ANNEX 1

COUNCIL MEETING – 25 FEBRUARY 2021

AGENDA ITEM NO. 6 (1)

ANNUAL CAPITAL STRATEGY 2021/22

A report from the meeting of Cabinet held on 16 February 2021

1 INTRODUCTION

1.1 This report sets out the proposed Capital Strategy for the year 2021/22, including the Prudential indicators for capital finance for 2021/22.

1.2 The Council has adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code) which requires the Council to approve a treasury management strategy and Investment Strategy before the start of each financial year.

1.3 The CIPFA "Prudential Code" 2017 edition, "Treasury Management Code of Practice" 2017 edition and MHCLG revised guidance 2018 have resulted in the creation of a new Capital Strategy which is required to be approved by the Council before the start of each financial year.

1.4 There are currently two consultations in progress, one related to the CIFPA Prudential Code and the second related to the CIPFA Treasury Management Code. Both consultations are due to close on 12 April 2021. The CIFPA Prudential Code consultation is in response to the recommendation of the Public Accounts Committee and the substantial increase in commercial investment in the sector, CIPFA is proposing to strengthen the provisions within the code. CIPFA Treasury Management Code was last updated in 2017, since this date the landscape for public services has changed. There has been an increasing profile of the role of treasury management as a result of COVID-19, and the rise in commercial non-treasury investments is a contributing factor behind the need to strengthen its provisions to ensure that they are fit for the 21st century. The outcome of both consultations may require a revision to the Capital Strategy presented in this report.

2 PURPOSE

2.1 The purpose of the Capital Strategy is to give an 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.

2.2 The purpose of investment management operations is to ensure that all investment decisions that are made primarily to generate a profit have a suitable level of security and liquidity. Ensuring risks and rewards are monitored regularly.

2.3 The second main function of the Capital Strategy is to set the Prudential indicators for affordable, prudent and sustainable capital investment.

2.4 Appendix A sets out the Capital Strategy for 2021/22 to 2023/24 and fulfil key legislative requirements as follows:

- The **Capital Strategy** sets out 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 accordance with CIPFA's Code of Practice on Treasury Management, the CIFPA Prudential Code and MHCLG guidance on local government investments.

2.5 These policies and parameters provide an approved framework within which officers undertake the day-to-day capital, treasury and non- treasury investment activities.

3 SCOPE

3.1 This report covers the Council's capital management activities as set out in paragraphs 2.1 to 2.3 above. A summary of Treasury Management and commercial investments and the Council's borrowing requirements to fund the Capital strategy are set out. Prudential indicators are identified to set measures for affordability, prudent and sustainable. The funds invested consist of short-term cash available due to timing of income and expenditure, prudential borrowing and the Council's capital receipts.

3.2 The Council incurred prudential code borrowing in 2019/20 of £41.2m in relation to its capital expenditure. Further borrowing to support the financing of its approved capital programme in the year 20120/21 will also be required. It therefore commences the year 2021/22 in a position where its investment holdings continue to remain significant, but it also carries some accumulating debt. There will be an inevitable requirement to incur some further borrowing to service capital expenditure in future years.

3.3 On 26 November 2020 Public Works and Loan Board (PWLB) reversed the previous year 1% increase in standard rate. Alongside the reduction of the standard rate the terms of engagement were revised making it conditional that Local Authorities have no intention to buy investment assets primarily for yield in the current and follow two financial years. To access this facility the Council has revised its capital programme excluding all investment assets primarily for yield. The s151 Officer is required on application to the PWLB to submit strategic capital and financial plans.

3.4 Careful observation of the “gross debt v capital financing requirement” indicator will need to be undertaken progressively throughout the financial year.

3.5 Where a material change occurs to the attached strategies during the year a revised strategy will be presented to full council before the change is implemented.

4 RECOMMENDATIONS

4.1 The Council is recommended to approve the Capital Strategy for 2021/22 to 2023/24 and Prudential Indicators for 2021/22 at Appendix A.

P G TALYOR
PORTFOLIO HOLDER CORPORATE SERVICES

APPENDIX A

CAPITAL STRATEGY 2021/22

1 INTRODUCTION

1.1 This capital strategy is 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, 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, as outlined in the following Council account policy for 2021/22:

> "Expenditure on the acquisition, creation or enhancement of Property, Plant and Equipment is capitalised on an accruals basis, provided that it is probable that the future economic benefits or service potential associated with the item will flow to the Council and the cost of the item can be measured reliably (subject to a deminimus capitalisation threshold of £20,000 for land and buildings and £10,000 for plant, vehicles and equipment). Expenditure that maintains but does not add to an asset's potential to deliver future economic benefits or service potential (i.e. repairs and maintenance) is charged as an expense when it is incurred."

2.2 In 2021/22, the Council is planning capital expenditure of £24.7m as summarised below:

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

	2019/20 Actual	2020/21 Forecast	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
General Fund services	46.2	24.7	38.5	7.3	2.1
TOTAL	46.2	24.7	38.5	7.3	2.1

2.3 The main General Fund capital projects in 2020/21 include investment property acquisitions M&S Food Hall (Haslemere) and M&S Food Hall (Ferndown) In addition, regeneration site assembly costs associated with Union Street (Aldershot) and Farnborough Civic Quarter. The capital programme for 2021/22 includes a further £36m of regeneration expenditure.

