Annex 7A

Capital Strategy Report 2020/21

Introduction

This capital strategy report 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 has been written in an accessible style to enhance members' understanding of these sometimes technical areas.

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

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. 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 £10k are not capitalised and are charged to revenue in year.

In 2020/21, the Council is planning capital expenditure of £98.1m as summarised below:

Table 1: Prudential Indicator: Estimates of Capital Expenditure

	2018/19 actual £000	**2019/20 forecast £000**	**2020/21 budget £000**	**2021/22 budget £000**	**2022/23 budget £000**
General Fund	20,283	64,064	73,697	58,406	31,385
HRA	9,455	15,140	24,431	3,873	3,873
TOTAL	29,738	79,204	98,128	62,279	35,258

The main General Fund capital projects include the Property Investment Strategy (£126m apportioned across the forecast period), the Bus Rapid Transit project (£16.1m), major investment in Tides Leisure Centre (£5m) and Dover Market Square public realm improvements (£2.7m).

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 £24.2m to fund new housing development projects over the forecast period.

Governance: Service managers bid annually in August to include projects in the Council's capital programme. Bids are collated by Accountancy 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 Cabinet. The final capital programme is then presented to Cabinet in February and to Council in March each year.

For full details of the Council's current capital programme see Annex 6A.

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

	2018/19 actual £000	**2019/20 forecast £000**	**2020/21 budget £000**	**2021/22 budget £000**	**2022/23 budget £000**
External sources	2,604	6,067	15,921	8,176	0
Own resources	11,648	21,929	31,993	4,103	8,393
Debt	15,486	51,208	50,214	50,000	26,865
TOTAL	**29,738**	**79,204**	**98,128**	**62,279**	**35,258**

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) / loans fund repayments. Alternatively, proceeds from selling capital assets (known as capital receipts) may be used to replace debt finance. Planned MRP / repayments and use of capital receipts are as follows:

Table 3: Replacement of debt finance

	2018/19 actual £000	**2019/20 forecast £000**	**2020/21 budget £000**	**2021/22 budget £000**	**2022/23 budget £000**
Own resources	2,767	4,247	4,320	4,396	4,474

Annual Minimum Revenue Provision Statement 2020/21

Where the Council finances capital expenditure by debt, it must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP), although there has been no statutory minimum since 2008. The Local Government Act 2003 requires the Council to have regard to the Department for Communities and Local Government's Guidance on Minimum Revenue Provision (the CLG Guidance) most recently issued in 2012.

The broad aim of the CLG Guidance is to ensure that debt is repaid over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits (typically the expected life of the asset), or, in the case of borrowing supported by Government

Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.

The MHCLG Guidance requires the Council to approve an Annual MRP Statement each year and recommends a number of options for calculating a prudent amount of MRP. The following statement incorporates options recommended in the Guidance

For capital expenditure incurred before 1st April 2008, and for supported capital expenditure incurred on or after that date, MRP will be determined in accordance with the former regulations that applied on 31st March 2008.

For unsupported capital expenditure incurred after 31st March 2008, MRP will be determined by charging the expenditure over the expected useful life of the relevant asset equal to the average relevant PWLB rate for the year of expenditure, starting in the year after the asset becomes operational. MRP on purchases of freehold land will be charged over 50 years. MRP on expenditure not related to fixed assets but which has been capitalised by regulation or direction will be charged over 20 years.

- For unsupported capital expenditure incurred after 31st March 2008, MRP will be determined as being equal to the accounting charge for depreciation.
- Repayments included in annuity loans are applied as MRP.
- Capital expenditure incurred during 2010/21 will not be subject to a MRP charge until 2021/22.

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 / loans fund repayments and capital receipts used to replace debt. The CFR is expected to increase slightly 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

	18/19 actual £000	**19/20 forecast £000**	**20/21 budget £000**	**21/22 budget £000**	**22/23 budget £000**
General Fund services	57,866	59,758	62,950	112,950	139,815
Council housing (HRA)	71,911	69,617	67,250	64,807	62,285
TOTAL CFR	**129,777**	**129,375**	**130,200**	**177,757**	**202,100**

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

The AMP is used as a management tool to assist in ensuring that the Council's property assets meet the objectives set out in the Council's Corporate Property Strategy. It covers:

Revenue maintenance requirements;

Capital works programmes;

Data on performance of significant corporate assets; and

Properties identified for disposal.

Expenditure on repairs and maintenance forms a direct link with the revenue budget, which contains the resources to meet the programme of repairs and maintenance. Standards of maintenance, and therefore of required expenditure, are to some extent subjective. The Strategic Director (Operations and Commercial) confirms that there are sufficient resources to keep properties generally wind and water-tight, but it continues to be a challenge to maintain all buildings without deterioration. Continuing with this approach increases the risk, but it ensures that the limited budget focuses mainly on essential maintenance.

