Capital Strategy 2020/21

Introduction

1. This Capital Strategy report 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.

2. Decisions made this year on capital, investment and treasury management will have financial consequences for the Council for many years into the future. They are therefore subject to both a national regulatory framework and to local policy framework, summarised in this report.

3. The Strategy is an integral part of the Council's overall financial and asset management planning framework and summarises key themes from:

   - The Investment Strategy (Annex I),
   - The Treasury Management Strategy (Annex J) and the
   - The Minimum Revenue Provision Policy (MRP) Statement (Annex H)

4. The Capital Strategy also provides an overview of risk management and the long-term sustainability of capital investment plans.

5. The Strategy will:

   - ensure capital expenditure contributes to the achievement of the Organisational Strategy
   - set a Capital Programme which is affordable and sustainable
   - maximise the use of the Council's assets
   - provide a clear framework for decision making and prioritisation relating to capital expenditure
   - establish a corporate approach to the review of asset utilisation

The Strategy covers distinct, but inter-related elements of capital and investment activity as follows:

6. **Capital Expenditure and Financing:** the Council incurs two types of capital expenditure, (the Capital Programme and commercial investment). The Strategy covers both of these areas, setting out the Council's capital expenditure and financing plans over the medium-term. It provides an overview of the governance arrangements for approval and monitoring of expenditure and, in relation to commercial investment activities, sets out the due diligence process and the Council's risk appetite in respect of these, including proportionality in respect of overall resources.

7. The section includes a projection of the Council's capital financing requirement and how this will be funded and repaid. It links to the Council's borrowing strategy and sets out the Council's policy to meet its statutory duty to make an annual revenue provision for the repayment of debt (Appendix 1).

8. **Prudential Indicators** Local Authority borrowing is governed by CIPFA's Prudential Code, which requires Local Authorities to set indicators which ensure that the level of borrowing is affordable, prudent and sustainable. The Prudential Indicators are set in the Treasury Management Strategy Statement each year, and monitored throughout the year by the Audit & Governance Committee. The Strategy highlights the key indicators relating to borrowing levels.

9. **Treasury Management Investments** provides an overview of the Council's approach to the management of investments and cash flows. Further details on this are contained in the Council's Treasury Management Strategy.

10. **Use of capital resources for revenue purposes** provides a summary of the Council's plans to utilise the Governments flexibilities to use capital receipts to finance the costs of its transformation plans. These are further detailed in the Council's Flexible Use of Capital Receipts policy.

11. **Knowledge & Skills** summarises the knowledge and skills available to the Council to support it in its decision making in these areas.

Capital Expenditure and Financing

12. Capital expenditure is where a Local Authority spends money on assets, such as infrastructure, 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.

13. In 2020/21, the Council has a total capital requirement of £277m as summarised in Table 1. Of this, £176m will form the capital budget and the remaining £88m comprises the capital pipeline; schemes that represent the capital ambitions of the Council but are subsequent to further detailed business cases and member approval. In addition, the Council is planning to spend £13m on its programme of investment properties.

Table 1 - Prudential Indicator: Estimates of Capital Expenditure

	2018/19 actual £m	2019/20 forecast £m	2020/21 budget £m	2021/22 budget £m	2022/23 budget £m	2023/24 budget £m	2024/25 budget £m	Total budget £m
Capital Programme - Budget	128	154	176	162	163	199	152	851
Capital Programme - Pipeline			88	193	165	87	63	597
Commercial Investment	100	7	13	23	11	9	0	56
TOTAL	**228**	**161**	**277**	**378**	**339**	**295**	**215**	**1,504**

14. Capital expenditure for 2020/21 includes £1m due to a change in the accounting for leases and the Private Finance Initiative which require us to treat all leased assets as capital expenditure. The projection is based on expected lease renewals, however is likely to change if leasing new assets is determined to be the best solution to our accommodation needs.

15. The increased stability of the 2020/21 budget achieved in part through additional government funding, means we can deliver an ambitious Capital Programme of c£1.4bn over the next 5 years, if all proposals are approved. The revenue implications of this proposed programme are integrated and factored into the financial planning over the Medium-Term Financial Strategy (MTFS) period.

