CAPITAL STRATEGY

INTRODUCTION

1.1 This Capital Strategy 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. It sets out the strategic direction for KCC's capital management and investment plans and is an integral part of our medium to long term financial and service planning and budget setting process. It establishes the principles for prioritising KCC's capital investment and incorporates requirements from the prudential system.

Capital Expenditure and Financing

1.2 Capital expenditure is where the Council spends money on assets, such as property, highways assets 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 £10,000 are deemed *de-minimis,* they are not capitalised and are instead charged to revenue in year.

1.3 Details of the Council's policy on capitalisation are included in the Council's annual Statement of Accounts, the relevant extract is set out below:

"Assets that have physical substance and are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes and that are expected to be used during more than one financial year are classified as Property, Plant and Equipment.

1.4 All expenditure on the acquisition, creation or enhancement of Property, Plant and Equipment above our *de-minimis* of £10k (£2k in schools) is capitalised on an accruals basis. In this context, enhancement means work that has substantially increased the value or use of the assets. Work that has not been completed by the end of the year is carried forward as "assets under construction".

Capital Strategy Principles

1.5 The core principles of the Council's Capital Strategy are as follows:

The Capital Strategy will:

- Be based on delivering the Council's strategic priorities,
- Set out and deliver the Council's statutory responsibilities on a risk-based approach,

- Ensure the capital programme is long term (10 years), deliverable, realistic and affordable,
- Exclude property investments where loans are provided to third parties, such as No Use Empty – these will be considered as part of the Treasury Management Strategy,
- View borrowing as a last resort – affordability across the medium to long term will be key.

The Council's Strategic Outcomes

1.6 Work is progressing on the new 5-year plan and is due to be completed in the latter part of 2021. The launch of this has been delayed to take into account the impact of the pandemic, however the Interim Strategic Plan which focuses on priorities over the next 18 months was approved at County Council in October and the capital strategy will be refreshed annually to incorporate this. The capital programme will continue to be aligned with the 3-year rolling Strategic Delivery Plan.

1.7 Capital investment should also evidence how it will support the priorities and principles set out in significant strategies. The following are examples of the Council's key strategies:

- Kent and Medway Growth and Infrastructure Framework – this sets out the future strategic infrastructure requirements for the county
- Local Transport Plan 4 – this plan sets out strategic transport priorities
- Commissioning Plan for Education Provision – this sets out changes to existing schools and the commissioning of new schools
- Kent Environment Strategy – this sets out priorities to support economic growth whilst protecting and enhancing Kent's environment
- KCC Net Zero 2030 – this sets out the targets and approach for KCC to reach net-zero emissions by 2030
- ICT Strategy – this provides direction and strategic priorities to shape KCC's technology environment
- Asset Management Strategy – this sets the framework for managing the Council's property portfolio effectively

Affordability

1.8 Capital plays an important role in delivering long-term priorities as it can be targeted in creative and innovative ways. However, capital is not unlimited or "free money" – capital funding decisions can have significant revenue implications. Every £10m of prudential borrowing costs approximately £0.7m per annum in revenue financing costs (including repayment of the principal) for 25 years, assuming an asset life of 25 years. For Information Technology projects the revenue costs are much higher per annum as the life is shorter. This is in addition to any ongoing maintenance and running costs associated with the investment. The more revenue that is tied up to repay borrowing, the less is available for service provision, and this is considered alongside revenue pressures.

1.9 In assessing affordability, indicators set by the Prudential Code and the Council's own internal set of fiscal indicators are considered. The fiscal indicator "net debt costs should not exceed 15% of net revenue spending" has been reviewed and this will now be reduced towards 10% over the medium term. This is considered a more suitable maximum to ensure long-term affordability of the capital programme.

1.10 In 2021-22, the Council is planning capital expenditure of £424.2m as shown in the following table:

Table 1: Prudential Indicator 1: Estimates of Capital Expenditure in £millions

	2019-20 Actuals	**2020-21 Forecast**	**2021-22 budget**	**2022-23 budget**	**2023-24 budget**
General Fund services	229.4	367.3	424.2	314.7	318.9
Capital investments	24.2	0.5	0.0	0.0	0.0
TOTAL	253.6	367.8	424.2	314.7	318.9

1.11 The main General Fund capital projects include: investments in additional school places to increase capacity (£134m), highways, structures & waste enhancement (£89m), highways and other transport improvements (£98m), modernisation and improved utilisation of council premises (£22m), other school projects (£48m), economic development initiatives (£24m), community projects (£5m) and adults projects (£3m).

