

CORPORATE OVERVIEW AND SCRUTINY PANEL – 23 JANUARY 2020

CAPITAL STRATEGY 2020/21

1. INTRODUCTION

- 1.1. The Capital Strategy is a high level document, giving an overview of how capital expenditure, capital financing and treasury management come together, with an overview of current activities and the implications for future financial sustainability.
- 1.2. By producing this strategy report, the Council is following statutory guidance issued by the Government in January 2018.

2. OVERVIEW OF WHAT IS INCLUDED IN THE CAPITAL STRATEGY

- 2.1. The Capital Strategy confirms at high level what the Council is intending to spend its money on over the medium term and how it intends to finance this expenditure. Over the period covered by 2020/21 to 2022/23, total capital expenditure is forecast at around £119m.
- 2.2. As demonstrated throughout the report, the Council is intending to utilise the cash balances it has accrued to deliver the various adopted investment strategies, including Commercial Property, Residential Property and Housing to 2026, and will supplement these internal resources when necessary with external borrowing and in accordance with advice it receives from its contracted Treasury Management experts.
- 2.3. It is vitally important that the Council has regard to the relationship between the financing costs of the capital programme and the revenue General Fund, and Housing Revenue Account. This is covered within the report by the prudential indicators.
- 2.4. This Council has established a sound level of governance surrounding its capital investments and employs suitably qualified personnel in order to fulfil the objectives of the Strategy. External support and expertise is sought where necessary, and officers have the ability to communicate openly and freely with members of the Cabinet.

3. MINIMUM REVENUE PROVISION

- 3.1. Where General Fund capital spend has been financed by loan (internal borrowing), and has increased the Capital Financing Requirement (CFR), the Council is required to make a provision to repay a proportion of the accumulated amount each year. This amount is charged to revenue and is called the Minimum Revenue Provision (MRP). This charge reduces the CFR each year, and is based on the expected economic use period related to the capital expenditure.
- 3.2. Full Council is required to approve an MRP statement in advance of each financial year. The Council is recommended to approve the following MRP statement:

“ For capital expenditure that has been incurred, and which has given rise to a CFR, the MRP policy for expenditure other than that incurred on investment property, shall be to charge revenue

an amount equal to the depreciation of any asset financed by loan. The MRP policy specific to investment properties financed by loan, shall be to charge revenue an amount equivalent to the sum of borrowing utilised, over a repayment period of 50 years.”

4. ENVIRONMENTAL / CRIME AND DISORDER IMPLICATIONS

4.1. There are no implications arising from this report.

5. RECOMMENDATIONS

5.1. The Corporate Overview and Scrutiny Committee is recommended to request Cabinet approve the Capital Strategy 2020/21, including the adoption of the MRP statement.

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Background Papers:

Capital Strategy 2020/21

1.0 Introduction

This capital 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.

The report also includes the prudential indicators, as required by the 2017 Prudential Code.

2.0 Capital Expenditure and Financing

Capital expenditure is where the Council spends money on assets, such as property or vehicles, that will be used for more than one year. 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.

In 2020/21, the Council is planning capital expenditure of £37.194m as summarised below:

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

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
General Fund services	3.289	8.547	9.894	6.875	3.875
Council housing (HRA)	17.733	21.403	15.800	23.000	27.200
Capital investments	0.248	5.360	11.500	14.000	6.700
TOTAL	21.270	35.310	37.194	43.875	37.775

The General Fund capital programme includes the cyclical replacement of Vehicles and Plant, Smarter Working at £1m and a New Depot Facility at £5m. The Council also plans to incur £32m of capital expenditure on investments, which are detailed later in this report in section 4.

The Housing Revenue Account (HRA) is a ring-fenced account which ensures that council housing does not subsidise, or is itself subsidised by, other local services. HRA capital expenditure is therefore recorded separately and includes the maintenance of existing stock and the building and acquisitions of new homes over the forecast period, in line with the Housing strategy.

Governance: Service managers bid annually in the early Autumn to include projects in the Council's capital programme. Bids are collated by the Head of Finance and evaluated by the Executive Management Team. The Corporate Overview and Scrutiny Panel appraise the proposed programme and makes recommendations to the Cabinet. The final capital programme is then presented to Cabinet and to Council in February each year.

