Capital Strategy Report 2019/20

Summary
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. It has been written to enhance members' understanding of these technical areas.

Portfolio - Finance and
Date Signed Off – 11 February 2019

Wards Affected
All

Recommendation

The Executive is advised to RECOMMEND to Full Council the approval of the Capital Strategy, as set out at Annex A to the report.

1. Resource Implications

1.1 This new report summarises the capital programme, treasury strategy and investment strategy. These documents set out how the Council intends to manage its £14m of investments, £139m of borrowing and £180m of investment property together with approval for the 2019/20 capital programme of £2.3m.

1.2 Following 8 years of Government funding cuts the Council embarked on strategy of income generation through property in order to maintain valuable services. In addition further property was acquired in order to advance the Council's regeneration aims in Camberley. In 2019/20 this is budgeted to contribute £1.2m to the Councils revenue budget without which it would not be possible to provide many of the Council's discretionary services. This income however is not without risk and despite the Council having strategies in place to manage risk this income is not guaranteed.

1.3 In addition in order to fund this, the Council has entered in to £139m of borrowing with annual budgeted interest costs of £2.8m. The strategy for the management of these borrowing has significant revenue implications for the Council and this is explored in more detail in this paper.

2. Key Issues

2.1 The 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. It has been written in an

accessible style to enhance members' understanding of these sometimes technical areas and fully complies with the Prudential Code 2017.

2.2 The revised Prudential code stipulates that a summary Capital Strategy should be prepared which summarised the Council Capital, Investment and Borrowing plans. This document fulfils those requirements. Members requiring further detail are advised to refer to the more detailed underlying strategies and plans.

3. Options

3.1 Members can accept, reject or amend the recommendations within this paper.

4. Proposals

4.1 It is proposed that the Executive:
(i) NOTE the contents of the capital strategy;
(ii) RECOMMEND approval of the Capital Strategy by Full Council

5. Supporting Information

5.1 The Capital strategy is included as Annex A within this paper.

5.2 Government guidance on local government investment and the Prudential Code .

6. Corporate Objectives And Key Priorities

6.1 Property investment and Treasury Management not only supports the Council objectives around place in that it supports the local economy but also prosperity in that it generates income to support services and assists with regeneration.

7. Legal Issues

7.1 The Council has to have regard to statutory guidance in respect of Local Government Investments and the Prudential Code.

8. Governance Issues

8.1 Full Council is required to approve the Capital Strategy.

9. Sustainability

9.1 Investment in property is one of the ways that the Council is not only sustaining its local economy but also sustaining Council services in the face of significant cuts in Government funding. This report also looks at the affordability and sustainability of the Council's capital programme and borrowings.

10. Risk Management

10.1 Investing in property and Treasury Management are not without risk. Rents and investment returns can fall and the value of investments can also fluctuate. The Council takes steps to minimise these risks by the use of professional advisors and due diligence but this is not a guarantee.

10.2 The Council maintains reserves to enable it to deal with a level of risk and in terms of property purchases with the intention of holding it for the longer term. That said the Council is not immune to the wider economy and thus service could be put at risk if the anticipated income and returns are not delivered. This risk though does need to be set against the very real risk of services being cut completely had the Council opted not to invest in property at all.

Annexes	**Capital Strategy 2019/20**
Background Papers	
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Annex A

Capital Strategy Report 2019/20

Introduction

1. 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. It has been written in an accessible style to enhance members' understanding of these sometimes technical areas.

Capital Expenditure and Financing

2. 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 £25,000 are not capitalised and are charged to revenue in year.

3. In 2019/20, the Council is planning capital expenditure of £2.348m as summarised below:

Prudential Indicator: Estimates of Capital Expenditure in £ millions

	2017/18 actual	**2018/19 forecast**	**2019/20 budget**	**2020/21 budget**	**2021/22 budget**
Capital Projects	1.9	10.4	2.348	0.640	0.600
Capital investments	2.5	36.0	0.0	0.0	0.0
TOTAL	4.4	46.4	2.348	0.640	0.600

4. The main General Fund capital projects include:
    - Disabled facilities grants – grants for improvements to enable residents to stay in their own home;
    - Replacement community bus;
    - IT equipment including filer storage and switches;
    - Final instalment of the High street Camberley public realm improvements.