1.12 **Governance**: Service managers bid to include projects in the Council's capital programme. Capital finance colleagues provide advice during this process. Projects must come forward with alternative options for delivering outcomes, and with a variety of funding options. All projects must be supported by a business case, using the agreed template which captures this information. The business case must also show realistic phasing of the proposed project, with project plans to support this. If a project slips, funding assigned to that project could have been attributed to other projects that were ready to proceed. A critical element of the business case is to identify revenue costs and revenue savings as these will be integral to the budget setting process. Bids are collated by the Capital Team in Corporate Finance who calculate the financing cost (which can be nil if the project is fully externally financed). These are then discussed as part of the budget process, and the final capital programme is presented to Cabinet in January and to County Council in February each year for approval.

Statutory Requirements

1.13 The Council will ensure that appropriate capital funding is allocated on a risk-based approach, to meet immediate statutory requirements, such as health and safety, Disability Discrimination Act (DDA), basic need and other legal requirements. Increasingly, it is anticipated that satisfying statutory requirements and avoidance of legal challenges will need to play a more prominent role in capital investment decisions. Nonetheless, whilst there may be a statutory requirement, capital bids will still need to explore alternative options to satisfy the affordability requirement. Capital spend may not always be necessary to achieve the minimum or required outcomes. Funding for capital projects will be applied in the most logical and efficient way, for example, to use specific grants for their intended purpose or time limited funding first, and where grant is not sufficient other sources of external funding will be explored, before using the Council's resources.

Invest/Spend to save bids

1.12 Invest/spend to save bids are encouraged as these will be integral to achieving additional savings/income which is increasingly important to ease the pressure on the revenue budget, although not at the expense of meeting the Council's statutory obligations and strategic priorities. Any bids under this category will be rigorously reviewed and challenged to ensure all relevant costs including any costs of borrowing or other revenue impacts have been adequately accounted for and the identified savings are realistically achievable within a reasonable period.

Enhancement of Existing Estate and Roads

1.13 Maintenance of the estate and highway roads and structures network is coming under increasing pressure following years of reactive works. The development of a longer-term capital planning period will help provide the service with future funding stability and the ability to highlight forthcoming pressures for early consideration by Members. The level of investment in this area will ensure our statutory responsibilities are met, again using a risk-based approach.

- Full details of the Council's capital programme are set out in Appendices A and B.

FUNDING

1.14 All capital expenditure must be financed, either from external sources (government grants, developer contributions and other external funding), the Council's own resources (revenue, reserves and capital receipts from sale of assets) or borrowing. The planned financing of the above expenditure is as follows:

Table 2: Capital financing in £millions

	2019-20 actual	2020-21 forecast	2021-22 budget	2022-23 budget	2023-24 budget
External sources*	158.5	260.8	252.5	235.5	314.8
Own resources	35.3	22.5	20.1	17.0	4.4
Borrowing	59.8	84.5	151.6	62.2	-0.3
TOTAL	**253.6**	**367.8**	**424.2**	**314.7**	**318.9**

*External sources include funding from loan repayments. The Council operates a number of revolving loan schemes, the majority of which are funded from external sources. However, this will also include an element of funding that was originally from the Council's own resources but cannot now be separately identified.

Grants

1.15 The challenging financial environment means that national government grants are reducing or changing in nature and becoming more heavily prescribed. These prescriptions reduce the freedom to decide where and how to spend grants – they are largely tied to specific service areas such as education or highways. An increasing number of funding schemes directly relate to housing and economic growth such as Local Growth Funding (LGF) from Local Enterprise Partnerships (LEPs). This funding is specific to individual projects and must be closely monitored. The Council's aim is to use other, less specific grants for their intended purpose in a way that meets statutory obligations. Where the grant is not sufficient, other sources of external funding such as Central Government grants and s106/Community Infrastructure Levy (CIL) will be explored first, before using the Council's resources such as capital receipts and borrowing.

Developer Contributions: Community Infrastructure Levy (CIL)/S106

1.16 Developer contributions continue to be a challenging issue and need careful consideration when they are put forward to fund major projects. The nature of s106 agreements means that once the total funding figure has been secured with a s106 contract, the funding is received by the County Council in staged payments as the development is built out, with the full funding potentially not received until the development has been fully completed. Depending on size, a development can take several years to be fully completed. Developer contributions will be built into the programme at the point they are secured within s106 agreements, but it must also be recognised that at this point there are still risks around housing development and realisation of the funding. Careful monitoring of expenditure against this funding is critical.

1.17 Any forward funding arrangements of developer contributions must be approved to ensure appropriate debt costs arising from forward funding are built into the repayments. The repayment schedule must be formalised by being built into the s106 agreement. Delays in housebuilding due to Covid-19 and additional costs to builders to ensure covid-safe workplaces means there is likely to be even greater requirements for forward funding, and renegotiation of agreements.

