Somerset Council

Capital Strategy 2023/24– 2024/26

Capital Strategy Report 2023/24

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1. Background and Context

This capital strategy for 2023/24 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. This is the first strategy for the new Somerset Council which combines the programmes of all five Councils for the first time.

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 emerging Unitary 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.

This is the first budget setting process for Somerset Council, and this is reflected in the strategy taken towards capital approvals. Firstly, by reviewing priorities and slippage in the short-term to reduce the capital programme. Secondly it constrains new programme approvals to only those that are Health and Safety related, those with the highest priority, and those that are wholly externally funded. This strategy therefore has a focus for 2023/24 but as decisions made this year on capital and treasury management will have financial consequences for many years into the future the potential implications for forward years are set out.

It is clear that the programme will need to be revisited post vesting day. This will enable the new authority to review projects alongside the new Corporate Plan, In addition to this we have requested that all five authorities do not reprofile their programmes after Quarter 2. This enables the new authority to set a programme for 2023/24 but on the understanding that the capital projects currently being delivered will have year end balances that will require reviewing and updating. Therefore, a revised programme will need to be set in Quarter 1 or Quarter 2 of 2023/24.

This report summarises the requirements of and compliance to both national regulatory and to local policy frameworks. Both the Prudential Code and Treasury Management Code have been revised during December 2021. The revised Codes include clarification and examples of what is and is not classified as prudent borrowing activity. These added principles are intended to protect the public purse and avoid misinterpretation of the Code’s provisions. The focus is around strengthening the governance and transparency arrangements surrounding commercial activity as well as actively discouraging this activity funded by borrowing. The other edits include proposing of a liability benchmark to be adopted as a treasury management tool over the coming year and integration of Environmental, Social and Governance risks into the policy framework.

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 the Corporate 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. This capital strategy, non-treasury investment strategy, and the capital MTFP align to service planning and the corporate asset strategy. Asset information is overseen by the Asset Strategy Group which manages the built estate as Corporate Landlord and additional (non-property information) is maintained by Services.

2. Capital Expenditure and Financing

Capital expenditure occurs when the Council spends money on assets, such as property or vehicles, that will be used for more than one year. In local government this also 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.

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

In 2023/24, the Council is planning capital expenditure of £279.8m. The following table shows our planned spend for the future:

Table 1: Estimates of Capital Expenditure

	2022/23 forecast Q2 All Somerset Authorities £m	**2023/24 Somerset Council budget £m**	**2024/25 budget £m**	**2025/26 budget £m**
Capital Expenditure HRA (Housing Revenue Account)	46.8	46.8	37.8	33.7
Capital Expenditure GF (General Fund)	180.2	233.0	58.2	20.1
Total Capital Expenditure	**227.0**	**279.8**	**96.0**	**53.8**

This table includes an overview of capital spend – including historic County and District Council, General Fund and the Housing Revenue Account spend, to enable comparisons across years to be made. It includes both the current approved capital programme and the proposed 2023/24 programme due to be put to Full Council on 22nd February 2023. For example, the 2023/24 General Fund budget of £233.0m is made up of £170.5m current programme and £62.5m 2023/24 proposed new schemes.

The Housing Revenue Account (HRA) is a ring-fenced, self-financing, account used to manage the Council's housing stock. Somerset Council acts as the Landlord to the tenants of properties in Somerset West and Taunton, whereas the properties in Sedgemoor are managed through an ALMO (Arms-Length Management Organisation) The HRA has its own ring-fenced revenue account, capital programme and reserves. This ensures that council housing neither subsidises, nor is itself subsidised by, Council Tax-payers. The HRA Capital Programme's main purpose is to invest in the housing portfolio to replace major components periodically, to ensure that the decent homes standard and warmer homes standards are maintained and that fire safety regulations are adhered to.

Within the General Fund 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 financed). The bids are appraised against a set criterion including a comparison of service priorities against the affordability of the financing costs. Director Groups of previous County and District Councils have undertaken a final review before the draft capital programme is then presented to relevant Scrutiny Committee(s) prior to its consideration by the Cabinet in February for recommendation to Council in February each year.

For full details of the Council's 2023/24 capital programme, see the main 2023/24 Budget and MTFP report within the papers to Full Council on 22nd February 2023.

