Capital Strategy Report 2020/21

Summary
This Capital Strategy Report, which was introduced for the first time last year, 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. It is provided so as to enhance members' understanding of these technical areas.

Portfolio - Finance
Date Consulted: 3 February 2020

Wards Affected
All

Recommendation

The Executive is advised to RECOMMEND to Full Council that Capital Strategy, as set out at Annex A to this report, be agreed.

1. Resource Implications

1.1 This report summarises the capital programme, treasury strategy and investment strategy. These documents set out how the Council intends to manage its £13m of investments, £164m of borrowing and £171m of investment property together with approval for the 2020/21 capital programme of £1.5m.

1.2 The Council has acquired property for two reasons as follows:

- Property acquired to generate an income to maintain services following years of Government Funding cuts. This property also contributes to the economic sustainability in that it primarily consists of employment sites in the borough. This income however is not without risk and despite the Council having strategies in place to manage risk this income is not guaranteed.
- Property acquired to assist with the regeneration of Camberley Town centre and its economic vitality. These assets may not generate a return in the short term but it was vital that the Council controlled them if its development aims for the Camberley were to be moved forward.

1.3 In order to fund this, the Council has £164m of borrowing with annual budgeted interest costs of £3.8m.The strategy for the management of this 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 was a new report in 2019/20 and is intended to give 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 with a view to enhance members' understanding and also fully complies with the Prudential Code 2017.

2.2 The 2017 Prudential Code stipulates that a summary Capital Strategy should be prepared which summarises the Council's 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 which can be found elsewhere on this agenda.

2.3 Currently property investment has been restricted to within the borough boundary or close to as this not only generates an income but also fulfils the aim of supporting the economy of the borough by maintaining employment sites in line with Government guidance. However the number of properties available for investment in this area are limited and so the Council may need to look further afield in order to address the Council's financial pressures. Councils are permitted to depart from statutory Government Guidance, but must set out clearly the reasons for doing so and consider the risks – were this to be the case this would form the basis of a separate report to members in the future.

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 maintaining Council services in the face of reductions 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 2020/21**
Background Papers	
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Annex A

Capital Strategy Report 2020/21

Introduction

1. This Capital Strategy report givies 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 with the intention of enhancing members' understanding of these sometimes technical areas.

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

Capital Expenditure and Financing

3. 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.

4. In 2020/21, the Council is planning capital expenditure of £2.348m as summarised below:

Prudential Indicator: Estimates of Capital Expenditure in £ million*s*

	2018/19 Actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
Capital Projects	10.352	39.040	1.479	1.000	1.000
Capital investments	41.780	0.0	0.0	0.0	0.0
TOTAL	52.132	39.040	1.479	1.000	1.000

5. The main General Fund capital projects include:
   - Disabled facilities grants – grants for improvements to enable residents to stay in their own home;
   - Car park resurfacing;
   - IT equipment including Laptops and printers;
   - Upgrades to Council facilities such as Frimley Lodge Park.

6. The Council may also incur further capital expenditure on investments, such as improvements to the SQ shopping centre, repurposing of BHS and Hof as well as the acquisition of additional investment property. These will be brought forward to members on a case by case basis for their

consideration as required. Hence they have not been included in this report.

7. The figures do not include the implications of any schemes which may be carried forward from one year to the next. This will be considered by members on the basis of a report to be presented later in the year

8. **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.

9. 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 2020.

10. 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

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
External sources	2.317	0.750	1.000	1.000	1.000
Own resources	2.321	0.250	0.479		
Debt	47.494	38.040	0.000		
TOTAL	**52.132**	**39.040**	**1.479**	**1.000**	**1.000**

11. 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

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
MRP Payment	1.400	2.159	2.213	2.274	2.320
Use of Capital	0.827	0.250	0.479	0.000	0.000

Receipts					

12. The Council's full MRP statement is included within the Treasury Strategy report for 2020/21 which can be found on the February 2020 Executive agenda

13. 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 2020/21. 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

	31.3.2019 actual	31.3.2020 forecast	31.3.2021 budget	31.3.2022 budget	31.3.2023 budget
General Fund services	2	7	7	7	8
Capital investments	188	218	217	214	211
TOTAL CFR	**190**	**225**	**224**	**221**	**219**

14. **Asset management**: To ensure that capital assets continue to be of long-term use, the Council is currently preparing an updated asset management strategy which will be presented to members in 2020/21

15. **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

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
Asset sales	4.9	0	0	0	0
TOTAL	**4.9**	**0**	**0**	**0**	**0**

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, 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.

17. Due to decisions taken in the past, the Council currently has £164m borrowing at a budgeted average interest rate of 2.00% and an average of £13m treasury investments at a budgeted average interest rate of 1.0%.

18. **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%).

19. 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 February 2021 and February 2022 and have fixed interest rates of 2.85% and 2.91%

20. 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

	31.3.2019 actual	**31.3.2020 forecast**	**31.3.2021 budget**	**31.3.2022 budget**	**31.3.2023 budget**
Gross Debt	179	164	163	160	158
Capital Financing Requirement	190	225	224	221	219

21. 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.

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

	2019/20 limit	2020/21 limit	2022/22 limit	2022/23 limit
Authorised limit – total external debt	235	235	235	235
Operational boundary – total external debt	230	230	230	230

23. The authorised and operational boundaries have not been increased in 2020/21 to reflect the changes due to the change in the accounting treatment for leases as the amount is not material.

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

25. **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.

26. 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

	31.3.2019 actual	31.3.2020 forecast	31.3.2021 budget	31.3.2022 budget	31.3.2023 budget
Near-term investments	30.0	11.0	11.0	11.0	11.0
Longer-term investments	2.0	2.0	2.0	2.0	2.0
TOTAL	**32.0**	**13.0**	**13.0**	**13.0**	**13.0**

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

28. **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. Half yearly reports on treasury management activity are presented to Executive and

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

Commercial Activities

29. 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.

30. Total commercial investments are currently valued (as at date of the last market valuation) at £148m with the largest being the SQ shopping centre and associated land holdings in Camberley. The market value includes a write down for the property in Camberley Town centre due to the current state of the retail market. As there is no intention to sell these assets in the foreseeable future these losses have not been realised.

31. 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 highlight 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 currently subject to an overall maximum investment limit of £200m – however this may be reviewed depending on the Council's strategic requirements. 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 as a last resort be sold.

32. **Governance**: Decisions on whether to purchase commercial investments can only be made by Full Council on the recommendation of Executive.

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

34. 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 2020/21.

Liabilities

35. In addition to debt of £164m detailed above, the Council is committed to making future payments to cover its pension fund deficit (valued at £6.3m) It also set aside last year £0.5m to cover risks of business rates appeals

and revaluations and £1.5m for bad debts. These provisions will be reviewed as part of the accounts closure process for 2019/20.

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

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

Prudential Indicator: Proportion of financing costs to net revenue stream

	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
Financing costs (£m)	**2.063**	**2.067**	**2.077**	**2.079**
Proportion of net revenue stream	**19.08%**	**19.18%**	**18.75%**	**18.25%**

38. Further details on the revenue implications of capital expenditure are included within the Capital programme included within the February 2020 Executive agenda.

39. **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

40. 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, the property department has a qualified surveyor with investment experience and the legal department has lawyers experienced in property matters.

41. 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.