5. The Council will also incur further capital expenditure on investments, such as further improvements to the SQ shopping centre and acquisition further investment property. These will come forward for approval from members as required.

6. **Governance**: Service Heads bid annually in October to include projects in the Council's capital programme. Bids, which include business cases, are collated by finance who calculate the financing cost (which can be nil if the project is fully externally financed). The Corporate Management Team

appraises all bids based on a comparison of service priorities against financing costs and makes recommendations to Executive in February which in turn makes recommendations to Council as part of the annual budget setting process.

7. Further details of the Council's capital programme can be found in the Capital Programme Report which can be found by on the Executive agenda for February 2019.

8. 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:

Capital financing in £ millions

	2017/18 actual	**2018/19 forecast**	**2019/20 budget**	**2020/21 budget**	**2021/22 budget**
External sources	**0.7**	**3.3**	**1.3**	**0.6**	**0.6**
Own resources	**0.9**	**0.0**	**1.1**	**0.0**	**0.0**
Debt	**2.8**	**41.1**	**0.0**	**0.0**	**0.0**
TOTAL	**4.4**	**46.4**	**2.4**	**0.6**	**0.6**

9. 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)" . Councils are required by law to make MRP transfers over the life of a loan so as ensure that Councils are able to repay debt. Alternatively, proceeds from selling capital assets (known as capital receipts) may be used to replace debt finance. Planned MRP transfers and use of capital receipts are as follows:

Replacement of debt finance in £ millions

	2017/18 actual	**2018/19 forecast**	**2019/20 budget**	**2020/21 budget**	**2021/22 budget**
MRP Payment	1.318	1.369	2.014	2.047	2.098

10. The Council's full MRP statement is included within the Treasury Strategy report for 2019/20 which can be found on the February 2019 Executive agenda

11. 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 fall by £1m during 2019/20. Based on the above figures for expenditure and financing, the Council's estimated CFR is as follows:

Prudential Indicator: Estimates of Capital Financing Requirement in £ millions

	31.3.2018 actual	31.3.2019 forecast	31.3.2020 budget	31.3.2021 budget	31.3.2022 budget
General Fund services	2	7	7	7	8
Capital investments	140	177	176	174	171
TOTAL CFR	**142**	**184**	**183**	**181**	**179**

12. **Asset management**: To ensure that capital assets continue to be of long-term use, the Council is currently preparing an asset management strategy. This will be presented to members in 2019/20

13. **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. Repayments of capital grants, loans and investments also generate capital receipts. The Council does not plan to receive any capital receipts from asset sales in future years. The 2018/19 receipt relates to Ashwood House. However this may change if surplus land is brought forward for sale or disposal.

Capital receipts in £ millions

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
Asset sales	0	5.2	0	0	0
TOTAL	**0**	**5.2**	**0**	**0**	**0**

<u>Treasury Management</u>

14. 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.

15. Due to decisions taken in the past, the Council currently has £139m borrowing at an average interest rate of 1.8% and an average of £14m treasury investments at an average rate of 1.0%.

16. **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%).

17. Following advice from the Council's Treasury advisors the Council has retained the bulk of its borrowing in short term loan so as to take advantage of low interest rates. In order to cap its exposure to interest rate rises the Council has entered in to two forward dated 40 year loans with an insurance company of £25m each which commence in 2020/21 and 2021/22 and have fixed interest rates of 2.85% and 2.91%

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

Prudential Indicator: Gross Debt and the Capital Financing Requirement in £ millions

	31.3.2018 actual	**31.3.2019 forecast**	**31.3.2020 budget**	**31.3.2021 budget**	**31.3.2022 budget**
Debt	120	147	146	145	143
Capital Financing Requirement	142	184	183	181	179

19. Statutory guidance is that debt should remain below the capital financing requirement, except in the short-term. As can be seen from table above, the Council expects to comply with this in the medium term. If the Council decides to acquire more investments these will be funded by debt and the CFR will be rise accordingly.

20. **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 a minimum level of £10m at each year-end. This benchmark is currently £158m and is forecast to fall to £154m over the next three years.

