Appendix 2

Capital Strategy 2019/20

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1.0 Why is a Strategy Needed?

1.1 Introduction

This capital strategy is a new report for 2019/20, giving 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.

2.0 Capital Expenditure and Financing

2.1 Capital Expenditure

Capital expenditure is where the Council spends money on assets, such as property or vehicles, that will be used for more than one year. In local government this includes spending on assets owned by other bodies, and loans and grants to other bodies enabling them to buy assets. The Council has some limited discretion on what counts as capital expenditure, for example assets costing below £10,000 are not capitalised and are charged to revenue in year.

- For details of the Council's policy on capitalisation, see the Council's Code of Financial Management.

In 2019/20, the Council is planning capital expenditure of £7.7m as summarised below:

Table 1: Prudential Indicator: Estimates of Capital Expenditure in £m

	2017/18 actual	**2018/19 forecast**	**2019/20 budget**	**2020/21 budget**	**2021/22 budget**
General Fund services	8.5	10.3	7.7	7.0	10.7
Capital investments	5.7	0	0	0	0
TOTAL	**14.2**	**10.3**	**7.7**	**7.0**	**10.7**

The main capital projects include Disabled Facilities Grants (£2.2m), Alms Close Industrial Unit Construction (£1.0m) and Oak Tree Centre (£1.0m).

2.2 Governance

Service managers bid annually in August to include projects in the Council's capital programme. Bids are collated by the Finance team who calculate the financing cost (which can be nil if the project is fully externally financed). The Finance and Procurement Governance Board appraises all bids based on a comparison of service priorities against financing costs and makes recommendations to the Senior Leadership Team. The final capital programme is then presented to Cabinet in January and to Council in February each year.

The capital project will be monitored through its lifecycle by the Project Management Governance Board.

- For full details of the Council's capital programme, including the project appraisals undertaken, see here Capital Bids

All capital expenditure must be financed, either from external sources (government grants and other contributions), the Council's own resources (revenue, reserves and capital receipts) or debt (borrowing, leasing and Private Finance Initiative). The planned financing of the above expenditure is as follows:

Table 2: Capital financing in £m

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
External sources	2.8	2.2	1.5	1.3	1.3
Own resources	3.6	3.1	1.2	0.8	0.7
Debt	7.8	5.0	5.0	4.9	8.7
TOTAL	**14.2**	**10.3**	**7.7**	**7.0**	**10.7**

Debt is only a temporary source of finance, since loans and leases must be repaid, and this is therefore replaced over time by other financing, 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 replace debt finance. Planned MRP and use of capital receipts are as follows:

Table 3: Replacement of debt finance in £m

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
Own resources	1.8	2.0	2.4	2.5	2.8

- The Council's full minimum revenue provision statement is available as part of the MTFS report.

The Council's cumulative outstanding amount of debt finance is measured by the capital financing requirement (CFR). This increases with new debt-financed capital expenditure and reduces with MRP and capital receipts used to replace debt. The CFR is expected to increase by £2.6m during 2019/20. Based on the above figures for expenditure and financing, the Council's estimated CFR is as follows:

Table 4: Prudential Indicator: Estimates of Capital Financing Requirement in £m

	31.3.2018 actual	31.3.2019 forecast	31.3.2020 budget	31.3.2021 budget	31.3.2022 budget
General Fund services	36.6	44.6	47.2	49.6	55.6
Capital investments	5.0	0	0	0	0
TOTAL CFR	**41.6**	**44.6**	**47.2**	**49.6**	**55.6**

2.3 Asset management

To ensure that capital assets continue to be of long-term use, the Council has various strategies to manage assets held by services

2.4 Asset disposals

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 to repay debt. The Council is currently also permitted to spend capital receipts on service transformation projects until 2021/22. Repayments of capital grants, loans and investments also generate capital receipts. The Council plans to receive £0.8m of capital receipts in the coming financial year as follows:

Table 5: Capital receipts in £m

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
Asset sales	0.42	0.52	0.88	0.45	0.40
Loans repaid	0.27	0.32	0.32	0.32	0.32
TOTAL	**0.69**	**0.84**	**1.20**	**0.77**	**0.72**

3.0 Borrowing, debt and investments

3.1 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, while a shortage of cash will be met by borrowing, to avoid excessive credit balances or overdrafts in the bank current account. 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.

Due to decisions taken in the past, the Council currently has £20.5m borrowing at an average interest rate of 2.94% and £18.1m treasury investments at an average rate of 0.5%.

3.2 Borrowing strategy

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 therefore seeks to strike a balance between cheap short-term loans (currently available at around 0.75%) and long-term fixed rate loans where the future cost is known but higher (currently 2.0 to 3.0%).

Projected levels of the Council's total outstanding debt (which comprises borrowing, and leases are shown below, compared with the capital financing requirement (see above).