- Full details of the Council's capital programme are available within the Feb 2020 Cabinet papers (Medium Term Financial Plan / Annual Budget 2020/21)

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). The planned financing of the above expenditure is as follows:

Table 2: Capital financing in £ millions

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
External sources (Grants / DC's)	2.868	5.129	5.037	3.675	4.075
Capital Receipts	4.829	3.649	3.500	3.000	2.000
Capital Reserves	3.401	12.393	5.627	9.727	8.767
Revenue Contributions	9.415	9.225	8.848	8.673	8.873
Debt / Loan	0.757	4.914	14.182	18.800	14.060
TOTAL	21.270	35.310	37.194	43.875	37.775

Generally any borrowing required to meet the Council's capital expenditure is met by using cash held in reserves rather than raising loans. This action is known as internal borrowing and is assumed for 2020/21. Internal borrowing is replaced over time by other financing, usually from revenue which is known as minimum revenue provision (MRP, explained further below). Alternatively, additional (beyond those already anticipated within the financing as shown within table 2) proceeds from selling capital assets (known as capital receipts) may be used to replace debt finance. Planned MRP and debt repayment are as follows:

Table 3: Replacement of debt finance in £ millions

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
Capital Expenditure Financed by Debt / Loan	0.757	4.914	14.182	18.800	14.060
Own resources - Debt Repayment	-4.100	-4.100	-4.100	-4.100	-4.100
Own resources - MRP Provision	-1.232	-1.315	-1.615	-1.951	-2.203
Movement in CFR	-4.575	-0.501	8.467	12.749	7.757

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, debt repayments and capital receipts used to replace debt. The CFR is expected to increase by £8.467m during 2020/21. 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 £ millions

	31.3.2019 actual	31.3.2020 forecast	31.3.2021 budget	31.3.2022 budget	31.3.2023 budget
General Fund services	3.278	2.806	3.240	3.992	4.244
Council housing (HRA)	136.401	132.301	131.729	133.829	137.369
Capital investments	1.646	5.717	14.322	24.218	28.184
Total CFR at Year End	141.325	140.824	149.291	162.039	169.797
Movement in CFR from one year to the next	-4.575	-0.501	8.467	12.749	7.757

Minimum Revenue Provision: Where General Fund capital spend has been financed by loan (internal borrowing), and has increased the CFR, the Council is required to make a provision to repay a proportion of the accumulated amount each year. This amount is charged to revenue and is called the Minimum Revenue Provision (MRP). This charge reduces the CFR each year, and is based on the expected economic use period related to the capital expenditure.

Full Council is required to approve an MRP statement in advance of each financial year. The Council is recommended to approve the following MRP statement:

“ For capital expenditure that has been incurred, and which has given rise to a CFR, the MRP policy for expenditure other than that incurred on investment property, shall be to charge revenue an amount equal to the depreciation of any asset financed by loan. The MRP policy specific to investment properties financed by loan, shall be to charge revenue an amount equivalent to the sum of borrowing utilised, over a repayment period of 50 years.”

For Council Housing and the refinancing settlement of 2012, the Council has an approved business plan that will charge amounts to revenue to ensure that any borrowings are reduced in accordance with the maturity of the debt outstanding.

Asset management: Service Managers from across the Council manage assets in their service delivery areas. The Council’s Service Manager for Estates and Valuation has overall responsibility for the management of the Council’s property estate records, including liaising with the Council’s Accountancy department on statutory annual financial reporting. To ensure that property assets continue to be of long-term use, the Council will be producing an overarching Accommodation Strategy.

Asset disposals: When a capital asset is no longer needed, it may be sold so that the proceeds (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. Council dwelling sales through the Right to Buy scheme also generate capital receipts, and although some of these are currently returned the government, the majority are available to the Council to spend on new housing. The Council plans to receive £2.2m of capital receipts in the coming financial year as follows:

Table 5: Capital receipts in £ millions

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
Asset sales	5.015	3.000	2.000	2.000	2.000
Loans repaid	0.201	0.201	0.201	0.201	0.201
TOTAL	5.216	3.201	2.201	2.201	2.201

- In 2018/19, the Council received capital receipts from the sale of St Johns Street car park and a proportion of Hardly Industrial Estate.
- All other forecast asset disposals relate to Right to Buy receipts.
- In 2014, the Council arranged £2m of prudential borrowing on behalf Lymington Harbour Commissioner. This is being repaid annually.

3.0 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 will become 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.

At the last balance sheet date (31/03/19), the Council had £135.5m borrowing at an average interest rate of 3.21% (due to the HRA refinancing settlement in 2012), and held £64.1m treasury investments earning an average rate of 1.87%.

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 2.5 to 3.5%).

Projected levels of the Council's total outstanding debt (which comprises borrowing in relation to the refinancing of the HRA in 2012/13 and new borrowing required to finance the capital programme) are shown below, compared with the capital financing requirement (see above).

Table 6: 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
Debt	135.5	131.2	126.9	128.9	142.9
Capital Financing Requirement	141.3	140.8	149.3	162.0	169.8

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.

Affordable borrowing limit: The Council is legally obliged to set an affordable borrowing limit (also termed the authorised limit for external debt) each year and to keep it under review. 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 £millions

	2019/20 limit	2020/21 limit	2021/22 limit	2022/23 limit
Authorised limit – total external debt	201.6	201.6	216.5	224.3
Operational boundary – total external debt	186.3	186.3	200.3	208.0

- Further details on borrowing are included within the treasury management strategy

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 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.

