Somerset County Council

Capital Strategy 2022/23– 2024/25

Improving Lives

www.somerset.gov.uk

Capital Strategy Report 2022/23

Contents

1. Background and Context

This capital strategy is a report for 2022/23, 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 County 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 last budget setting for Somerset County Council, given the local Government Reorganisation in Somerset, and this is reflected in the strategy taken towards capital approvals capital. 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 being considered. This strategy therefore has a focus for 2022/23 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.

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 County 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 and the capital MTFP align to service planning and the corporate asset strategy. Asset information is overseen by the Corporate Property 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 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.13 PPE) within the annual statement of accounts: gov.uk/how-the-council-works/budgets-and-accounts/

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

In 2022/23, the Council is planning capital expenditure of £107.728m. The following table shows our planned spend for the future:

Table 1: Estimates of Capital Expenditure

	2020/21 actual £m	**2021/22 forecast £m**	**2022/23 budget £m**	**2023/24 budget £m**	**2024/25 budget £m**
Capital Expenditure	122.091	173.773	109.244	45.902	16.159

This table includes both the current approved capital programme and the proposed 2022/23 programme due to be put to Full Council on 23rd February 2022. For example, the 2022/23 budget of £109.244m is made up of £72.162m current programme and £37.082m 2022/23 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 the affordability of the 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 February for recommendation to Council in February each year.

For full details of the Council's 2022/23 capital programme, see section 16 of the main 2022/23 MTFP report and appendix 9 of the papers to Full Council on 23rd February 2022.

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

	2020/21 actual £m	2021/22 forecast £m	2022/23 budget £m	2023/24 budget £m	2024/25 budget £m
External sources	81.219	134.144	65.008	15.925	10.222
Own resources:					
Capital receipts	1.172	6.468	2.484	1.432	0.000
Revenue / Reserves	1.291	0.704	1.060	0.000	0.000
Debt	39.219	32.457	40.692	28.545	5.937
TOTAL	**122.901**	**173.773**	**109.244**	**45.902**	**16.159**

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

	2020/21 actual £m	2021/22 forecast £m	2022/23 budget £m	2023/24 budget £m	2024/25 budget £m
Own resources	3.620	4.382	5.329	6.286	7.254

- The Council's full minimum revenue provision statement is available in appendix 9 of the 2022/23 MTFP papers to Full Council on 23rd 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 £34.044m during 2022/23. 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

	31.03.2021 actual £m	31.03.2022 forecast £m	31.03.2023 budget £m	31.03.2024 budget £m	31.03.2025 budget £m
TOTAL CFR	**458.106**	**484.976**	**520.020**	**549.949**	**547.740**

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 £5.150m of capital receipts in the current financial year.

Table 5: Capital receipts

	2020/21 actual £m	2021/22 forecast £m	2022/23 budget £m
TOTAL asset sales	**6.047**	**5.150**	**5.000**

Department for Levelling Up, Housing and Communities (DLUHC) 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 as part of Government announcements in February 2021 this is extended to March 2026. The authority’s use of receipts under this directive is a total of £17.267m to March 2020. The Authority has not applied the directive since, however this additional flexibility remains available. An Efficiency Strategy will be required if this flexibility is recommended and would require full Council approval.

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, the Authority currently has long term borrowing of £324.550m at an average interest rate of 4.66%. The authority continues to maximise the use of the cash held before taking costly external debt, this is referred to as internal borrowing. It is anticipated the level of internal borrowing at 31/03/2022 will be £75.4m.

The budget for debt interest paid in 2022/23 is £15.378m, based on an average debt portfolio of £364.550m at an average interest rate of 4.21%. The budget for Treasury and strategic investment income in 2022/23 is £1.360m, based on an average investment portfolio of £220m at an average return of 0.7%. (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 cheaper short-term loans (currently available at around 0.10%) and long-term fixed rate loans where the future cost is known but is higher (currently 1.5 to 2.5%).

Projected levels of the Council's total outstanding debt (which comprises of borrowing and Private Financing Initiatives (PFI) liabilities, are shown below, compared with the capital financing requirement (with reference to table 4 above).

Table 6: Prudential Indicator: External Debt and the Capital Financing Requirement

	31.3.2021 actual £m	31.3.2022 forecast £m	31.3.2023 budget £m	31.3.2024 budget £m	31.3.2025 budget £m
Short term debt	7.220	10.000	10.000	10.000	10.000
Long term debt *	334.173	332.099	325.814	312.993	288.701
Assumed debt not yet taken	0.000	0.000	40.000	80.000	120.000
PFI & leases	42.533	39.872	38.669	37.350	36.031
Total external borrowing	**383.926**	**381.971**	**414.483**	**440.343**	**454.732**
Capital Financing Requirement	**458.106**	**484.976**	**529.020**	**549.949**	**547.740**

*(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 7: Prudential Indicators: Authorised limit and operational boundary for external debt

	2020/21 limit £m	2021/22 limit £m	2022/23 limit £m	2023/24 limit £m	2024/25 limit £m
Authorised limit – borrowing	399.570	397.572	451.924	485.927	509.649
Authorised limit – PFI and leases	55.533	52.872	51.301	49.989	49.677
Authorised limit – total external debt	**455.103**	**450.444**	**503.225**	**535.916**	**559.326**
Operational boundary – borrowing	369.570	367.572	406.924	440.927	464.649
Operational boundary – PFI and leases	47.533	44.872	43.301	41.989	40.677
Operational boundary – total external debt	**417.103**	**412.444**	**450.225**	**482.916**	**505.326**

**There is a change to the accounting standards for leasing, due for adoption 1st April 2022 having been deferred by 1 year as announced by CIPFA in November 2020. The impact of this will be to bring all material leases greater than one year onto the authority's balance sheet, thus creating additional borrowing liability, this is estimated to be £6.7m. Any new leases being entered during 2022/23 will also effect the limits and an estimate of this has been allowed for separately within the Authorised borrowing Limit.*

4. Investment Strategy

Treasury investments: is the management of the Council's cash flows, borrowing 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.

- the Treasury Management Strategy can be found as part of the 2022/23 MTFP papers to Full Council on 23rd February 2022.

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 Finance & Governance 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 County Council (SCC) 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 Council 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 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 both considerations the Authority does not plan to make this type of investment and therefore does not have a current Investment Strategy.

As it remains an option available to the Authority, a policy paper was endorsed at Cabinet on 18th December 2019, the full paper can be found here; http://democracy.somerset.gov.uk/ieListDocuments.aspx?CId=134&MId=740&Ver=4

This sets out the regulatory boundaries, options available and outlines the appropriate governance be put in place should any of the arrangements be taken forward.

5. Other long-term liabilities

In addition to debt of £383.926m detailed above, the Council is committed to making future payments to cover its pension fund deficit. The deficit reported in the 2020/21 accounts was £993.554m (as at 31/03/2021). It has also set aside £11.194m (as at 31/03/2021) 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 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 145 and 158 of the 2020/21 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

	2020/21 actual	**2021/22 forecast**	**2021/23 budget**	**2023/24 budget**	**2024/25 budget**
Financing costs (£m)	23.907	24.621	25.735	26.810	27..841
Proportion of net revenue stream	6.63%	6.59%	6.43%	6.57%	6.75%

- Further details on the revenue implications of capital expenditure can be found in section 16 of the main 2022/23 MTFP report to Full Council on 23rd February 2022.

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 & Governance is satisfied the proposed capital programme is prudent, affordable and sustainable. This follows full challenge of all capital bids against set criteria of affordability and service need.

Only schemes that will have fully 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 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.