Table 6: Prudential Indicator: Gross Debt and the Capital Financing Requirement in £m

	31.3.2018 actual	**31.3.2019 forecast**	**31.3.2020 budget**	**31.3.2021 budget**	**31.3.2022 budget**
Debt (incl. PFI & leases)	20.9	20.7	20.4	20.2	19.9
Capital Financing Requirement	41.6	44.6	47.2	49.6	55.6

Statutory guidance is that debt should remain below the capital financing requirement, except in the short-term. As can be seen from table 6, the Council expects to comply with this in the medium term.

3.3 Liability benchmark

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 and investment balances are kept to £5m at each year-end. This benchmark is currently £5.7m and is forecast to rise to £15.2m over the next three years.

Table 7: Borrowing and the Liability Benchmark in £m

	31.3.2018 actual	**31.3.2019 forecast**	**31.3.2020 budget**	**31.3.2021 budget**	**31.3.2022 budget**
Outstanding borrowing	20.9	20.7	20.4	20.2	19.9
Liability benchmark	6.9	5.7	5.6	8.1	15.2

The table shows that the Council expects to remain borrowed above its liability benchmark.

3.4 Affordable borrowing limit

The Council is legally obliged to set an affordable borrowing limit (also termed the authorised limit for external debt) each year. In line with statutory guidance, a lower "operational boundary" is also set as a warning level should debt approach the limit.

Table 7: Prudential Indicators: Authorised limit and operational boundary for external debt in £m

	2018/19 limit	**2019/20 limit**	**2020/21 limit**	**2021/22 limit**
Authorised limit – General	78	80	80	80
Authorised limit – Loans	15	20	20	20
Authorised limit – CIS	30	35	35	35
Authorised limit – total external debt	**123**	**135**	**135**	**135**
Operational boundary – General	73	70	70	70
Authorised limit – Loans	15	15	15	15
Authorised limit – CIS	30	30	30	30
Operational boundary – total external debt	**118**	**115**	**115**	**115**

- Further details on borrowing are in detailed in the Treasury Management Strategy.

3.5 Investment strategy

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

The Council's policy on treasury investments is to prioritise security and liquidity over yield, that is to focus 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 selected high-quality banks, to minimise the risk of loss. Money that could be held for longer terms is invested more widely, including in bonds, shares and property, 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, where 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 in £m

	31.3.2018 actual	31.3.2019 forecast	31.3.2020 budget	31.3.2021 budget	31.3.2022 budget
Near-term investments	3.5	16.0	15.8	13.1	5.7
Longer-term investments	4.0	4.0	4.0	4.0	4.0
TOTAL	**7.5**	**20.0**	**19.8**	**17.1**	**9.7**

- Further details on treasury investments are in the Council's Treasury Management Strategy 2019/20.

3.6 Governance

Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Director of Finance and staff, who must act in line with the treasury management strategy approved by Council. Half-yearly reports on treasury management activity are presented to Council. The Overview and Scrutiny Panel (Performance and Growth) is responsible for scrutinising treasury management decisions

4.0 Investments for Service Purposes

4.1 Service Investments

The Council makes investments to assist local public services, including making loans to local organisations. 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 / generate a profit after all costs.

4.2 Governance

Decisions on service investments are made by the relevant service manager in consultation with the Director of Finance and must meet the criteria and limits laid down in the Treasury Management Strategy. Most loans and shares are capital expenditure and purchases will therefore also be approved as part of the capital programme.

- Further details on service investments are in pages in the Investment Strategy.

5.0 Commercial Activities

5.1 Purpose of commercial activity

With central government financial support for local public services declining, the Council invests in commercial property purely or mainly for financial gain. Total commercial investments are currently valued at £35.169m with the largest being Shawlands Retail Park, Sudbury at £5m. The total portfolio provides a net yield (rental income/valuation) of 8.66%.

With financial return being the main objective, the Council accepts higher risk on commercial investment than with treasury investments. The principal risk exposures include see also Appendix A for further description and mitigation.

- Declining capital values risk
- Rising borrowing costs risk
- Illiquidity of assets risk
- Void risk
- Economic environment risk
- Regulatory risk
- Policy risk
- Resource risk

In order that commercial investments remain proportionate to the size of the authority, these are subject to a 6% gross yield and contingency plans are in place should expected yields not materialise.

5.2 Governance

Decisions on commercial investments are made by the Responsible Financial Officer in line with the criteria and limits approved by Council in the Treasury Management Strategy. Property and most other commercial investments are also capital expenditure and purchases will therefore also be approved as part of the capital programme.

