructure	1,445	3,125	2,669	1,646	0
LAC's	996	9,409	3556	0	0
Leisure	10,311	1,324	0	0	0
Urban Regeneration	31,345	50,446	13,949	0	0
Future Eastleigh	1,372	778	75	79	50
Housing	119,227	49,759	56,724	23,540	20,025
Investment	43,627	76	0	0	0
Total General Fund Services	**208,323**	**114,917**	**76,973**	**25,265**	**20,075**

Governance of Capital Expenditure

5. The current Community Investment Programme (CIP) is attached at appendix A1. 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 made by the relevant Local Area Committee (LAC).

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

7. For each proposed scheme, alignment to Corporate Strategic aims is checked before commitment to spend is made. This is done using a Project Initiation Matrix (PIM) to flesh out 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. A process map of the project process is shown at Appendix A2.

8. For all Strategic Capital Programmes there is a Programme Board chaired by a member of Management Team and comprising Councillors, including a member of Cabinet, alongside key members of staff who are involved in the implementation and delivery of capital schemes. The aim of Programme Boards is to ensure that schemes are managed efficiently and effectively, by identifying the Council's priorities and aligning capital expenditure to meet these priorities.

Financing of Capital Expenditure

9. 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:

Financing	2017/18 actual £'000	2018/19 forecast £'000	2019/20 budget £'000	2020/21 budget £'000	2021/22 budget £'000
External Sources	4,870	1,457	1,417	2,300	3176
Own resources	724	14,425	5,960	152	0
Borrowing	202,729	99,035	69,596	22,813	16,899
Total	**208,323**	**114,917**	**76,973**	**25,265**	**20,075**

10. 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.

11. 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:

Repayment of Borrowing	2017/18 actual £'000	2018/19 forecast £'000	2019/20 budget £'000	2020/21 budget £'000	2021/22 budget £'000
MRP	2,553	3,834	4,691	4,872	5,142

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

13. 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 £553m in 2019/20. Based on current projections for capital expenditure and financing, the Council's estimated CFR is as follows:

Prudential Indicator 2: Estimates of Capital Financing Requirement

Capital Financing Requirement	2017/18 actual £'000	2018/19 forecast £'000	2019/20 budget £'000	2020/21 budget £'000	2021/22 budget £'000
CFR	393,571	488,773	553,677	571,619	583,376

Asset Management

14. To ensure that capital assets continue to be of long-term use, the Council has an Asset Management Strategy 2015-2018 in place approved by Cabinet September 2014 and subsequently extended in November 2016 by the Audit & Resources Committee. This Strategy sets out the key future objectives and how the Council will effectively manage, use and review the assets. This strategy is currently being updated and will be reported to Cabinet in the coming months.

15. 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 currently also permitted to spend capital receipts on service transformation projects until 2021/22.

Treasury Management

16. 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.

17. 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 (currently available at around 0.75%) and

long term fixed rate loans where the future cost is known but higher (currently available at around 2.80%). The Council continues to weigh up this balance, and evaluates the market in an attempt 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.

18. 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.

Prudential Indicator 3: Net Borrowing and the Capital Financing Requirement

Net Borrowing and the CFR	2017/18 actual £'000	2018/19 forecast £'000	2019/20 budget £'000	2020/21 budget £'000	2021/22 budget £'000
Net Debt	359,504	454,706	519,610	537,552	549,309
CFR	393,571	488,773	553,677	571,619	583,376

19. Statutory guidance is that net borrowing should remain below the CFR, except in the short term. As can be seen from the table above, the Council expects to comply with this in the medium term.

20. 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 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 any Community Investment Programme approvals.

Prudential Indicator 4: Authorised limit and Operational Boundary for External Borrowing

Authorised Limit for External Borrowing	2017/18 actual £'000	2018/19 forecast £'000	2019/20 budget £'000	2020/21 budget £'000	2021/22 budget £'000
Borrowing	392,571	487,773	552,677	570,619	582,376
Other Long Term Liabilities	1,000	1,000	1,000	1,000	1,000
Total	**393,571**	**488,773**	**553,677**	**571,619**	**583,376**

Operational Boundary for External Borrowing	2017/18 actual £'000	2018/19 forecast £'000	2019/20 budget £'000	2020/21 budget £'000	2021/22 budget £'000
Borrowing	371,571	466,773	531,677	549,619	561,376
Other Long Term Liabilities	1,000	1,000	1,000	1,000	1,000
Total	**372,571**	**467,773**	**532,677**	**550,619**	**562,376**

21. Cabinet are requested to recommend that Council approve the Treasury management Strategy which is shown in detail in Appendix B.

Investments

22. 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.

23. 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. 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. Long 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.

Treasury Investments	2017/18 actual £'000	2018/19 forecast £'000	2019/20 budget £'000	2020/21 budget £'000	2021/22 budget £'000
Near-term investments	4,803	7,500	7,500	7,500	7,500
Longer-term investments	10,000	10,000	10,000	10,000	10,000
TOTAL	**14,803**	**17,500**	17,500	**17,500**	**17,500**

24. 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.