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 - HRA

	2022/23 forecast Q2 All Somerset Authorities £m	**2023/24 Somerset Council budget £m**	**2024/25 budget £m**	**2025/26 budget £m**
Major Repairs Reserve	20.9	18.1	17.8	18.5
RTB Receipts	4.7	4.2	8.5	8.3
Grants	3.2	1.5	0.3	
Other Capital receipts	1.6	0.8	11.2	2.4
RCCOs	-	1.2	-	-
Debt	16.4	21.0	-	4.5
TOTAL	**46.8**	**46.8**	**37.8**	**33.7**

Table 3: Capital financing - General Fund

	2022/23 forecast Q2 All Somerset Authorities £m	2023/24 Somerset Council budget £m	2024/25 budget £m	2025/26 budget £m
External sources	82.4	129.6	19.1	3.5
Own resources:				
Capital receipts	13.0	6.4	2.9	2.8
Revenue / Reserves	5.50	0.1	0.1	0.1
S106/CIL	10.2	10.8	4.4	4.4
Debt	69.1	86.0	31.7	9.3
TOTAL	**180.2**	**233.0**	**58.2**	**20.1**

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 4: MRP for the repayment of General Fund debt

	2022/23 forecast Q2 All Somerset Authorities £m	2023/24 Somerset Council budget £m	2024/25 budget £m	2025/26 budget £m
Own resources	15.1	21.4	22.7	24.5

- Note Depreciation rather than MRP is used for HRA debt
- Note 22/23 includes voluntary MRP of £3.7m
- The Council’s full minimum revenue provision statement is available as part of the 2023/24 Budget and MTFP papers to Full Council on 22nd February 2022.

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 £95.9m during 2023/24. It is worth noting that the Housing Revenue Account uses depreciation and therefore MRP is not charged to the HRA. Based on the above figures for expenditure and financing, the Council's estimated CFR is as follows:

Table 5: Prudential Indicator: Estimates of Capital Financing Requirement

	2022/23 forecast Q2 All Somerset Authorities £m	2023/24 Somerset Council budget £m	2024/25 budget £m	2025/26 budget £m
Housing Revenue Account	189.3	210.3	210.3	214.8
General Fund	945.2	1,022.1	1,031.0	1,015.7
TOTAL CFR	**1,134.5**	**1,232.4**	**1,241.3**	**1,230.5**

It is important to ensure capital plans are affordable and the Council can meet the costs of this debt over both the short- and long-term. The Council' s Medium Term Financial Plan reflects the impact of debt financing costs on revenue budgets in future years. In relation to Housing Revenue Account assets, the HRA Business Plan sets out the impact of capital expenditure over a 30-year period. Other measures of affordability are contained within the prudential indicators set out in the Treasury Management Strategy.

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 Somerset Councils plan to receive £6.3m of capital receipts in the current financial year, £11.0 in 2023/24, and have £18.7m banked from previous years as at the 31st March 2022.

Table 7: Capital receipts – General Fund

	2022/23 forecast Q2 All Somerset Authorities £m	2023/24 Somerset Council budget £m
TOTAL asset sales	**6.3**	**11.0**

Department for Levelling Up, Housing and Communities (DLUHC) have issued a revised 'flexible use of capital receipts' directive. This allows projects which will save revenue budget to be funded from capital receipts. This directive was issued in 2016 and as part of Government announcements in February 2021 this is extended to March 2026. The authority's expected use of receipts under this directive for 2022/23 and 2023/24 is expected to be a total of £15.9m. The Flexible Receipts Strategy outlines that the flexibility will be utilised to fund eligible Local Government Reorganisation costs in 2022/23 and 2023/24'. The Strategy will be presented to full Council approval as part of the MTFP and Budget Setting Report.

3. Treasury Management

Treasury management is the activity of 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 typically runs a cash surplus in the short term, particularly at the start of the financial year, as revenue income is received before it is spent.

Due to decisions taken in the past, all of the Somerset authorities have long-term borrowing of £400.3m at an average interest rate of 4.17% within the General Fund and £148.6m at an average interest rate of 2.81% within the HRA. The new authority will continue to maximise the use of the cash held before taking costly external debt, this is referred to as internal borrowing.

The budget for debt interest paid for General Fund debts in 2023/24 is £31.2m, based on an average debt portfolio of £835.5m at an average interest rate of 3.84%. The budget for Treasury and strategic investment income in 2023/24 is £13m based on an average investment portfolio of £350m at an average return of 3.75%. (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 continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. It strives to achieve as low but more 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 internal borrowing, cheaper short-term loans, and long-term fixed rate loans where the future cost is known but is at higher rates.