16. This will ensure:
    - A commitment to Surrey's future and that of its residents through significant investment in flood alleviation works. This will secure the homes of Surrey residents through a once in a generation opportunity to build flood defences to avoid the terrible impact we saw on people's lives in 2014; the scheme will also provide for new country parks and green space;
    - Significant investment in our Community – in our towns and high streets - of £100m over the next 5 years;
    - We look after our vulnerable older adults through building Extra Care Accommodation where they can live independently for longer;
    - We create additional local Special Educational Needs & Disabilities (SEND) places;
    - Significant investment in our road infrastructure;
    - We create a greener future, one of our strategic priorities. We are currently developing a number of propositions to deliver this, such as Solar Farms, Electric Charging points, Low emission buses and vehicles; and

- Acceleration of our Property Rationalisation Programme.

17. We want to invest in measures that help people lead more independent and fulfilling lives, harnessing the power and abilities that lie with families, communities and the latest digital technology. As a result, the Council leadership will focus on driving improvements rather than just focussing on balancing the budget.

Governance:

18. Capital projects are subject to a rigorous governance process to ensure they are aligned with the Council's priorities, represent value for money and are capable of being delivered within expected timescales. Capital Strategy Groups for Infrastructure, Property and IT develop projects throughout the budget setting process which are scrutinised and approved by Capital Programme Panel; a group of officers from across the organisation, including the Council's Section 151 Officer and senior service representatives. Projects approved by Capital Programme Panel are then included in the budget for approval by Cabinet and Council.

19. 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

	2018/19 actual £m	2019/20 forecast £m	2020/21 budget £m	2021/22 budget £m	2022/23 budget £m	2023/24 budget £m	2024/25 budget £m	Total budget £m
Grants and Contributions	97	95	101	86	74	76	67	404
Revenue budgets	1	1	8	6	6	7	6	33
Capital receipts	11	5	22	75	0	0	0	97
Borrowing	119	60	146	211	259	212	142	970
TOTAL	**228**	**161**	**277**	**378**	**339**	**295**	**215**	**1,504**

- Borrowing of £146m for 2020/21 consists of £133m to fund the Capital Programme (detailed in the Capital Budget) and £13m to fund commercial investment expenditure (Table 1).
- This table shows the planned usage of capital receipts for capital expenditure, including the application of amounts received in previous years. It does not include the use of capital receipts for transformation. To ensure a prudent estimate of borrowing, our planned overall usage of receipts is less than estimated income (shown in Table 5). This will be reviewed throughout the MTFS.

20. The capital receipts used for financing across the MTFS are based on receipts from assets already sold, and a prudent estimate of future receipts based on a planned disposal programme. This will be revisited regularly as the property estate rationalisation plans are finalised.

21. Borrowing 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 - Repayment of Debt Finance

	2018/19 actual £m	2019/20 forecast £m	2020/21 budget £m	2021/22 budget £m	2022/23 budget £m	2023/24 budget £m	2024/25 budget £m
MRP	20	15	15	21	25	29	34
Capital Receipts	29	0	0	0	0	0	0

22. 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 on service delivery and on investments, and reduces with MRP and capital receipts used to replace debt. The CFR is expected to increase by £153m during 2020/21. 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

As at 31st March	2018/19 actual £m	2019/20 budget £m	2020/21 budget £m	2021/22 budget £m	2022/23 budget £m	2023/24 budget £m	2024/25 budget £m
Capital Programme	779	815	964	1,126	1,342	1,512	1,610
Commercial Investment	456	454	458	472	474	473	464
TOTAL CFR	**1,235**	**1,269**	**1,422**	**1,598**	**1,816**	**1,985**	**2,074**

23. The capital financing requirement for 2020/21 and subsequent years includes a £45m increase due to a change in the accounting for leases and the Private Finance Initiative (PFI). This does not have an impact on the total cost of leases and PFI to the Council.

24. **Asset management:** To ensure that capital assets continue to be of long-term use, the Council has an Asset and Place Strategy. This sets out the Council's approach to the strategic management of its assets, how it will support service delivery and provide the Council income and how it will be used to promote growth and place shaping within Surrey and deliver the Community.

