WORCESTER CITY COUNCIL

CAPITAL STRATEGY

2019/20 -2021/22

DRAFT

February 2019

Introduction

This Capital Strategy fulfils the requirement, under the Prudential Code 2017 published by the Chartered Institute of Public Finance and Accountancy (CIPFA), to provide a high-level overview of how capital expenditure, capital financing and treasury management activities contribute to the provision of local public services. It also provides an overview of how associated risk is managed and the implications for future financial sustainability. It summarises a more detailed set of technical papers and management arrangements which have been published separately.

The figures and tables in this document are prepared on the basis of the proposed capital programme and do not reflect the impact of potential investments in relation to the Development Fund agreed by the Policy and Resources Committee at its meeting of 30 July 2018, except in relation to overall borrowing limits. A separate investment strategy document presented to the Policy and Resources Committee in February 2019 provides more background on the scope of potential future investments.

Capital Expenditure

Capital expenditure is expenditure 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 £5,000 are not capitalised and are charged to revenue in year. It is proposed as part of the Strategy that this figure be increased to £10,000 to better manage the increased requirement for capital accounting required under revised CIPFA guidance and Government regulations.

Details of the Council’s policy on capitalisation are included in accounting policies, summarised in the annual statement of accounts.

In 2019/20, the Council is planning capital expenditure of £5.537m as summarised below:

Table 1: Prudential Indicator: Estimates of Capital Expenditure

	2017/18 actual £m	2018/19 forecast £m	2019/20 budget £m	2020/21 budget £m	2021/22 budget £m
General Fund services	3.511	4.155	5.537	1.784	0.970
Capital investments	0	0	0	0	0
TOTAL	3.511	4.155	5.537	1.784	0.970

The main General Fund capital projects include:

- Preparation of the Sansome Walk site for development: £1.7m
- Housing Adaptations funded from Disabled Facilities Grants: £0.695m
- CCTV upgrade: £0.548m
- Improvements to 2 Copenhagen Street (the Kiln project): £0.445m

- Public realm improvements including a contribution towards repaving the Shambles: £0.4m

The estimated preparation costs for the Sansome Walk site were set at £1.7m in line with advice received in relation to the likely costs of demolition. This was reported to Full Council at its meeting of 17 July 2018. Subsequent findings have indicated that the demolition costs may be substantially in excess of this due to the level of asbestos at the site which was not previously identified. Fully revised capital costs will be identified and advised to Policy and Resources Committee and Full Council once plans for the future use of the site have been determined, as these will affect the capital sums required.

As noted above, the Council also plans to incur capital expenditure on investments, under the Development Fund proposals and through loans to third parties. These are covered in more detail in the Investment Strategy for 2019/20.

Capital programme development and financing

In line with the Capital and Asset Management Framework approved by the Policy & Resources Committee in October 2018, from 2019/20 service managers will bid to include projects in the Council's capital programme. Bids will be collated by the Capital Asset Management Group (CAMG) and will include calculations of the financing cost (which can be nil if the project is fully externally financed).

The CAMG will appraise all bids based on a comparison of service priorities against financing costs and will make recommendations to the Policy & Resources Committee as part of the budget-setting process for each financial year. The final capital programme will then recommended by the Policy & Resources to Committee to Council in February, as at present.

Full details of the Council's appraisal process are set out in the Capital and Asset Management Framework which can be viewed here: http://committee.cityofworcester.gov.uk/ieListDocuments.aspx?CId=400&MId=4298&Ver=4

All capital expenditure must be financed, either from external sources (government grants and other contributions), the Council's own resources (revenues, 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	2021/22 budget £m
External sources	1.364	1.524	1.732	0.695	0.695
Own resources	2.054	2.476	2.812	0.939	0.225
Debt	0.093	0.156	0.993	0.150	0.050
TOTAL	**3.511**	**4.155**	**5.537**	**1.784**	**0.970**

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. Planned MRP and use of capital receipts are as follows:

Table 3: Replacement of debt finance

	2017/18 actual £m	2018/19 forecast £m	2019/20 budget £m	2020/21 budget £m	2021/22 budget £m
Own resources	0.472	0.440	0.456	0.536	0.560

