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Somerset County Council

Corporate Capital Strategy 2019/20– 2021/22

Capital Strategy Report 2019/20

Contents

1. Background and Context

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 addresses the capital components of the wider financial strategies adopted by the Authority. It identifies the links and relationships that need to be made in considering and implementing the Capital Programme to support the Corporate Asset Management Plan objectives. This is done through the Medium Term Financial Plan (MTFP) and alerts services to the governance and control framework within which the investment planning and delivery takes place.

The Capital Programme is the term used for the Council's rolling plan of investment in both its own assets and those of its partners. The programme spans multi-years and contains a mix of individual schemes, many spanning more than one year. Some schemes will be specific investment projects while others may provide for an overarching schedule of thematic works e.g. "Highways".

Investing in assets can include expenditure on:

- Infrastructure such as highways, open spaces, coast protection;
- New build;
- Enhancement of buildings through renovation or remodelling;
- Major plant, equipment and vehicles;
- Capital contributions to other organisations enabling them to invest in assets that contributes to the delivery of the Council's priorities.

The Capital Programme is distinct from the Council's revenue budget which funds day-to-day services, but they are both linked and are managed together. This ensures they contribute to the Council's objectives set out in its County Plan and Corporate Asset Management Plan to achieve the most beneficial balance of investment within the resources available.

There is a strong link with the Treasury Management Strategy[1] that provides a framework for the borrowing and lending activity of the Council supporting the historic investment programme. Asset information can be obtained from the Corporate Property Group which manages the built estate as Corporate Landlord. Additional (non-property information) can be found within various service plans maintained by Services.

2. Capital Expenditure and Financing

[1] Treasury Management Strategy link: *to be added when approved at Full Council*

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 the ability to set a de-minimis level to capture only significant assets, however does not opt to do so. This allows the Council to review every item of expenditure and capitalise as appropriate.

- For details of the Council's policy on capitalisation, see the accounting policy (No.14 PPE) within the annual statement of accounts: http://www.somerset.gov.uk/information-and-statistics/financial-information/budgets-and-accounts/

In 2019/20, the Council is planning capital expenditure of £196.230m. The following table shows our planned spend for the future:

Table 1: Estimates of Capital Expenditure in £ millions

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
Capital Expenditure	103.606	126.733	196.230	103.633	71.598

This table includes both the current approved capital programme and the proposed 2019/20 programme due to be put to Full Council on 20th February 2019. For example, the 2019/20 budget of £196.230m is made up of £106.829m current programme and £89.4m 2019/20 proposed new schemes.

Service managers bid annually to include projects in the Council's capital programme. Bids are collated by corporate finance who calculate the financing cost (which can be nil if the project is fully externally financed). The bids are appraised against a set criterion including a comparison of service priorities against financing costs. The Senior Leadership Team undertakes a final review before the draft capital programme is then presented to relevant Scrutiny Committee(s) prior to its consideration by the Cabinet in January for recommendation to Council in February each year.

For full details of the Council's 2019/20 capital programme, see the council's website at : http://democracy.somerset.gov.uk/ieListDocuments.aspx?CId=134&MId=731&Ver=4

All capital expenditure must be financed, either from external sources (government grants and other contributions such as S106 and CIL), 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	2018/19	2019/20	2020/21	2021/22

	actual	forecast	budget	budget	budget
External sources	86.155	103.401	124.301	53.561	29.966
Own resources	5.550	1.540	2.736	1.335	0
Debt	11.901	21.792	69.193	48.737	41.632
TOTAL	**103.606**	**126.733**	**196.230**	**103.633**	**71.598**

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). Planned MRP budgets are as follows:

Table 3: MRP for the repayment of debt in £ millions

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
Own resources	0.000	1.039	2.269	3.910	4.927

- The Council's full minimum revenue provision statement is available here: *link to MRP statement going to audit committee in Jan19*

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, lease principal repayments and capital receipts used to replace debt. The CFR is expected to increase by £66.924m 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 budget	31.3.2021 budget	31.3.2022 budget
TOTAL CFR	**366.115**	**386.868**	**453.792**	**498.619**	**535.324**

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

- The Council's asset management strategy can be read here: http://www.somerset.gov.uk/organisation/council-buildings/. This strategy is due for renewal and is planned to be updated during 2019.

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 plans to receive £10.772m of capital receipts in the current financial year.

Table 5: Capital receipts in £ millions

	2017/18 actual	2018/19 forecast	2019/20 budget
TOTAL asset sales	7.799	10.772	9.850

Ministry of Housing, Communities and Local Government (MHCLG) have issued a 'flexible use of capital receipts' directive. This allows transformation projects which will save revenue budget to be funded from capital receipts. This directive was issued in 2016 and is extend until 2021/22. The Councils use and planned use of this can be found…*Summary to be presented to Cabinet [link]*

3. Treasury Management

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.

