Dorset Council Capital Strategy Report 2019/20

Introduction

This capital strategy is a new report for 2019/20, 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 has been written in an accessible style to enhance members' understanding of these sometimes technical areas.

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 some limited discretion on what counts as capital expenditure, for example assets costing below prescribed limits are not capitalised and are charged to revenue in year.

In 2019/20, the Council is planning capital expenditure of £65.3m followed by £39.8m in 2020/21 and £26.8m in 2021/22. The main capital projects include fully funded projects totalling £37.6m, partially funded schemes of £5.1m and schemes requiring funding totalling £22.6m.

Governance: It is envisaged that Heads of Service bid annually to include projects in the Council's capital programme. Bids are collated by finance who calculate the financing cost (which can be nil if the project is fully externally financed). All bids will be appraised based on a comparison of service priorities against financing costs and makes recommendations to the relevant committee. The final capital programme is then presented to Executive in January and to Council in February each year.

- For full details of the Council's capital programme is available in the relevant committee reports or by request.

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 1: Capital financing in £ millions

	2019/20 budget	2020/21 budget	2021/22 budget
External sources	40.2	25.0	19.3
Own resources	8.9	19.4	6.1
Debt	16.2	(4.6)*	1.4
TOTAL	**65.3**	**39.8**	**26.8**

**indicates a net repayment of debt*

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 2: Replacement of debt finance in £ millions

	2019/20 budget	2020/21 budget	2021/22 budget
Own resources	9.1	20.5	10.3

- The Council's full minimum revenue provision statement is available on request.

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 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 in £ millions

	31.3.2018 actual	31.3.2019 forecast*	31.3.2020 budget	31.3.2021 budget	31.3.2022 budget
Estimate CFR	359 0	369	376	362	355

**assumes £10m increase*

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 2021/22. Repayments of capital grants, loans and investments also generate capital receipts. The Council plans to apply capital receipts to current capital expenditure in the coming financial year and following years as follows:

Table 4: Capital receipts in £ millions

	2019/20 budget	2020/21 budget	2021/22 budget
Asset sales	0	11.5	1.2

- Further details of planned asset disposals are available on request.

<u>**Treasury Management**</u>

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.

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%).

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

Table 5: Prudential Indicator: Gross Debt and the Capital Financing Requirement in £ millions

	31.3.2019 forecast	31.3.2020 budget	31.3.2021 budget	31.3.2022 budget
Debt (incl. PFI & leases)	278.4	293.1	287.0	286.9
Capital Financing Requirement	369.0	376.2	362.4	354.9

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.

Liability benchmark: To compare the Council's actual borrowing against an alternative strategy, a liability benchmark can be calculated showing the lowest risk level of borrowing. This work will be undertaken following further balance sheet analysis and consolidation following year end.

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 6: Prudential Indicators: Authorised limit and operational boundary for external debt in £m

	2018/19 limit	2019/20 limit	2020/21 limit	2021/22 limit
Authorised limit – borrowing	472,500	400,000	400,000	400,000
Authorised limit – PFI and leases	36,000	35,000	35,000	35,000
Authorised limit - total external debt	508,500	435,000	435,000	435,000
Operational boundary – borrowing	448,000	390,000	390,000	390,000
Operational boundary – PFI and leases	36,000	35,000	35,000	35,000
Operational boundary - total external debt	484,000	425,000	425,000	425,000

- Further details on borrowing are in the treasury management strategy.

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.

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 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.

Total investments (as at December 2018) totalled £236.5m with £87.3m invested in pooled funds that are generally longer-term investments. It is envisaged that total longer-term investments will further increase in line with previously approved strategy.

Governance: Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the relevant Director/Head of Services/staff, who must act in line with the treasury management strategy approved by full Council. Quarterly reports on treasury management activity are presented and scrutinised by the relevant committee(s).

Investments for Service Purposes

The Council makes investments to assist local public services, including making loans to local groups/charities. In light of the public service objective, the Council is willing to take more risk than with treasury investments; however it still plans for such investments to generate a profit after all costs.

Governance: Decisions on service investments are made by the relevant Head of Service in consultation with the S151 officer and must meet the criteria and limits laid down in the relevant strategy. Most loans 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 may invest in commercial property purely or mainly for financial gain. Work continues on classifying and consolidating total commercial investments.

With financial return being the main objective, the Council accepts higher risk on commercial investment than with treasury investments. The principal risk exposures include vacancies and falls in capital value. These risks are managed by the relevant service area. In order that commercial investments remain proportionate to the size of the authority, these will become subject to an overall maximum investment limit and contingency plans will be in place should expected yields not materialise.

Governance: Decisions on commercial investments are made by the relevant Director in line with the criteria and limits approved by council in the investment strategy. Property and most other commercial investments are also capital expenditure and purchases will therefore also be approved as part of the capital programme.

The Council also has commercial activities, for example, hotels that generate a net income after costs, but exposing it to normal commercial risks. These risks are managed by the relevant Head of Service.

Liabilities

In addition to debt, the Council is committed to making future payments to cover its pension fund deficit (valued at £846m). It is also liable to set aside resources to cover risks of major provisions and financial guarantees. The Council is also at risk of having to pay for major contingent liabilities.

Governance: Decisions on incurring new discretional liabilities are taken by Heads of Service in consultation with the relevant Director. The risk of liabilities crystallising and requiring payment is monitored by finance and reported to committee.

- Further details on liabilities and guarantees can be found in the statement of accounts.

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. For 2019/20 the proportion of financing costs (net £13.6m) to net revenue stream is 4.6%.

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 Strategic Director is satisfied that the proposed capital programme is prudent, affordable and sustainable.

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 is a qualified accountant with many years' experience. The Council pays for junior staff to study towards relevant professional qualifications including CIPFA and ACCA.

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 such staff directly, and ensures that the Council has access to knowledge and skills commensurate with its risk appetite.