The Council's full minimum revenue provision statement is available at Appendix A

The amount that the Council needs to borrow to fund the planned capital programme 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 £0.5 million during 2019/20 as MRP applied will be exceeded by new debt financing. 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

	31.3.2018 actual £m	31.3.2019 forecast £m	31.3.2020 budget £m	31.3.2021 budget £m	31.3.2022 budget £m
General Fund services	11.502	11.218	11.755	11.369	10.859

<u>Asset management</u>

To ensure that capital assets continue to be of long-term use, the Council has established a Capital and Asset Management Framework. This requires all assets to be subject to a five year 'fit for purpose' assessment which will determine whether the asset continues to meet the Council's needs and whether it should be retained or disposed of. Assets that are retained will have a detailed forward maintenance programme. The decision to acquire new assets, including property investments, will include assessment of revenue costs of maintaining the asset over its expected life. A detailed Asset Management Strategy, due to be published in 2019/20, will set out these arrangements.

<u>Asset disposals</u>

When a capital asset is no longer needed, it may be sold so that the proceeds can be spent on new assets or to repay debt. Councils are currently also permitted to spend capital receipts on service transformation projects until 2021/22, but no projects are currently identified for capitalising in this way. Repayments of capital grants, loans and investments also generate capital receipts. The Council plans to receive capital receipts in the coming financial years as follows:

Table 5: Estimated capital receipts

	2017/18 actual £m	2018/19 forecast £m	2019/20 budget £m	2020/21 budget £m	2021/22 budget £m
Asset sales	0.541	0.750	0.750	1.000	0
Loans repaid	0.051	0	0	0	0
TOTAL	**0.592**	**0.750**	**0.750**	**1.000**	**0**

Asset sales are estimates only based on average sales in prior years and include the re-sale value of assets (such as vehicles and equipment) no longer required or replaced. Potential disposals will be notified to Policy and Resources Committee as and when identified.

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. Revenue cash surpluses are offset against capital cash shortfalls to reduce overall borrowing.

Due to decisions taken in the past, the Council currently has £7.3m borrowing at an average interest rate of 4.59% and (on average) £14.7m treasury investments at an average rate of 0.85%.

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 low-cost short-term loans and long-term fixed rate loans where the future cost is known but higher.

Projected levels of the Council's total outstanding debt are shown below, compared with the capital financing requirement.

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

	31.3.2018 actual £m	31.3.2019 forecast £m	31.3.2020 budget £m	31.3.2021 budget £m	31.3.2022 budget £m
Debt (incl. leases)	7.334	7.293	7.252	7.179	7.146
Capital Financing Requirement	11.502	11.218	11.755	11.369	10.859

Statutory guidance is that debt should remain below the capital financing requirement, except in the short-term, to ensure that the Council is not borrowing in excess of its needs. As can be seen from table 6, the Council expects to comply with this in the medium term. Any decisions made with regard to borrowing under the Development Fund will need to continue to meet this criterion. Therefore this Prudential Indicator will be revised and reported as such proposals are brought forward.

Liability benchmark

Under the Council's Capital and Asset Management Framework, approved by the Policy & Resources Committee at its meeting of 29 October 2018, external borrowing is only undertaken once all other forms of capital funding have been considered. Paragraph 10.4 of the Framework states that:

As the Council's borrowing limit is related to its revenue streams, and these are likely to remain restricted over the lifetime of this Framework, borrowing will be used only when other forms of financing are unavailable and principally only when financing an asset. Leasing will be considered as an alternative to borrowing to purchase in accordance with Strategy 4 but its use remains restricted by the same considerations of revenue impact.

The alternative is 'internal borrowing' whereby the Council uses cash reserves to fund capital expenditure which are then recovered over time through the Minimum Revenue Provision. The extent to which the Council is maximising opportunities for internal borrowing is considered as part of the Treasury Management Strategy Statement 2019/20 included as Appendix 4 to the Budget Report.

Affordable borrowing limit

Under the Prudential Code, the Council is required to set an affordable borrowing limit (also termed the authorised limit for external debt). In line with statutory guidance, a lower "operational boundary" is also set as a warning level should debt approach the limit.