25. Investments for service purposes are where the Council may choose to assist local public services by making loans to 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 in order to provide additional affordable housing that would not be provided by the open market. In light of 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.

26. Decisions on service investments are made by the relevant Service Manager 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 purchases will therefore be approved as part of the CIP.

27. Cabinet are requested to recommend that Council approve the Investment Strategy which is shown in detail in Appendix C.

Property Purchases

28. With central government financial support for local public services declining, the Council has purchased property in order to a meet a number of corporate objectives for Regeneration, Economic and Housing Development and achievement of its Efficiency Strategy, to enable it to continue to provide high quality local services.

29. Due to the nature of these transactions there is a higher risk, bringing with it a higher return. In order to mitigate the risk, the Council carries out additional

due diligence on these investments. The first element that is looked at is tenant covenant strength which is their ability 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.

30. Secondary to tenant covenant strength is the financial business case. The Council borrows for property purchases; therefore the Council ensures that the income from the tenant is in excess of the borrowing costs and repayment of borrowing (MRP) applicable to the purchase of the property.

31. In order to make the financial business case as resilient and low risk as possible, the Council adds in three additional costs, 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 cheap variable rates, any financial business case is charged at higher long term rates. This ensures should interest rates rise in the future, the Council will still make a financial return. This adjustment is transferred to the Interest Rate Reserve, an earmarked reserve used to mitigate the risk of future rate rises affecting the Councils ability to provide services.

32. The Council also charges a void adjustment to each business case. This reserves a percentage of the income so that 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 for up to 12 months should that tenant decide not to renew a lease, leaving the Council having to find a new tenant. This adjustment is transferred to the property reserve, an earmarked reserve used to ensure a future loss of tenant does not affect the Councils ability to provide services.

33. 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 put in reserve each year to cover future maintenance works to the buildings. This Maintenance Reserve is then used to fund the Repairs and Renewals Programme prepared by the Property Services Team.

34. Decisions on property purchases are also subject to additional levels of officer scrutiny, through meetings between members of Management Team, Asset Management, Planning, 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.

35. After all due diligence, property purchases are then treated as capital expenditure, and will therefore be approved as part of the capital programme.

36. Further information on property purchases is covered in more detail in the Investment Strategy.

Revenue Budget Implications

37. 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.

Prudential Indicator 5: Proportion of financing costs to net revenue stream

Financing costs compared to net revenue stream	2017/18 actual £'000	2018/19 forecast £'000	2019/20 budget £'000	2020/21 budget £'000	2021/22 budget £'000
Financing Costs	4,520	5,720	5,852	7,279	9,022
Proportion of net revenue stream	**45.30%**	**53.90%**	**56.70%**	**79.80%**	**95.30%**

38. Whilst the table above shows that the Council will continue to spend less on financing costs than on revenue spend net of financing costs over the forecast period, what it does not show is the annual surplus that these investments have bought into the Authority to spend on services.

Prudential Indicator 6: Revenue Surplus from Capital Financing

Financing costs compared to income generated	2017/18 actual £'000	2018/19 forecast £'000	2019/20 budget £'000	2020/21 budget £'000	2021/22 budget £'000
Financing Costs	4,520	5,720	5,852	7,279	9,022
Income/Savings generated by schemes funded by borrowing	10,976	17,820	18,714	19,675	20,311
Annual Surplus	**6,456**	**12,100**	**12,862**	**12,396**	**11,289**

39. Further details on the revenue implications of capital expenditure will be discussed in the 2019/20 Revenue Budget.

40. 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.

Knowledge and Skills

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

    a. A Finance team with four CIPFA qualified accountants, including two with over fifteen years of experience in Local Government accounting.

    b. An Asset Management Team with six RICS qualified Surveyors including four with over ten years' experience, two of which are also Registered Valuers.

c. A legal team with 6 qualified solicitors, including four with over 10 years' experience in Local Government and 3 with significant with property transaction knowledge.

42. 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.

43. Further details on officer's skills and knowledge, as well as external advisers can be found in the investment strategy at Appendix C.

Equality and Diversity Implications

44. The Equality Act is not relevant to the decision in this report as the decision does not relate to eliminating discrimination, advancing equality of opportunity, or fostering good relations between different people. An Equality Impact Assessment has not been carried out.

Conclusion

45. The Council is required to approve a Capital Strategy each financial year; it includes an overview of Capital Financing, Treasury Management and Investments. The report also includes the approval of the Prudential Indicators and MRP statement.

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Appendices:	10

LOCAL GOVERNMENT ACT 1972 – SECTION 100D

The following is a list of documents which disclose facts or matters on which this report or an important part of it is based and have been relied upon to a material extent in the preparation of this report. This list does not include any published works or documents which would disclose exempt or confidential information.

Local Government Act 2003
SI 2003/3146 - Local Authorities (Capital Finance and Accounting) (England) Regulations 2003

SI 2004/3055 - Local Authorities (Capital Finance and Accounting) (Amendment) (England) (No 2) Regulations 2004

Treasury Management Guidance Notes for Local Authorities (Third Edition 2011)

Prudential Code for Capital Finance in Local Authorities (Revised Third Edition 2011)