2.4 On 26 November 2020 Public Works and Loan Board (PWLB) reversed the previous year 1% increase in standard rate. Alongside the reduction of the standard rate the terms of engagement were revised making it conditional that Local Authorities have no intention to buy investment assets primarily for yield in the current and following two financial years. No expenditure has been incurred on such assets since 26 November 2020 and the Council does not plan to incur expenditure on investment assets primarily for yield within the revised capital programme.

2.5 **Governance**: Service managers bid annually in September 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). Corporate Management Team (CMT) and Executive Leadership Team (ELT) appraises all bids based on a comparison of service priorities against financing costs. The final capital programme is then presented to Cabinet early February and to Full Council in late February each year. Variation to capital bids and new capital bids can be received during the year.

- For full details of the Council's capital programme, including the project appraisals undertaken, see: Appendix 3, FIN2106 Revenue budget, Capital Programme and Council Tax

2.6 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

	2019/20 Actual	**2020/21 Forecast**	**2021/22 Estimate**	**2022/23 Estimate**	**2023/24 Estimate**
External sources	3.1	4.2	10.3	2.3	1.1
Own resources	0.1	0.1	0.0	0.0	0.0
Debt	43.0	20.4	28.2	5.0	1.0
TOTAL	**46.2**	**24.7**	**38.5**	**7.3**	**2.1**

2.6 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

	2019/20 Actual	2020/21 Forecast	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
Own resources	1.4	2.2	2.5	3.2	3.3

- The Council's full minimum revenue provision statement is available here: Appendix C, FIN 2104 Annual Treasury Management Strategy and Non-Treasury Investment Strategy

2.7 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 £17.8m during 2021/22. 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

	2019/20 Actual	2020/21 Forecast	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
General Fund services	103.8	122.4	148.0	150.1	147.5
MRP	-1.4	-2.2	-2.5	-3.2	-3.3
IFRIC 4 Lease Adjustment	-0.4	-0.4	-0.4	-0.4	-0.4
TOTAL CFR	**102.0**	**119.8**	**145.1**	**146.5**	**143.8**

2.8 **Asset management:** To ensure that capital assets continue to be of long-term use, the Council is in the process of putting an asset management strategy in place.

2.9 **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 is forecasting to receive the following capital receipts over the medium term.

Table 5: Capital receipts in £ millions

	2019/20 Actual	2020/21 Forecast	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
Asset sales	0	0.0	0.0	0.0	0.0
TOTAL	**0**	**0.0**	**0.0**	**0.0**	**0.0**

- The Council's Flexible Use of Capital Receipts Policy is available here: Appendix 4, FIN2106 Revenue budget, Capital Programme and Council Tax

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.

3.2 Due to decisions taken in the past, the Council currently has £97.0m borrowing at an average interest rate of 0.6% and £31.1m treasury investments at an average rate of 2.14%.

3.4 **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 lower-cost short-term loans (currently available at around 0.3%) and long-term fixed rate loans where the future cost is known but higher (currently 0.7 to 1.5%).

3.5 Projected levels of the Council's total outstanding debt (which comprises borrowing and leases are shown below, compared with the capital financing requirement (table 4).

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

Gross Debt and the Capital Financing Requirement in £ millions	**2019/20 Actual**	**2020/21 Forecast**	**2021/22 Estimate**	**2022/23 Estimate**	**2023/24 Estimate**
Debt (incl. leases)	102.0	119.8	145.1	146.5	143.8
Capital Financing Requirement	178.4	146.5	143.8	140.2	146.3
Difference	76.4	26.7	-1.3	-6.3	2.5

3.6 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.

3.7 **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 to maintain sufficient liquidity, minimise credit risk and maintain Market in Financial Instrument Directive II (MiFID II) status. This benchmark is currently £105.9m and is forecast to rise to £129.9m over the next three years.

Table 7: Borrowing and Liability Benchmark in £ millions

	2019/20 Actual	**2020/21 Forecast**	**2021/22 Estimate**	**2022/23 Estimate**	**2023/24 Estimate**
Outstanding borrowing	102.0	1119.8	145.1	146.5	143.8
Investment minimum	-10.0	-10.0	-10.0	-10.0	-10.0
Investments held that can be redeemed	-27.2	-23.9	-23.9	-23.9	-23.9
Liability benchmark	84.8	105.9	131.2	132.6	129.9

3.8 The table shows that the Council expects to remain borrowed above its liability benchmark. This is because a deliberate decision has been made to maintain investment fund balances and not deplete to cover potential borrowing costs.

3.9 **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 8: Prudential Indicators: Authorised limit and Operational Boundary for External Debt in £ millions

	2020/21 limit	2021/22 limit	2022/23 limit	2023/24 limit
Authorised limit – total external debt	134.8	160.1	161.5	158.8
Operational boundary – total external debt	129.8	155.1	156.5	153.8

- Further details on borrowing are contained in the treasury management strategy – Appendix A FIN 2104 Annual Treasury Management Strategy and Non-Treasury Investment Strategy

3.10 **Treasury Management 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.

