

South Northamptonshire District Council

Capital Strategy 2019/20

1 Introduction

- 1.1 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.

2 Capital Expenditure and Financing

- 2.1 Capital expenditure is where the Council spends money on assets, such as property or vehicles, which 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 Financial Regulations

In 2019/20, the Council is planning capital expenditure of £3.2m as summarised below:

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

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
TOTAL	2.9	7.3	3.2	0.1	0.1

- 2.2 The main capital projects include leisure centre refurbishments, vehicle replacement programme and replacement IT systems.

Governance

- 2.3 Service managers bid as part of the annual budget setting process, and throughout the year, to include projects in the Council's capital programme. Bids are collated by Finance who calculate the financing cost (which can be nil if the project is fully externally financed). The Budget and Financial Strategy Committee appraises all bids based on a comparison of service priorities against financing costs and makes recommendations to the Cabinet. The final capital programme is then presented to Council in February each year.

- 2.4 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 £ millions

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
External sources	0	0	0	0	0
Own resources	2.9	7.3	3.2	0.1	0.1
Debt	0	0	0	0	0
TOTAL	2.9	7.3	3.2	0.1	0.1

- 2.5 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 £ millions

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
Own resources	2.9	7.3	3.2	0.1	0.1

The Council's full minimum revenue provision statement is available via the Council's website.

- 2.6 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 £3.1m 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 £ millions

	31.3.2018 actual	31.3.2019 forecast	31.3.2020 forecast	31.3.2021 forecast	31.3.2022 forecast
TOTAL CFR	0	2.2	5.3	5.1	5.0

Asset management

2.7 To ensure that capital assets continue to be of long-term use, the Council has an asset management strategy in place. This is a multi-level approach structured as follows:

- At a tenancy level the Comprehensive Asset Register (a database of key lease events) is being updated and used to identify forthcoming lease events such as expiries, rent reviews and breaks. These are allocated to specific asset managers to progress whose work schedules are reviewed monthly.
- At a property level this comprises the preparation of asset management plans for each asset which are then subject to periodic review and updating. This process is ongoing and intended to allow a critical examination of the performance of each asset and inform medium / long term decision making, such as the asset's suitability for simple retention, future capital investment or sale.
- At a portfolio level the make-up of the portfolio will be considered bi-annually in terms of its sector weighting and suitability to meet the Council's longer term objectives of providing a secure risk weighted income stream

The Council's asset management strategy can be read via the Council's website.

Asset disposals

2.8 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 does not expect to receive any capital receipts in the coming financial year.

3 Treasury Management

3.1 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 (31/12/18) has £30.8m treasury investments at an average rate of 0.81%.

Borrowing strategy

3.2 The Council's main objectives when borrowing will be to achieve a low but certain cost of finance while retaining flexibility should plans change in future. These objectives can be conflicting, and the Council therefore would seek 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, PFI liabilities, leases) are shown below, compared with the capital financing requirement (see above).

Table 5: 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 (incl. PFI & leases)	0	0	0	0	0
Capital Financing Requirement	0	2.2	5.3	5.1	5.0

- 3.3 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

- 3.4 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 6: Prudential Indicators: Authorised limit and operational boundary for external debt in £m

	2018/19 limit	2019/20 limit	2020/21 limit	2021/22 limit
Operational boundary total external debt	0	0	0	0
Authorised limit total external debt	5	5	5	5

Further details on borrowing can be found in the treasury management strategy

Investment strategy

- 3.5 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.

- 3.6 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 7: Treasury management investments in £millions

	31.3.2018 actual	31.3.2019 forecast	31.3.2020 forecast	31.3.2021 forecast	31.3.2022 forecast
Near-term investments	25.4	18.1	15.0	15.2	15.3
Longer-term investments	1.5	1.5	1.5	1.5	1.5
TOTAL	26.9	19.6	16.5	16.7	16.8

Further details on treasury investments can be found in the treasury management strategy.

Governance

- 3.7 Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Section 151 Officer and staff, who must act in line with the treasury management strategy approved by Council. Reports on treasury management activity are presented to the Audit Committee. The Audit Committee is responsible for scrutinising treasury management decisions.

4 Investments for Service Purposes

- 4.1 The Council makes investments to assist local public services, including providing loans to local charities and businesses where there is demonstrable public benefit. 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 at least break even.

Governance

- 4.2 Decisions on service investments are made by the relevant service manager in consultation with the Section 151 Officer and must meet the criteria and limits laid down in the Investment Strategy. Most loans are capital expenditure and will therefore also be approved as part of the capital programme.

Further details on service investments are in the Investment Strategy

5 Commercial Activities

5.1 With central government financial support for local public services declining, the Council invests in commercial property mainly for financial gain but also for strategic economic regeneration. Total commercial investments are currently valued at £1.5m with the largest being The Old Mill, Towcester.

