CAPITAL STRATEGY REPORT 2019/20

Introduction

1. This capital strategy is new for 2019/20, providing a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of local public services. The strategy also provides an overview of how associated risk is managed and the implications for future financial sustainability.

2. As part of the amendments implemented in the 2018/19 Treasury Management Code, it is now a requirement that all Local Authorities will need to produce a Capital Strategy each year.

3. This strategy should be considered with other strategies which will provide a holistic view of the Council's financial planning framework; the Medium Term Financial Strategy, Capital Programme, Treasury Management Strategy, Investment Strategy and the Minimum Revenue Provision Statement.

Capital Expenditure and Financing

4. Capital expenditure is where the Council spends money on assets, such as property or vehicles that will be used or provide a service 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 £10,000 are not capitalised and are charged to revenue in year.
5. In 2019/20, the Council is planning capital expenditure of £124.26m as summarised below:

Table 1: Prudential Indicator: Estimates of Capital Expenditure

	2017/18 actual £m	**2018/19 estimate £m**	**2019/20 budget £m**	**2020/21 budget £m**
General Fund services	**82,254**	**131,496**	**97,674**	**39,381**
Housing Revenue Account (HRA)	**11,877**	**17,379**	**26,586**	**44,462**
TOTAL	**94,131**	**148,875**	**124,260**	**83,843**

6. The Council has spent £17m capital expenditure on commercial investments and plans to spend £25m on commercial investment properties in 2019/20 and 2021/22 in accordance with the Investment Property Strategy approved by Cabinet in 2015.

7. The Housing Revenue Account (HRA) is a ring-fenced account which ensures that council housing does not subsidise, or is itself be subsidised, by other local services. HRA capital expenditure is therefore recorded separately, and includes the building of new general needs, shared ownership and supported housing as well as works to stock and major adaptations to existing properties.

Governance of Capital Expenditure

7 Specific capital projects are identified primarily through the Council's annual budget setting process which revises the approved capital programme for future years. Service managers submit business cases for new projects, outlining the reasons and benefits for the proposal and the estimated cost and method of financing. The final revised capital programme is submitted first to Cabinet and Council for approval in February each year.

8 Implications of existing and new capital investment proposals in terms of the future impact on prudential borrowing levels and capital financing costs are taken into account in setting the revenue budget which is also approved by Council in February each year. The various sources of finance for all existing and new capital projects and programmes are identified and included in the Council's budget.

9 Some capital projects arise which require more short-term implementation during the current financial year and these are usually managed through existing programme budgets included in the three year programme where there is anticipated need for that type of investment. These projects would normally be managed within overall borrowing limits approved by Council.

Review of the existing Capital Programme and new Proposals

10 The Capital Programme is usually prepared over a three year period, However for 2019/20 a review of the Capital Programme was carried out in order for the Programme to be aligned with principles being developed to help define what Council services in Harrow should look like in the future, given the current significant budget gaps in the Revenue Budget for 2020/21 and 2021/22. The aim of this review being to set a revised affordable Capital Programme. The principles used are as follows:

- Is this capital needed to meet a statutory obligation? Also, is the amount requested the minimum requirement?

- Is this capital required to operate safely? Also, is the amount requested the minimum requirement?
- Does the capital investment make a net financial contribution to Harrow after accounting for all revenue costs (capital financing costs, implementation costs and any ongoing running costs)?
- Does the capital investment generate additional external funding?
- Is this capital requirement essential to sustain the organisation? Also, is the amount requested the minimum requirement?
- Where a project has already started, can existing contractual arrangements be re-negotiated?

11 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

	2017/18 actual £m	**2018/19 forecast £m**	**2019/20 budget £m**	**2020/21 budget £m**
External sources	18,765	19,548	21,046	16,838
Own resources	16,890	14,016	7,411	16,496
Debt	58,476	115,311	95,803	50,509
TOTAL	**94,131**	**148,875**	**124,260**	**83,843**

12 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. MRP is a statutory mechanism for General Fund borrowing and details on how this is calculated is included in the MRP Statement policy. The HRA also provide a regular contribution towards it financing of debt. As an indication of the current cost of the existing capital programme, the proposed Council budget for 2019/20 includes £32.6m for MRP and interest costs.

13 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 £73,977m during

2019/20. Based on the above figures for expenditure and financing, the Council's estimated CFR is as follows:

Table 3: Prudential Indicator: Estimates of Capital Financing Requirement

	31.3.2018 actual £m	31.3.2019 forecast £m	31.3.2020 budget £m	31.3.2021 budget £m
General Fund services	343,209	443,267	504,689	517,571
Council housing (HRA)	151,015	150,046	162,622	178,859
TOTAL CFR	**494,224**	**593,313**	**667,311**	**696,430**

Asset Management

14 The maintenance and improvement of the Council's property assets and wider infrastructure are managed and formally set out in the Council's organisational structure, with specific service teams in place to manage various parts of the Council's asset portfolio.

15 In general, assets are managed in accordance with the principles of good estate management. The Council seeks continuous improvement in the quality of assets used to deliver services and wherever possible use its ownership of assets to deliver service improvements.