25. **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. The Council is currently also permitted to spend capital receipts on service transformation projects until 2022/23.

26. In the Spending Review 2015, the Chancellor of the Exchequer announced that to support Local Authorities to deliver more efficient and sustainable services, the government will allow Local Authorities to spend up to 100% of their capital receipts from the sale of non-housing assets on revenue costs incurred to generate ongoing revenue efficiency, to reduce costs and / or transform service delivery in a way that reduces costs or demand for services in future years. This flexibility relates to expenditure which is properly incurred for the financial years that begin on 1 April from 2016 to 2021.

27. Local Authorities are only able to use capital receipts in the years in which this flexibility is offered. In using the flexibility, the Council will have due regard to the requirements of the Prudential Code, the CIPFA Local Authority Accounting Code of Practice and the current edition of the Treasury Management in Public Services Code of Practice. The Flexible use of Capital Receipts Strategy is included in the 2020/21 Final Budget Report and Medium-Term Financial Strategy, which shows how the flexibilities are proposed to be utilised.

28. Repayments of capital grants, loans and investments also generate capital receipts, but none are expected within the current MTFS period. The Council plans to receive £125m of capital receipts in the coming financial years as follows. The programme of property rationalisation and asset sales from 2020/21 onwards is under review.

Table 5 - Capital Receipts Receivable

	2018/19 actual £m	2019/20 forecast £m	2020/21 budget £m	2021/22 budget £m	2022/23 budget £m	2023/24 budget £m	2024/25 budget £m
Asset sales	9	21	55	70			

Treasury Management

29. 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.

30. Due to decisions taken in the past, the Council's borrowing at 31st March 2019 was £676m, with an average interest rate of 2.8%. Newer loans are taken at a much lower rate, however the Council had £397m of long-term debt at a rate of 4.1%. During 2019/20, debt is expected to rise by £50m

to £726m. In 2019/20, the Council has average treasury investments of approximately £42m at an average rate of 0.5%.

31. **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%).

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

Table 6 - Prudential Indicator: External Borrowing and the Capital Financing Requirement

As at 31st March	2018/19 actual £m	2019/20 forecast £m	2020/21 budget £m	2021/22 budget £m	2022/23 budget £m	2023/24 budget £m	2024/25 budget £m
External Borrowing	676	726	837	1,038	1,278	1,458	1,562
Capital Financing Requirement	1,235	1,269	1,422	1,598	1,816	1,985	2,074

Note, the growth in external debt from 2019/20 to 2020/21 above (£111m) consists of £146m increased borrowing (Table 2), reduced by £15m of minimum revenue provision (Table 3) and a £20m increase in our ability to borrow internally against cash balances.

33. 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.

34. **Liability benchmark:** To compare the Council's actual borrowing against an alternative Strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes that cash and investment balances are kept to a minimum level of £10m at each year-end. This benchmark is currently projected to be £823m for 2020/21 and is forecast to rise to £1,541m over the next four years. As the table demonstrates, the Council aims to stay as close as possible to the liability benchmark.

Table 7 - External Borrowing and the Liability Benchmark

	31.3.2019 actual £m	31.3.2020 forecast £m	31.3.2021 budget £m	31.3.2022 budget £m	31.3.2023 budget £m	31.3.2024 budget £m	31.03.2025 budget £m
External Borrowing	675	726	837	1,038	1,278	1,458	1,562
Liability benchmark	676	732	823	1,029	1,272	1,458	1,541

35. **Affordable borrowing limit:** The Council is legally obliged to set an affordable borrowing limit (also termed the authorised limit for external debt) each year and to keep it under review. In line with statutory guidance, a lower "operational boundary" is also set as a warning level should debt approach the limit. Further details and context are provided in the Treasury Management Strategy.