The Council revised the Operational Boundary and Authorised Limit in October 2018 as part of the establishment of the Development Fund. However the limits must be reviewed annually as part of the Prudential regime.

The report of October 2018 set a limit on the Development Fund of £20m on the previously agreed requirement to generate income of £200k per year from such investments. However, the Development Fund proposals themselves take into account changes in the approach to such schemes, including the need to focus on local development rather than purely income generation. Therefore the scope of the Fund can be broadened to increase the opportunities that are currently available, rather than setting a limit based solely on the level of revenue income to be generated by the schemes.

The proposed limits set out in Table 7 allow sufficient capacity to borrow to meet existing borrowing requirements (CFR 2019/20), anticipated financing needs in the subsequent two years and potential Development Fund requirements once these proposals are brought to fruition.

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

	2018/19 limit £m	2019/20 limit £m	2020/21 limit £m	2021/22 limit £m
Authorised limit	32.4	51	55	57
Operational boundary	26.8	44	48	49

Investment strategy

Treasury investments are necessary to ensure the prudent management of cash balances arising from receiving cash before it is paid out again. Investments made for service reasons or purely for 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 short 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 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.

Table 9: Treasury management investments

	31.3.2018 actual £m	31.3.2019 forecast £m	31.3.2020 budget £m	31.3.2021 budget £m	31.3.2022 budget £m
Near-term investments	11.1	10.9	11.0	9.2	7.9
Longer-term investments	0	3.0	3.0	3.0	3.0
TOTAL	**11.1**	**13.9**	**14.0**	**12.2**	**10.9**

Further details on treasury investments are included in the Treasury Management Strategy Statement included as Appendix 4 to the Budget Report.

Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Corporate Director Finance and 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 the Policy &

Resources committee. The Policy & Resources Committee is responsible for scrutinising treasury management decisions.

Investments for Service Purposes

The Council may make investments to assist local public services, including making grants to local service providers and local small businesses to promote economic growth. In light of the public service objective, the Council is willing to take more risk than with treasury investments. The details of the Council's risk approach to such investments is set out in the Commercial Strategy, approved by the Policy & Resources Committee at its meeting of 17 January 2018.

Decisions on service investments are made by the Corporate Director Finance and Resources 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.

Commercial Activities

With central government financial support for local public services declining, the Council has a greater need to ensure that where it invests in commercial property to promote economic benefits locally, or outside the Worcester City boundary, there is also a sufficient commercial return on that investment. Existing commercial investments are currently valued at £5.294m, providing a gross income of £212,000.

In addition, the Council has invested £3m in the CCLA property Investment Fund. This is a fund which is based on income returns from a wide range of property investments. The returns are pooled and distributed to investors which must be Charities, Churches or Local Authorities. Anticipated income from the £3m investment in 2018/19 is £120,000 – a return of approximately 4%.

Where financial return is a significant objective, the Council accepts a higher level of risk on commercial investments than with treasury investments. A report on the establishment of a Development Fund approved by the Policy & Resources Committee July 2018 provides a maximum investment limit of £20m for the Fund. This is to ensure that such investments remain proportionate to the Council's size.

Principal risk exposures include: falls in the capital value of investment properties; increase in the costs of maintaining properties; void periods and other periodic reductions in income. These risks are considered and assessed as part of the proposal for each investment. Moreover a governance framework relating to risk has been established through the Council's Commercial Strategy (2018) and the Capital and Asset Management Framework (October 2018). The latter summarises the risk arrangements relating to the acquisition of Commercial assets:

"The primary objective of strategic capital spending is to acquire and dispose of assets and to maintain the value of existing assets, with the best possible financial benefit while ensuring the effective management of risk, in accordance with the following principles:

- *The purchase value of non-financial investment assets will not exceed the total value approved for the Development Fund*

- *Borrowing will not be undertaken to finance assets unless other options have been exhausted*

- *Assets will not be acquired unless there is reasonable assurance of sufficient revenue capacity to maintain the asset at its expected value during its lifetime*

- *Assets will be retained to the maximum life value and only disposed of when they have ceased to be fit for purpose (as opposed to adherence to fixed lifecycles)*

- *Planned and programmed maintenance will be co-ordinated to maintain the maximum value of assets over their lifetimes."*

Assessment of 'reasonable assurance' will be undertaken in consultation with professional experts, including the Council's Treasury Advisers, estate management experts and property professionals. No assets will be acquired without full financial assessment and survey of physical conditions, in accordance with the Commercial Strategy and the Policy and Resources Development Fund statement, July 2018.