- ➢ Further details on commercial investments and limits on their use are in the Investment Strategy
- ➢ Further details on the risk management of commercial investments are in the Investment Strategy

6.0 Liabilities and guarantees

6.1 Liabilities

In addition to debt of £20.5m detailed above, the Council is committed to making future payments to cover its pension fund deficit (valued at £216m). The Council has also set aside £1.6m to cover risks from NDR Appeals Provision. The Council is also at risk of having to pay for contingent liabilities (as at 31st March 2018), including Contaminated Land (£3.3m), NHS Trust (£2.0m) and Municipal Mutual Insurance Liquidation (£0.6m). The Council has not put aside any money because the requirement to pay will only materialise if a future event outside the control of the council occurs.

6.2 Governance

Decisions on incurring new discretional liabilities are taken by service managers in consultation with the Responsible Financial Officer. The risk of liabilities crystallising and requiring payment is monitored by Finance. New liabilities are reported to the Responsible Financial Officer for approval/notification as appropriate.

- Further details on liabilities are included in the 2017/18 statement of accounts (page 94) Statement of Accounts 2017-18

7.0 Revenue Budget Implications

7.1 Minimum Revenue Provision

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 funded from Council Tax, business rates and general government grants.

Table 9: Prudential Indicator: Proportion of financing costs to net revenue stream

	2017/18 actual	**2018/19 forecast**	**2019/20 budget**	**2020/21 budget**	**2021/22 budget**
Financing costs (£m)	1.915	4.186	4.503	4.607	4.875
Proportion of net revenue stream	9.5%	24%	26%	28%	27%

Note that the above include around £2m of MRP for CIS which may not materialise.

- Further details on the revenue implications of capital expenditure are set out in the 2019/20 revenue budget.

7.2 Sustainability

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 35 years into the future. The Responsible Financial Officer is satisfied that the proposed capital programme is prudent, affordable and sustainable, on the basis that;

- Services have been involved in the process to identify future capital requirements.
- Bids for capital expenditure have been scrutinised by the Finance and Procurement Governance Board, including a presentation to the board.
- MRP has been calculated according to the approved policy.
- A business plan will need to be produced for each project before it commences
- The capital project will be monitored by the Project Management Governance Board.
- Capital receipt projections are prudent and based on historic experience.
- The costs of borrowing have been built into the budget and MTFS, along with due sensitivity analysis on the current and medium term costs of borrowing, these have been included in the s.25 statement within the 2019/20 Budget (and Medium Term Financial Strategy 2020/21 to 2023/24)

8.0 Knowledge and Skills

8.1 Qualifications

The Council employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. For example, the Head of Resources, is a qualified accountant with 25 years' experience, and the Estates Manager is a member of the Royal Institution of Chartered Surveyors. The Council can provide junior staff with funding to study relevant professional qualifications including CIPFA, and AAT.

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 Barker Storey Matthews as property consultants and other consultants as specialist tasks are identified. This approach is 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 staff training can be found in the Council's Workforce Strategy

- The Council has a guide for use of external advisors- The Professional Services Guide.

Appendix A

Risks inherent in the Council's investments in commercial property

	Risk	Description of risk	Mitigation
A	**Falling capital value**	Reduction in the market value of the property	Commission regular condition surveys Ensure maintenance is carried out (including tenant repairs) Perform regular maintenance Plan capital improvements Monitor general market movements, if falling consider divestment of some of the portfolio Use active asset management including negotiation leases before terminations to maintain asset values
B	**Rising borrowing costs**	Increase in the cost of servicing loan interest	Only use fixed rate borrowing (PWLB)
C	**Illiquidity of assets**	Assets cannot be sold in the short-term	Keep sufficient funds in short-term investments Keep funds in the CCLA property fund, which is property based but is available to sell quicker than property Keep open channels to short-term borrowing Seek relationships with other local authorities that have surplus cash Maintain properties to make them more desirable if a sale is required
D	**Void risk**	Empty properties reduce rental income	Market empty properties on an active basis Keep close contact with tenants so their intentions are known

			Monitor tenant covenant
E	**Economic environment risk**	General economic condition worsen leading to reduced demand for commercial properties	Diversify the portfolio geographically and by type (retail, commercial, industrial)
F	**Regulatory risks**	Changes to legislation or accounting regulations effect the operation of the CIS	Maintain awareness of the direction of Government and Treasury policies. Influence policy direction through nation groups, e.g. CIPFA, LGA, s151. Respond to consultations on relevant regulation changes
G	**Policy risks**	Changes to council priorities lead to lack of corporate support for the CIS	Influence corporate policy through officer forums Maintain relationships with political leadership Market the CIS internally to ensure the strategy is understood Integrate the CIS income streams into the budget
H	**Resource risk**	Lack of resource in terms of skills and time	Pay market salaries to recruit and retain the people with the right skills and experience Provide training to keep skills up to date Have sufficient budget to buy in professional skills and advice when required Provide member commercial investment training