Borrowing and the Liability Benchmark in £ millions

	31.3.2018 actual	**31.3.2019 forecast**	**31.3.2020 budget**	**31.3.2021 budget**	**31.3.2022 budget**
Outstanding borrowing	120	147	146	145	143
Liability benchmark	114	158	156	156	154

21. The table shows that the Council expects to remain borrowed lower than its liability benchmark.

22. **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.

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 – total external debt	190	190	190	190
Operational boundary – total external debt	185	185	185	185

23. Further details on borrowing are included in the treasury management strategy which can be found within the February Executive agenda

24. **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.

25. 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 will 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.

Treasury management investments in £millions

	31.3.2018 actual	31.3.2019 forecast	31.3.2020 budget	31.3.2021 budget	31.3.2022 budget
Near-term investments	**12.0**	**13.0**	**13.0**	**13.0**	**13.0**
Longer-term investments	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**
TOTAL	**14.0**	**15.0**	**15.0**	**15.0**	**15.0**

26. Further details on treasury investments are included within the treasury management strategy which is included within the February executive agenda

27. **Governance:** Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Executive Head of Finance and staff, who must act in line with the treasury management strategy approved by Executive and Council and the half yearly reports on treasury management activity are presented to

Executive. The Performance and Finance committee is responsible for scrutinising treasury management decisions.

Commercial Activities

28. With Central Government financial support for local public services declining, the Council has invested in some commercial property purely or mainly for financial gain. It has also invested in assets, especially those within Camberley Town centre, for economic development and regeneration and as a consequence has accepted a lower return and a higher risk.

29. Total commercial investments are currently valued at £180m with the largest being the SQ shopping centre and associated land holdings in Camberley.

30. With financial return being the main objective, the Council accepts higher risk on commercial investment than with treasury investments. The principal risk exposures in the short term include loss of tenants, property valuation and voids. In the medium term there are risks around maintenance. These risks are managed by a rigorous due diligence process prior to purchase to high light any concerns and then after purchase by the use of professional managers and advisors to advice the Council on how to maintain its investment returns. In order that commercial investments remain proportionate to the size of the authority, these are subject to an overall maximum investment limit of £200m. Should investment yield fall by 2% the Councils reserves are sufficient to cover this loss for the short term until new tenants/uses are in place or the asset could be sold.

31. **Governance**: Decisions on commercial investments are made by Full Council on the recommendation of Executive.

32. Further details on commercial investments and limits on their use are in Investment strategy which is included within the February executive agenda.

33. The Council also has limited commercial activities such as the Theatre, community services etc. which whilst being primarily operated for community benefit does expose it to some commercial risk. This risk is not considered to be significant for the 2019/20.

Liabilities

34. In addition to debt of £139m detailed above, the Council is committed to making future payments to cover its pension fund deficit (valued at £914k) It also set aside last year £2.7m to cover risks of business rates appeals and revaluations and £1m for bad debts. These provisions will be reviewed as part of the accounts closure process for 2018/19.

35. **Governance**: The risk of liabilities crystallising and requiring payment is monitored by finance and reported within the annual financial statements.

Revenue Budget Implications

36. 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.

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)	**-0.211**	**0.270**	**1.342**	**1.306**	**1.306**
Proportion of net revenue stream	**-1.96%**	**2.44%**	**12.36%**	**11.65%**	**11.44%**

37. Further details on the revenue implications of capital expenditure are included within the Capital programme included within the February 2019 Executive agenda.

38. **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 50 years into the future. The Executive Head of Finance is satisfied that the proposed capital programme is prudent, affordable and sustainable because it is either funded by external grant or there is sufficient revenue to cover the costs of borrowing.

Knowledge and Skills

39. The Council employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. For example, the Executive Head of Finance is a qualified accountant with over 30 years' experience and the professional property advisors the Council uses are all qualified surveyors with many years' experience. In addition the Chief Executive has many years of experience in property investment and development. The Council is very supportive of training and pays for junior staff to study towards relevant professional qualifications.

40. 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, Montagu Evans as property consultants and Addleshaw Goddard as external lawyers. 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.