Decisions on commercial investments are made by the Corporate Director Finance and Resources in line with the criteria set out above and limits approved by the Policy & Resources Committee. 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 provided in the Commercial Strategy, Development Fund Statement and Capital and Asset Management Framework.

Liabilities

In addition to debt of £7.3m detailed above, the Council is committed to making future payments to cover its pension fund deficit. It also maintains a General Fund balance to cover unforeseen risks and has set aside reserves of £0.4m to mitigate reductions in planned income from activities and £0.7m to help manage reductions in expected business rates.

The Council is also at risk of having to pay for known contingent liabilities, which are reported as part of the Statements of Accounts. As at 31 March 2018 two of these were identified:

- Liabilities arising from the collapse of Municipal Mutual Insurance (MMI)

- Provisions for business rates appeals.

In both cases the actual level of liability cannot be known and therefore specific level for any reserve cannot be identified. In addition, the MMI liability may be fully paid out (two payments have been made to date totalling £136,170) while the provision for business rates appeals is calculated as part of the budget estimates. This potential liability is therefore already allowed for.

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 9: 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)	0.697	0.577	0.546	0.810	0.831
Proportion of net revenue stream	6.34%	5.70%	5.37%	7.90%	7.85%

This indicator is subject to change as a result of investments arising from the Development Fund proposals. However, the Commercial Strategy requires that any proposal must make a positive return over the lifetime of the scheme and a positive return over the first five years. Therefore any effect on the above indicator should be positive in overall terms but may be negative in individual years. To help manage the risks associated with each project the impact on the above indicator will be reported as part of the business case for any proposed acquisition utilising the Development Fund.

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 Corporate Director Finance and Resources is a CIPFA qualified accountant with over 20years' experience in public finance, the Head of Finance is an ICAEW qualified accountant with a similar level of experience in both private and public sector organisations and the Head of Property is a Fellow of the Royal Institution of Chartered Surveyors and a Register Valuer. The Council pays for junior staff to study towards relevant professional qualifications including CIPFA and ACT (treasury).

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, and engages with local property consultants according to the needs of each individual proposal. This approach is more cost effective than employing such staff directly, and ensures that the Council has access to knowledge and skills commensurate with its risk appetite.

Appendix A

Annual Minimum Revenue Provision Statement 2019/20

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 Ministry for Housing, Communities and Local Government's *Guidance on Minimum Revenue Provision* (the MHCLG Guidance) most recently issued in 2018.

The broad aim of the MHCLG 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, 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 as well as locally determined prudent methods.

The Council is recommended to approve the following MRP Statement*:*

For capital expenditure incurred before 1 April 2008 the MRP policy will be:

- A straight line repayment starting from 2016/17 of £114,060 which will repay the borrowing in 2047/48;

From 1 April 2008 for all supported and unsupported borrowing (including PFI and finance leases) the MRP policy will be:-

- **Asset life method** – MRP will be based on the estimated life of the assets, in accordance with the regulations and with effect from 2016/17 the method of repayment will be through an annuity calculation (providing a consistent overall annual borrowing charge).

Capital expenditure incurred during 2019/20 will not be subject to a MRP charge until 2020/21.

Based on the Council’s latest estimate of its Capital Financing Requirement on 31st March 2019, the budget for MRP has been set as follows:

	31.03.2019 Estimated CFR (£m)	2019-20 Estimated MRP (£m)
Capital expenditure before 01.04.2008	3.308	0.114
Unsupported capital expenditure after 31.03.2008	7.910	0.342
Total General Fund	**11.218**	**0.456**