Table 8: 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	35.5	21.3	15.8	5.0	5.0
Longer-term investments	28.6	26.4	13.4	5.0	5.0
TOTAL	64.1	47.7	29.2	10.0	10.0

- Further details on treasury investments are included within the treasury management strategy

Table 8 suggests that the majority of the Councils cash will be utilised over the period through internal borrowing to fund the needs of the Councils capital programme, until minimum balances reach £10m. Use of cash for capital programme financing will be supplemented through external borrowing, when required (hence the increase in debt headroom as per table 7). The Council should expect to retain a minimum level of cash, known as the **Liability Benchmark**. The General Fund balance reserve at £3m and the HRA reserve at £1m are an absolute minimum, with further headroom added to set where the Council's basic benchmark should be (**£10m** in total).

Governance: Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Head of Finance and staff, who must act in line with the treasury management strategy approved by Council. A mid-year and an outturn report on treasury management activity are presented to the audit committee. The audit committee is responsible for scrutinising treasury management decisions.

4.0 Commercial Activities

With central government financial support for local public services declining, the Council intends to invest in commercial and residential property mainly for financial gain. The Council will invest in, and will lend to its Wholly Owned Trading Company for purposes of income generation through residential property. Total commercial investment properties were valued at £5.2m as at 31/03/19. In 2019/20, the Council purchased a bare land site in Ringwood with planning permission for industrial development and a car park in Lymington with a long-leaseholder.

With financial return being the main objective, the Council accepts higher risk on commercial and residential investment than with treasury investments. The principal risk exposures include vacancies and falls in capital values. These risks in relation to commercial property are managed by predominantly targeting acquisitions with existing medium-long term tenancies in place and being sensible about the purchase price in relation to the income yields achievable. In order that commercial investments remain proportionate to the size of the authority, these are subject to an overall maximum investment limit of £30m. Residential property investments are subject to an overall investment limit of £10m.

Governance: Decisions on commercial investments are made by an investment panel in line with the criteria and limits approved by Council in the Commercial Property Investment strategy. Decisions on residential investments are taken by the Board of Directors of the

wholly owned company, in line with the criteria and limits approved by Council in the Residential Property Strategy. Property and most other commercial investments are also capital expenditure and purchases have therefore also been pre-approved as part of the capital programme.

- Further details, including the risk management on commercial and residential investments are outlined in these respective strategy documents;
 - [Commercial Property Investment Strategy](#)
 - [Residential Property Investment Strategy](#)

5.0 Liabilities

In addition to debt of £135.5m detailed above, the Council is committed to making future payments to cover its pension fund liability (valued at £93m as at 31/03/19), It has also set aside £4.3m in provisions, with £4.0m of this to cover risks of business rate appeals.

Governance: Decisions on incurring new discretionary liabilities are taken by the Head of Finance. The risk of liabilities crystallising and requiring payment is monitored by Accountancy and reported when necessary.

- Details on liabilities are shown within the Council's balance sheet on page 17 of the 2018/19 Annual Financial Report, further supported by notes to the accounts (http://www.newforest.gov.uk/media/39125/Annual-Financial-Report-201819/Pdf/Annual_Financial_Report_18-19.pdf)

6.0 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 funded from Council Tax, business rates and general government grants for the General fund, and the income receivable from rents within the HRA.

*In relation to the finance costs incurred within the General Fund, the income to be generated will exceed the additional MRP and interest charges, but as this income is to be used to directly contribute towards the funding of services, the income is not netted off against the finance costs within the table 9.

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

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
General Fund; Financing costs (£m)	0.22	0.46	1.06	1.69	2.08
General Fund; Proportion of net revenue stream	1.3%	2.6%	6.1%	9.7%	11.9%
HRA; Financing costs (£m)	4.1	3.9	3.9	4.1	4.4
HRA; Proportion of net revenue stream	14.7%	14.3%	14.1%	14.3%	15.0%

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 Head of Finance is satisfied that the proposed capital programme is prudent, affordable and sustainable considering that the majority of the planned expenditure is revenue earning.

7.0 Knowledge and Skills

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 Finance and the Council's two principal accountants are all qualified accountants with several years' experience between them, the Service Manager for Estates and Valuation is a qualified solicitor with many years' of experience in property law, commercial and corporate transactions and is supported by highly experienced and professionally qualified surveyors and valuers (members of the Royal Institution of Chartered Surveyors).

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 has a Service Level Agreement with Hampshire County Council's Treasury Management department for day-to-day treasury management activities. The Council instructs external surveyors, valuers, architects and quantity surveyors to provide specialist advice on a project by project basis. 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.