3.11 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 9: Treasury Management Investments in £ millions

	2019/20 Actual	2020/21 Forecast	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
Near-term investments	2.3	2.0	2.0	2.0	2.0
Longer-term investments	21.9	21.9	21.9	21.9	21.9
TOTAL	**24.2**	**23.9**	**23.9**	**23.9**	**23.9**

3.12 **Risk management:** The effective management and control of risk are prime objectives of the Council's treasury management activities. The treasury management strategy therefore sets out various indicators and limits to constrain the risk of unexpected losses

- Further details on treasury investments are contained in the Treasury Management Strategy - Appendix A FIN 2104 Annual Treasury Management Strategy and Non-Treasury Investment Strategy

3.13 **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 Full Council. Year-end report and half-yearly reports on treasury management activity are presented to Licencing, Audit & General Purposes Committee (LA&GP). The LA&GP Committee is responsible for scrutinising treasury management decisions.

4 NON-TREASURY INVESTMENTS FOR SERVICE PURPOSES

4.1 The Council makes investments to assist local public services, including making loans to local businesses to promote economic growth, the Council's subsidiaries that provide services. 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 Executive Head of Finance and must meet the criteria and limits laid down in the investment 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 contained in the investment strategy: Appendix B FIN 2104 Annual Treasury Management Strategy and Investment Strategy

5 COMMERCIAL ACTIVITIES

5.1 With central government financial support for local public services declining, the Council has undertaken some investment in commercial properties purely or mainly for financial gain. Total commercial investments for 2020/21 are forecast to be £138.0m, the portfolio providing a net return after all costs of 3.4%.

5.2 With financial return being the main objective, the Council accepts higher risk on commercial investment than with treasury investments. The principal risk exposures for commercial investments include level of competition, barriers to entry/exit, and future market prospects. For commercial properties, risks include quality and financial security of tenants, building quality and relevance.

These risks are managed by:

- Assessment of the relevant market sector(s) including the level of competition, barriers to entry/exit, future market prospects
- Assessment of exposure to particular market segments to ensure adequate diversification
- Appointment of external advisor to manage designated commercial property investments
- Use of further external advisors if considered appropriate by the Executive Head of Finance
- Full and comprehensive report on all new investments to Cabinet
- Continual monitoring of risk across the whole portfolio and specific assets

5.3 In order that commercial investments remain proportionate to the size of the Council, these are subject to an overall maximum investment limit of £180m and contingency plans are in place should expected yields not materialise.

5.4 With the introduction of stricter PWLB access requirements the Council has no intention to buy investment assets primarily for yield in the current and following two financial years.

5.5 **Governance:** Decisions on the day-to-day management of commercial investments are made by the Executive Head of Regeneration and Property in line with the criteria and limits approved by LA&GP Committee, Cabinet and Full 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 contained in of the investment strategy: Appendix B FIN 2104 Annual Treasury Management Strategy and Investment Strategy

6 LIABILITIES

6.1 In addition to debt of £131.2m detailed above, the Council is committed to making future payments to cover its pension fund deficit. It has also set aside funds to cover risks of Business Rate Appeals. The Council is also at risk of having to pay for Local Land Charges but has not put aside any money because the value of claim is unknown.

6.2 **Governance:** Decisions on incurring new discretional liabilities are taken by service managers in consultation with the Executive Head of Finance. The risk of liabilities crystallising and requiring payment is monitored by Finance and reported quarterly to committee. New liabilities exceeding £2m are reported to full council for approval/notification as appropriate.

- Further details on liabilities and guarantees are on page 46 and 49 of the 2019/20 statement of accounts: https://www.rushmoor.gov.uk/statementofaccounts

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 10: Prudential Indicator: Proportion of Financing Costs to Net Core Revenue Stream in £ million

	2019/20 Actual	2020/21 Forecast	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
Financing Costs	2.4	3.0	3.2	4.1	4.3
Proportion of Net Core Revenue Stream	23.0%	28.4%	31.8%	38.4%	40.5%

- Further details on the revenue implications of capital expenditure are contained in the 2021/22 revenue budget: Appendix 1, FIN2106 Revenue budget, Capital Programme and Council Tax

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 50 years into the future. The Executive

Head of Finance is satisfied that the proposed capital programme is prudent, affordable and sustainable because the net budget demand on the Council and the risks within the programme have been reviewed and are within the Council’s risk appetite and tolerances.

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 Executive Head of Finance is a qualified accountant (Chartered Institute of Public Finance and Accountancy) with 20 years’ experience of local government finance, the Executive Head of Regeneration and Property is a qualified surveyor (Royal Institute of Chartered Surveyors). The Council pays for junior staff to study towards relevant professional qualifications including CIPFA, ACT (treasury) and 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 Lambert Smith Hampton Investment Management Ltd (LSHIM) as commercial property consultants as required depending on the nature of the professional advice sought 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.