Table 8 - Prudential Indicators: Operational Boundary and Authorised Limit for External debt

	2019/20 limit £m	2020/21 limit £m	2021/22 limit £m	2022/23 limit £m	2023/24 limit £m	2024/25 limit £m
Operational boundary – borrowing	966	1,087	1,438	1,698	1,888	1,992
Operational boundary – PFI and leases	143	136	119	98	80	58
Operational boundary – total external debt	**1,109**	**1,223**	**1,557**	**1,796**	**1,968**	**2,050**
Authorised limit – borrowing	1,553	1,587	1,938	2,198	2,388	2,492
Authorised limit – PFI and leases	143	136	119	98	80	58
Authorised limit – total external debt	**1,696**	**1,723**	**2,057**	**2,296**	**2,468**	**2,550**

The authorised limit and operational boundary for 2020/21 and subsequent years include a £45m increase due to a change in the accounting for leases and the Private Finance Initiative.

36. **Treasury investment Strategy:** 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.

37. The Council's policy on treasury investments is to prioritise security and liquidity over yield; 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, including in bonds, shares and property, 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. Further details on treasury investments are in the Treasury Management Strategy.

38. **Risk management:** The effective management and control of risk are prime objectives of the Council's treasury management activities. The Treasury Management Strategy therefore sets out various indicators and limits to constrain the risk of unexpected losses and details the extent to which financial derivatives may be used to manage treasury risks.

39. **Governance:** 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 approved by Council. Regular reports on treasury management activity are presented to the Audit and Governance Committee. The Audit and Governance Committee is responsible for scrutinising treasury management decisions.

Commercial Activities

40. With central government financial support for local public services declining, the Council invests in commercial property, both directly and through its wholly owned subsidiary, Halsey Garton Ltd. Total commercial investments are currently valued at £500m with the largest being a loan to Halsey Garton Ltd totalling £233m and providing a net return after all costs of approximately £14m per annum.

41. With financial return being the main objective, the Council accepts higher risk on commercial investment than with treasury investments. The principal risk exposures include reduction in capital value, under occupancy and defaults. These risks are managed by the relevant management board, and through the Shareholder and Investment Panel. In order that commercial investments remain proportionate to the size of the Council, commercial equity investments and loans are subject to a rigorous scrutiny process, and contingency plans are in place should expected yields not materialise.

42. **Governance:** Decisions on commercial investments are made by Asset Strategy Board. Property and most other commercial investments are also capital expenditure and purchases will therefore also be approved as part of the Capital Programme.

43. Further details on commercial investments and limits are included in the Investment Strategy.

Revenue Budget Implications

44. 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

	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget	2023/24 budget	2024/25 budget
Financing costs (£m)	23	31	37	44	50	60
Proportion of net revenue stream	2.57%	3.18%	3.86%	4.61%	5.31%	6.45%

45. Financing costs for 2020/21 and subsequent years include a £5m increase due to a change in the accounting for leases and the Private Finance Initiative (PFI). This will not change the overall revenue cost of leases and PFI, but reclassify them as finance costs rather than service costs.

46. **Sustainability:** 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 50 years into the future. The Executive Director of Resources is satisfied that the proposed Capital Programme is prudent, affordable and sustainable because it remains proportional to the overall Council's revenue budget. The programme also contains significant elements which are intended to contain future revenue spend, for example through demand management in adult social care, and SEND school placements, which reduce the net impact of capital financing costs on the revenue budget.

Knowledge and Skills

47. The Council employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. The Council pays for officers to study towards relevant professional qualifications including CIPFA.

48. All officers involved in the treasury and investment management function have access to relevant technical guidance and training to enable them to acquire and maintain the appropriate level of expertise, knowledge and skills to undertake the duties and responsibilities allocated to them. The Council currently employs treasury management advisers, and seeks external legal and property related advice and due diligence as required. The Council's commercial investment Strategy is supported by guidance from our advisors, CBRE.

49. Those charged with governance (Members of the Audit and Governance Committee and the Corporate Overview Select Committee) recognise their individual responsibility to ensure that they have the necessary skills to complete their role effectively. The Section 151 Officer will

ensure that elected members tasked with treasury management responsibilities, including those responsible for scrutiny, have access to training relevant to their needs and responsibilities.

50. The Orbis partnership enables the creation and development of specialist resources. Centres of Expertise have been established for key areas of finance, and central teams of pooled expertise have been created to provide robust services which are resilient to meet the changing service needs of partners.

51. 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. 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.

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