Table 8: Prudential Indicator: External Debt and the Capital Financing Requirement

	31.3.2023 forecast £m	31.3.2024 budget £m	31.3.2025 budget £m	31.3.2026 budget £m
Short term debt	N/A	210.0	210.0	210.0
Long term debt *	N/A	522.8	511.5	499.6
Assumed debt not yet taken	N/A	261.0	260.0	274.5
PFI & leases	N/A	77.3	76.0	74.7
Total external borrowing	**N/A**	**1,071.1**	**1,057.5**	**1,058.8**
Housing Revenue Account	189.3	210.3	210.3	214.8
General Fund	945.2	1,022.1	1,031.0	1,015.7
Total CFR	**1,134.5**	**1,232.4**	**1,241.3**	**1,230.5**

*(reduces for MRP set aside & actual debt repayments)

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 9: Prudential Indicators: Authorised limit and operational boundary for external debt

	2022/23 limit £m	2023/24 limit £m	2024/25 limit £m	2025/26 limit £m
Operational boundary – borrowing	N/A	1,004.4	1,013.1	1,015.7
Operational boundary – PFI and leases	N/A	79.3	78.0	76.7
Operational boundary – total external debt	**N/A**	**1,083.8**	**1,091.1**	**1,092.4**
Authorised limit – borrowing	N/A	1,039.4	1,048.1	1,050.7
Authorised limit – PFI and leases	N/A	84.3	83.0	81.7
Authorised limit– total external debt	**N/A**	**1,123.7**	**1,131.1**	**1,132.4**

Please note this includes General Fund and Housing Revenue Account

Treasury investments: is the management of the Council's cash flows, and treasury investments, and the associated risks. The Council has significant debt and treasury investment portfolios and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the Council's prudent financial management.

Investments made for service reasons or for the purpose of generating a positive income (net of costs), known as non-treasury investments, are not considered to be part of treasury management.

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 Treasury Management Strategy for the adoption by the Council.

Risk management: No treasury management activity is without risk. The successful identification, monitoring and control of risks are the prime criteria by which the effectiveness of its treasury management activities will be measured. The main risks to the Council's treasury activities are:

- Credit and Counterparty Risk (security of investments)
- Liquidity Risk (inadequate cash resources)
- Market or Interest Rate Risk (fluctuations in price / interest rate levels)
- Refinancing Risk (impact of debt maturing in future years)
- Legal & Regulatory Risk.

The Authority's policy on treasury investments is to prioritise security and liquidity over yield; that is to focus on minimising risk rather than maximising returns in accordance with DLUHC guidance. 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. The strategy includes some prudential indicators which manage risk in setting the boundaries.

Governance: Decisions on treasury management investment and borrowing are delegated to the Director of Resources and staff, who must act in line with the annual treasury management strategy approved by Full Council each year. In formulating the Treasury Management Strategy, and the setting of Prudential Indicators, Somerset Council (SC) adopts the Treasury Management Framework and Policy recommended by CIPFA, see **appendix A** of the Treasury Management Strategy.

Further governance is provided by the comprehensive Treasury Management Practices (TMP's) which set out the main categories of risk that may impact on the achievement of Treasury Management objectives.

A mid-year and an annual outturn report on treasury management activity are presented to Full Council. The audit committee is responsible for scrutinising treasury management decisions.

Treasury (Commercial) investments: Describing the Council's approach to non-treasury investment is a requirement of the DLUHC.

With central government financial support for local public services declining, the Somerset District Councils explored the options of investing in non-treasury investments purely or mainly for financial gain. With financial return being the main objective, with this comes higher risk on commercial investment than with treasury investments. Borrowing to invest purely for commercial income gain is now strongly discouraged by Treasury, to the point the PWLB is explicit in not being used for this sole purpose. The revision to the Prudential Code, 2021, also tightens the regulatory controls on this type of activity. Given the complexity and value of the investments made a separate strategy for Non-Treasury Investments is required and will be presented as part of the MTFP and Budget Setting Report in February 2023.

4. Other long-term liabilities

In addition to debt detailed above, the Council is committed to making future payments to cover its pension fund deficit. The deficit reported in the 2021/22 accounts was £812.7m (as at 31/03/2022). It has also set aside £7m (as at 31/03/2022) as a provision 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 Council 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 outlined in each Somerset Councils 2021/22 statement of accounts:

5. 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 10: Prudential Indicator: General Fund Proportion of financing costs to net revenue stream

	2022/23 forecast	2023/24 budget	2024/25 budget	2025/26 budget
Financing costs (£m)	N/A	53.5	55.6	57.6
Proportion of net revenue stream	N/A	9.98%	9.68%	9.13%

Table 11. Prudential Indicator: Housing Revenue Fund Proportion of financing costs to net revenue stream

	2022/23 forecast	2023/24 budget	2024/25 budget	2025/26 budget
Financing costs (£m)	4.9	6.2	6.9	7.2
Proportion of net revenue stream	10.1%	12.1%	12.4%	12.8%

- Further details on the revenue implications of capital expenditure can be found in 2023/24 MTFP report to Full Council on 22nd February 2023.

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 Director of Finance and Governance is satisfied the proposed new capital schemes are prudent, affordable and sustainable. This follows full challenge of all capital bids against a set criteria. There will however be a need to continually review the overall programme against the authority's Corporate Plan and ongoing financial position to ensure that the capital programme continues to meet the objectives of the new authority.

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

6. 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 Director of Finance & Governance and section 151 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.