The budget for debt interest paid in 2019/20 is £16.12m, based on an average debt portfolio of £356.3m at an average interest rate of 4.52%. The budget for investment income in 2019/20 is £1.53m, based on an average investment portfolio of £160m at an interest rate of 0.95%. (These figures are net of balances held on behalf of external investors i.e. the Local Enterprise Partnership).

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, Private Financing Initiatives (PFI) liabilities, are shown below, compared with the capital financing requirement (see above).

Table 6: Prudential Indicator: External 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
Short term debt	8.360	10.000	10.000	10.000	10.000
Long term debt *	316.101	309.606	306.483	301.285	294.708
Assumed debt not yet taken	0.000	21.792	90.985	139.723	181.355
PFI & leases	44.118	42.948	41.972	40.970	39.872
Total external borrowing	**368.579**	**384.346**	**449.440**	**491.978**	**525.935**
Capital Financing Requirement	**366.114**	**385.443**	**450.733**	**493.447**	**527.551**

*(reduces for MRP & debt repayment)

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 in £m

	2018/19 limit	2019/20 limit	2020/21 limit	2021/22 limit
Authorised limit - borrowing	415.631	486.981	536.356	578.973
Authorised limit - PFI and leases	53.948	53.972	53.970	53.872
Authorised limit - total external debt	469.579	540.953	590.326	632.845
Operational boundary - borrowing	385.631	456.981	506.356	548.973
Operational boundary - PFI and leases	47.948	46.972	45.970	44.872
Operational boundary - total external debt	433.579	503.953	552.326	593.845

4. Investment Strategy

Treasury investments: arise from receiving cash before it is paid out again. Investments made for service reasons or for the purpose of generating a positive income (net of costs) 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, 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.

This capital strategy contains the prudential indicators approved by the council. The Treasury management strategy contains further details on treasury investments criteria and governance. There are also 3 Treasury management indicators that are set out in section 4 of the TMS for the adoption by the authority.

- the treasury management strategy is here *to be added when approved at Full Council*

Non-Treasury investments: describing the Council's approach to this is a new requirement of the Ministry of Housing, Communities and Local Government (MHCLG) and is also an area that members have indicated that they wish to investigate.

With central government financial support for local public services declining, the Council intends to explore investing in non-treasury investment options purely or mainly for financial gain. With this in mind a sum of £100m has been proposed in the Capital Programme as being identified for this purpose pending the appropriate strategy and governance being put in place. With financial return being the main objective, the Council accepts that there will almost certainly be higher risk on non-treasury investments than with treasury investments, hence robust procedures are required to ensure that all investments are thoroughly understood and well managed.

To create an Investment Strategy (for non-treasury investments), the framework must include:

- Criteria for which 'assets' to invest in, including specification of the balance / mix of a portfolio (i.e. asset types);
- Clear governance arrangements and democratic accountability ensuring transparent and open decision making and rigorous due diligence (property, legal, financial);
- Clear long term corporate strategies to set Council priorities, including:
    - Setting out balance of focus on local economic prosperity v income generation
    - Management of existing property assets (i.e. sell or retain), where relevant;

- Adequate resource, mainly across finance, legal and property to:
    - carry out due diligence on potential opportunities
    - support activity to manage investments once made;
- Sufficient investment funds to support the set-up costs, and;
- Sufficient flexibility within the Council's resources, for example in regard of CFR headroom.

Options for investment opportunities include:

- Physical assets, such as property and land. The Council does not have any of these held for investment purposes at present, although assessment of existing assets for alternative use not yet been undertaken. While this asset type does present the opportunity for local growth stimulation as well as the income and growth potential, a large investment is needed to produce a diversified portfolio, there are considerable set up costs and the time lag to generating a return can be significant.
- Businesses, such as solar farms, an energy company or innovation companies. The Council invests in none of these at present. This investment type can be quicker to deliver a return (than property) and can still support local economic growth, but there are still challenges to find opportunities and the need to secure relevant expertise to appraise business cases.
- Financial, such as loans, banks or investment funds. This asset type is easier to invest with more predictable costs than the other classes, and there are in-house skills to handle these investments. This asset also presents the opportunity for more diversification and better liquidity, although returns can be more volatile and there are ongoing fees. The Council will also need to maintain a close watch on the headroom within its CFR to ensure that this is not breached.

Given that non-treasury investments will be a new approach for Somerset County Council, it is essential that there are carefully considered governance arrangements put in place to ensure that there is robust appraisal of any investments that may be made. Examples of the type of arrangements that may be considered include:

- Investment Board – comprising members, officers and professional advisers (as required) to review and provide views on potential investment decisions to be undertaken by either the Cabinet Member for Resources or the Section 151 Officer. This Board would need to meet regularly for the Cabinet Member or Section 151 Officer to be able to act swiftly on any opportunities presented to the Board;
- Gateway process – to determine whether to pursue a proposal. Clear criteria need to be pre-determined and rigorously applied (to minimise optimism bias);
- Cabinet / Cabinet Member for Resources / Section 151 Officer approval – the Councils constitution (Cabinet Scheme of Delegation) would need amending to clarify the proposed decision-making arrangements and any limits or internal consultation requirements prior to the exercise of delegated powers.