With financial return being an objective, the Council accepts higher risk on commercial investment than with treasury investments. The principal risk exposures are listed below together with an outline of how those risks are managed:

Illiquidity:	<p>The Council acknowledges illiquidity as a risk in property and whilst it cannot be avoided the risk is mitigated by the following strategies:</p> <ul style="list-style-type: none"> a) The Council invests across a range of sectors. Illiquidity is to an extent fluid and at any given time varies across sectors. This allows the Council the opportunity to effect sales, if required, in the more liquid sectors. b) The Council's assets are likewise diversified in terms of lot size. This affords the Council the ability to access a range of purchaser types e.g. small local investors, listed property companies or institutions. c) The Council does not invest in high risk assets which can be the most illiquid of all. d) The Council's investments are not what is termed 'Investment Grade', but they are fundable – i.e. if sold they could be suitable for debt backed investors. e) The Council does not invest in specialist properties, where the market tends to be most illiquid. f) The Council's assets are uncharged. It is often lenders who require assets to be sold and whilst gearing does not increase illiquidity per se, it can expose an owner to greater risk of selling an illiquid asset at an inopportune time.
Tenant default:	<p>The Council's portfolio is not populated by large national concerns and tenant default risk is managed in two ways:</p> <ol style="list-style-type: none"> 1. Tenants are vetted when entering the portfolio either as new tenants when property is let or as replacement tenants when existing tenants assign their leases. It has to be acknowledged that there is less control when a tenant applies for consent to assign, though guarantees may be sought. 2. Risk is managed by diversification as only a small proportion of tenants will fail in any given year.
Obsolescence:	<p>A significant proportion of the Council's portfolio comprises mixed use and simple retail assets which have relatively low obsolescence compared to offices where there are substantial amounts of plant and machinery. Where we have offices we try to introduce sinking / replacement funds where we are able to collect from tenants an annual sum to put towards high cost items such as the replacement of lifts or air conditioning.</p>

Capital expenditure	Please see above but also note that the Council aims to let space on Full Repairing terms which either makes the tenant either explicitly responsible for maintaining the asset or allows the Council to recover the cost of repairs through the service charge provisions of the relevant lease.
Market risk:	Two key market risks are falling rents in response to declining economic conditions and extended marketing voids when leases end or tenants fail. These risks are mitigated in three main ways: <ol style="list-style-type: none"> 1. Lease lengths should be 3 – 5 yrs + which obviates most market risks during the period of the tenancy. 2. Rents are reviewed in an upwards only direction. This means that they cannot fall during the term of a lease. 3. Tenant failure – see above under Tenant Default, re: vetting and diversification policies.
Returns eroded by	All investment assets incorporate periodic rent reviews which provide a hedge against inflation. Property is generally accepted as performing better than fixed income assets in times of inflation.
Rising interest rates:	The portfolio is ungeared and therefore un-mortgaged.

Governance

- 5.2 Decisions on commercial investments are made by Members and Statutory Officers in line with the criteria and limits approved by Council in the Investment 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 the Investment Strategy

- 5.3 The Council also has commercial activities in trading companies, exposing it to normal commercial risks. These risks are managed by the governance structure in place. The Shareholder Committee is regularly informed of the progress of each company. The Shareholder meets with the directors both formally and informally to ensure there is a consistent dialog between the companies and the council.

6 Liabilities

- 6.1 The Council is committed to making future payments to cover its pension fund deficit (valued at £42m). The pension liability is the underlying commitments that the authority has in the long run to pay retirement benefits, less the fair value of the assets held within the scheme.

However, statutory arrangements for funding the deficit mean that the financial position of the authority remains healthy, because:

- the deficit on the local government scheme will be made good by increased contributions over the remaining working life of employees (i.e. before payments fall due), as assessed by the scheme actuary,
- finance is only required to be raised to cover discretionary benefits when the pensions are actually paid

It has also set aside £0.5m to cover risks relating to business rates appeals.

Governance

- 6.2 Decisions on incurring new discretionary liabilities are taken by service managers in consultation with Statutory Officers. The risk of liabilities crystallising and requiring payment is monitored by Finance and reported monthly to the Budget and Financial Strategy Committee and Cabinet. New liabilities are reported to full council for approval/notification as appropriate.

Further details on liabilities and guarantees are on page 75 of the 2017/18 statement of accounts

7 Revenue Budget Implications

- 7.1 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 8: Prudential Indicator: Proportion of financing costs to net revenue stream

	2017/18 actual	2018/19 forecast	2019/20 forecast	2020/21 forecast	2021/22 forecast
Financing costs (£m)	0	0	0.1	0.3	0.3
Proportion of net revenue stream	0%	0%	1%	2%	2%

- Further details on the revenue implications of capital expenditure in the 2019/20 revenue budget

Sustainability

- 7.2 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 Section 151 Officer is satisfied that the proposed capital programme is prudent, affordable and sustainable.

8 Knowledge and Skills

- 8.1 The Council employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. For example, the Section 151 Officer is a qualified accountant with many years' experience. The Council pays for junior staff to study towards relevant professional qualifications including CIPFA, ACT (treasury), and the RICS.
- 8.2 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 should an investment opportunity arise, the Council would instruct the appropriate advisors.
- 8.3 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.