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 2022/23. Repayments of capital grants, loans and investments also generate capital receipts. The Council plans to receive £1m of capital receipts in the coming financial year as follows:

Table 5: Capital receipts receivable

	2018/19 actual £000	**2019/20 forecast £000**	**2020/21 budget £000**	**2021/22 budget £000**	**2022/23 budget £000**
Un-ring-fenced capital receipts	730	1,000	1,000	1,000	1,000

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 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 has £79m long term borrowing at an average interest rate of 3.4% and £55m treasury investments at an average rate of 3.2%.

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%).

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 6: Prudential Indicator: Gross Debt and the Capital Financing Requirement

	18/19 actual £000	**19/20 forecast £000**	**20/21 budget £000**	**21/22 budget £000**	**22/23 budget £000**
Debt (incl. PFI & leases)	15,486	51,208	50,214	50,000	26,865
Capital Financing Requirement	129,777	129,375	130,200	177,757	202,100

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. 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

	2019/20 limit £m	**2020/21 limit £m**	**2021/22 limit £m**	**2022/23 limit £m**
Authorised limit – borrowing	338.5	338.5	338.5	338.5
Operational boundary – borrowing	333.0	333.0	333.0	333.0

Further details on borrowing can be found in the treasury management strategy – Annex 7B.

Treasury 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

	18/19 actual £m	19/20 forecast £m	20/21 budget £m	21/22 budget £m	22/23 budget £m
Total investments	48.0	50.0	50.0	50.0	50.0

Further details on treasury investments can be found in the treasury management strategy – Annex 7B

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 and details the extent to which financial derivatives may be used to manage treasury risks.

Governance: Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Strategic Director (Corporate Resources) and staff, who must act in line with the treasury management strategy approved by Council. Quarterly reports on treasury management activity are presented to Governance. The Scrutiny Committee is responsible for scrutinising treasury management decisions.

Investments for Service Purposes

The Council makes investments to assist local public services, including making loans to local service providers, businesses investing in the district to promote economic growth and 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 after all costs.

Governance: Decisions on service investments are made by the relevant service manager in consultation with the Strategic Director (Corporate Resources) 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 included in the Investment Strategy – Annex 7C.

Commercial Activities

With central government financial support for local public services declining, the Council invests in commercial property purely or mainly for financial gain and to lend to its housing company (once established) for the same reason. Total commercial investments are currently valued at £22m with the largest being B&Q, Whitfield (£17m) providing a net return after all costs (including an allowance for borrowing) of 1.3%, £230k per annum.

With financial return being the main objective, the Council accepts higher risk on commercial investment than with treasury investments. The principal risk exposures include changes in interest rates, properties voids, tenant business failure and non-payment of rent. These risks are managed by the Property Investment Group comprising officers from Legal, Finance and Property Services. In order that commercial investments remain proportionate to the size of the Council, these are subject to an overall maximum investment limit of £200m.

Governance: Decisions on commercial investments are approved by the Portfolio Holder for Corporate Resources and Performance in line with the criteria and limits approved by Council in the Property 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 included in the Investment Strategy – Annex 7C.

Liabilities

In addition to debt of £50.2m detailed above, the Council is committed to making future payments to cover its pension fund deficit (valued at £76m). It has also set aside £2m to cover risks of NDR appeals and Municipal Mutual Insurance claims. The Council is also at risk of having to pay for costs towards termination of its Kent wide housing Private Finance Initiatives, further claims from Municipal Mutual Insurance and relating to the East Kent Housing and Civica pension schemes. The Council has not put aside any money because the risks of these events occurring continue to be assessed as very remote (see the 2018/19 Statement of Accounts for further information).

Revenue Budget Implications

Although capital expenditure is not charged directly to the revenue budget, interest payable on loans and MRP / loans fund repayments 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 revenue stream

	2018/19 actual	**2019/20 forecast**	**2020/21 budget**	**2021/22 budget**	**2022/23 budget**
General Fund	0.70%	3.24%	1.91%	1.88%	1.82%
HRA	13.70%	17.42%	18.12%	17.52%	17.45%

Further details on the revenue implications of capital expenditure are included in the Capital and Special Revenue section of the 2020/21 Budget and MTFP.

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 Strategic Director Corporate Resources is satisfied that the proposed capital programme is prudent, affordable and sustainable because of the financial viability analysis that has been completed on the planned expenditure.

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 Strategic Director of Corporate Resources is a qualified Accountant with many years' experience, the Strategic Director of Corporate Resources is a qualified Civil Engineer. The Council pays for staff to study towards relevant professional qualifications.

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. This approach is more cost effective than employing such staff directly and ensure that the Council has access to up to date knowledge and skills commensurate with its risk appetite.