Asset Disposals

16 Assets are continually reviewed, to determine those that may be declared surplus to service requirements, with regular monitoring meetings. Proposals to change the purpose, to redevelop or to sell an asset are reported to Cabinet. Surplus assets may be sold to generate proceeds, known as capital receipts, which can be used to finance capital expenditure on new assets or enhancements to existing assets, or to repay debt. With the approval of Cabinet, surplus assets can also be appropriated between the General Fund and Housing Revenue Account (HRA) to reflect planned changes in use of the land where notional receipts are transferred between the funds.

17 Right to Buy Council housing sales, repayments of capital grants, loans and investments also generate capital receipts. The Council is currently also permitted to spend capital receipts on service transformation projects until 2021/22.The Council plans to invest £3.1m of capital receipts on transformational projects in the coming financial year (2019/20).

Treasury Management

18 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.

19 As at the 31 March 2019 the Council's total external borrowing was £346m and £26m was held in short term treasury (cash) investments.

Borrowing strategy

20 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 low cost short-term loans (currently available at around 1.10%) and long-term fixed-rate loans where the future cost is known but higher (currently 2.5 to 3.0%).

21 Projected levels of the Council's total current outstanding debt (which comprises borrowing, PFI liabilities, leases) are shown below, compared with the projected capital financing requirement (see details above).

Table 4: Prudential Indicator: Gross Debt & Capital Financing Requirement

	31.3.2018 actual £m	**31.3.2019 forecast £m**	**31.3.2020 budget £m**	**31.3.2021 budget £m**
Debt (incl. PFI & leases)	341,061	360,860	550,252	600,329
Capital Financing Requirement	494,224	593,313	667,311	696,430

22 Statutory guidance requires that debt should remain below the capital financing requirement, except in the short-term. As can be seen from table 4 above, with the existing levels of debt the Council expects to comply with this in the medium term...

23 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. Further details on borrowing can be found in the Treasury Management Strategy.

Table 5: Prudential Indicators: Authorised Limit and Operational Boundary for external debt

	2017/18 limit £m	2018/19 limit £m	2019/20 limit £m	2020/21 limit £m
Authorised Limit – total external debt	494	593	667	696
Operational Boundary – total external debt	358	550	646	695

Treasury Investment Strategy

24 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.

25 The Council’s policy on treasury investments is to prioritise security and liquidity over yield, which 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 in funds including in bonds and shares, to balance the risk of loss against the risk of receiving returns below inflation. Both short-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.

26 The Council will aim to hold a level of short-term investment balances which are not excessive, but will ensure sufficient liquidity to manage the day-to-day activities of the Council. Shorter-term investments are forecast at £30m over the next 5 years.

27 Further details on treasury investments can be found in the Treasury Management Strategy.

28 Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Director of Finance and staff, who must act in line with the treasury management strategy. The treasury management strategy statement is agreed by Cabinet in February prior to agreement at full Council before the start of each financial year. Amendments to the treasury management strategy during the year are only done with Cabinet approval.

29 Treasury activity is monitored and reported to senior management on a daily and weekly basis. Monthly reports on treasury management activity, including compliance with prudential indicators, are provided to Cabinet as part of the budget monitoring process.

Use of Commercial Investments

30 The Council approved its Investment Property Strategy in December 2015. The strategy allowed the acquisition of an investment property portfolio at a total cost not to exceed £20m with no single purchase to exceed £5m. Under this strategy the Council have acquired 4 commercial investments at a cost of £17m. A £700k net income contribution is included in the budget. The Council approved a further £25m capital programme investment in commercial properties on the basis that a revenue stream is provided to support the revenue budget from commercial property rents

31 The income target from the commercial portfolio makes up less than 5% of the Council's revenue budget and therefore the risk can be considered to be minimal and proportionate

Liabilities

32 In addition to long term debt detailed above, the Council is committed to making future payments to cover its pension fund deficit and has made provisions to cover risks such as insurance claims and non-domestic rates appeal losses. The Council is also at risk of having to pay for claims following legal proceedings but has not put aside any money because the claims are denied and will be defended, and in some instances, counterclaims pursued.

Revenue Budget Implications

33 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 6: Prudential Indicator: Proportion of financing costs to net revenue stream

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget
Financing costs (£m)	24,321	25,000	32,872	34,008
Proportion of net revenue stream (%)	14.7	14.8	19.5	20.3

Net revenue stream is the general fund budget requirement, which is funded through Council Tax Business Rates and Government Grants.

Sustainability

34 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 35 years into the future. The Director of Finance is satisfied that both the proposed individual schemes and the overall programme are tested for affordability, sustainability and prudence.

35 Projects to be financed from planned borrowing fall into three broad financing strategies, with a fourth category of investment to be financed from future Council Tax revenues. The broad financing strategies are investment projects where specific capital receipts are recognised on completion of the project to cover costs; commercial activity with full funding through dividends, interest and principle repayments; and invest to save projects where borrowing costs are offset by ongoing revenue savings. The fourth category is projects linked to service delivery projects to meet the demands of residents.

Knowledge and Skills

37 The Council employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions.

38 The Council adopts a continuous performance and development programme to ensure officers are regularly appraised and any training needs identified. Where appropriate, officers will attend training sessions, seminars and workshops to ensure their knowledge is up to date and relevant. Council Members are provided access to additional training where required.

39 Where Council staff does not have the knowledge and skills required, use is made of external advisers and consultants that are specialists in their field.