Depending on the assets that might be invested in, and particularly in regard of property investments, it may be necessary to have a:

- Shareholder Board - comprising members and professional advisers to ensure effective oversight of the property portfolio and alignment with corporate priorities;
- 'Property' Company – 'arms-length' company would be required to make any investments in properties for financial gain (rather than economic prosperity).

Some of the principal risks that the Council needs to address in formulating its approach to non-treasury investments are:

- Failing to identify realistic net gains – being over-ambitious could lead to investments with an inappropriate level of risk;
- Some investments will not pay back immediately, requiring an investment approach which is affordable in cash-flow terms;
- Not setting out clear parameters for investment areas (e.g. retail, commercial, residential portfolio mix);
- An inability to secure adequate commercial skills / resource to advise on the investment options;
- Allowing insufficient time to set up rigorous due diligence, governance and transparent democratic accountability;
- Not establishing 'smart' democratic processes to ensure investments can be approved at pace, and;
- The Government are taking steps to tighten this area of local authority investment – they have indicated they may go further in the near future.

In order that commercial investments remain proportionate to the size of the Authority, they will be subject to an overall maximum investment limit, which will be set by the Council in due course. At present the suggested indicative future value of these investments is £100m per the draft Capital Programme; there is no potential investment return built into the MTFP at this time apart from a notional £250k identified as a pipeline saving in 2020/21. If and when any income is built into the revenue budget, then contingency plans will need to be in place should expected yields not materialise.

It is proposed, in the covering report to this Strategy, that the Cabinet delegates authority to small working group of members and officers to create the necessary governance, systems and processes to ensure that the non-treasury investment approach can be realised within 2019/20.

5. Other long-term liabilities

In addition to debt of £368.579m detailed above, the Council is committed to making future payments to cover its pension fund deficit. This is reported in the 2017/18 accounts at £802.463m (as at 31/03/2018). It has also set aside £11.530m (as at 31/03/2018) to cover risks of insurance claims, business rate appeals and other legal claims. The Council is also at risk of having to pay for contingent liabilities but has not put aside any money because of the low risk and uncertainties around potential value.

Governance: Decisions on incurring new discretional liabilities will initially be considered by service managers for discussion with the relevant director. If it is recommended that the liability may be undertaken then the relevant director will consult with the Chief Finance Officer (S151 officer), Monitoring Officer and County Solicitor before any recommendation is made to the Senior Leadership Team prior to any decisions taken. Depending on the extent of the liability envisaged, it may be necessary to make a formal decision through a democratic process. The risk of liabilities crystallising and requiring payment is monitored by corporate finance and reported quarterly to audit committee. New liabilities exceeding £500m are reported to Cabinet and Full Council for approval.

- Further details on provisions and contingent liabilities are on pages 123 and 134 of the 2017/18 statement of accounts: http://www.somerset.gov.uk/information-and-statistics/financial-information/budgets-and-accounts/

6. 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.

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

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
Financing costs (£m)	19.930	24.315	23.266	26.661	28.922
Proportion of net revenue stream	6.39%	5.97%	6.91%	8.15%	8.60%

➢ Further details on the revenue implications of capital expenditure are on pages [X] to [X] of the 2019/20 revenue budget [link]

Sustainability: Due to the long-term nature of capital expenditure and financing, the revenue budget implications of expenditure incurred in the next few years will extend into the future years. The Interim Finance Director is satisfied the proposed capital programme is prudent, affordable and sustainable. This follows scrutiny of all capital bids against set criteria:

Key	
Grant/ contribution funded	Fully financed from external funding (i.e. No SCC requirement)
Part funded - part debt financed	Significant external funding. Some requirement for SCC debt
Contractually committed schemes	Schemes underway with contracts. Revenue cost implications to withdraw
Statutory/compliance	Subject to value for money assessment before they are undertaken
Invest to save and reduce operational costs	Full business case provided to evidence payback vs debt costs
Invest to generate a net income stream	Full business case provided to evidence payback vs debt costs
Invest in wider economic growth	Full business case provided to evidence payback vs debt costs
Response to public/partner requests	Non statutory, with no external funding or direct payback
Discretionary schemes	Non statutory, with no external funding or direct payback

Only schemes that will have full approved funding in place are consider as part of the capital programme and the cost impact of borrowing forms part of the revenue medium term financial planning.

7. Knowledge and Skills

The Council employs professionally qualified and experienced staff in all positions with responsibility for making capital expenditure, borrowing and investment decisions. For example, the Chief Finance Officer will always be a qualified accountant with substantial experience and there is a range of significant experience and expertise within the Treasury Team. Where necessary, the Council pays for junior staff to study towards relevant professional qualifications, for example CIPFA.

Where the Council needs additional resources, external validation of officers work or 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 additional resources directly and ensures that the Council has access to knowledge and skills commensurate with its risk appetite.