1.18 Several districts in Kent have adopted the Community Infrastructure Levy (CIL), a flat rate tariff charge. CIL rates are set by districts as the Charging Authorities, they are also responsible for collection and spend of the levy. The share of CIL funding which the County Council will receive in the future is unknown and cannot currently be forecast as unlike s106 agreements the money raised through CIL is administered by the district council and KCC does not automatically receive a share.

1.19 The "pooling restriction" has been removed in recent regulations. This had previously prevented local authorities using more than five section 106 obligations to fund a single infrastructure project. This is a positive move as it will help to unlock funds. However, the monitoring requirements have increased significantly, and revised arrangements will need to be put in place to ensure compliance with the new regulations.

1.20 The Planning White Paper is likely to have a significant impact on the way developer contribution funding is distributed in the future. The likely impacts will continue to be investigated as more details are forthcoming, but initial indications are that it could create a significant forward funding requirement which would need to be carefully managed by the Council.

Borrowing

1.20 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. Borrowing is a combination of external loans and internal borrowing (from cash reserves). Debt is usually only repaid when a loan matures. Occasionally the Council can refinance debt with replacement borrowing at a lower rate of interest, this is rare as there are usually excessive penalties to repay loans earlier than their normal maturity. Planned MRP debt during the medium-term planning period is as follows:

Table 3: Replacement of debt finance (MRP) in £millions

	2019-20 actual	**2020-21 forecast**	**2021-22 budget**	**2022-23 budget**	**2023-24 budget**
MRP	59.3	59.1	59.4	60.5	58.2

- The Council's full minimum revenue provision statement is at Appendix M.

1.21 The level of borrowing to fund the capital programme considers the revenue implications and the requirements of the prudential code. In line with the Code, borrowing is not undertaken in advance of need. The 10-year capital programme planning period will assist in more effective management of borrowing levels over the longer-term.

1.22 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 and reduces with repayments from MRP and capital receipts used to replace debt. The CFR is expected to increase by £92.2m during 2021-22 to £1.4bn. Based on the above figures for expenditure and financing, the Council's estimated CFR is shown in table 4:

Table 4: Prudential Indicator 2: Estimates of Capital Financing Requirement £millions

	31.3.2020 actual	**31.3.2021 forecast**	**31.3.2022 budget**	**31.3.2023 budget**	**31.3.2024 budget**
TOTAL CFR	1,285.0	1,310.3	1,402.5	1,404.2	1,345.7

The in-year movement in the total row equals borrowing from table 2 less MRP from table 3

Asset Management and Capital Receipts

1.23 To ensure that capital assets continue to be of long-term use, the Council has an asset management strategy in place. This sets the framework for managing the property portfolio effectively over the next 3 to 5 years. It will guide future strategic property decisions to make sure the property portfolio is managed sustainably and efficiently so that it can adapt to remain fit for the future and support frontline delivery. Property assets are an important part of supporting and enabling the Council to transform the way public services are delivered with partners and it is therefore essential that an innovative and forward-thinking strategy is in place.

- The Council's asset management strategy can be found here: Asset management strategy - Kent County Council

1.24 When a capital asset is no longer needed, it may be sold so that the proceeds, known as capital receipts, can repay debt or be spent on new assets. The Council has had a rigorous disposal programme over the past few years which has helped to minimise the level of borrowing. Going forward the same level of receipts will not be achievable as many surplus assets have already been sold. Increasingly capital receipts will need to be generated from underutilised assets rather than surplus assets. In some cases this may require additional capital investment to develop these assets which would need to be included and approved on an individual scheme basis as part of refreshing future capital programmes. The Council's Infrastructure division will continue to work with service directorates and public sector partners to explore options to release property and maximise capital receipts, with a view to creating a sustainable pipeline of funds in the future.

1.25 Repayments to the Council of capital grants, loans to third parties and investments also generate capital receipts. The timing of when capital receipts are banked and applied to fund the capital programme will not necessarily match, and where necessary, timing differences will be managed through short term internal borrowing from cash balances. The following table shows when the Council plans to apply capital receipts and loan repayments in the coming financial years:

Table 5: Capital receipts to be applied in £millions

	Prior Years	**2021-22 budget**	**2022-23 budget**	**2023-24 budget**
Application of asset sales	42.5	11.9	8.1	3.8
Loan repayments	39.7	16.4	18.7	8.1

Treasury Management

1.15 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.

1.16 As at 31 December 2020 the Council had £877.1m external borrowing, at an average interest rate of 4.51% and £440m treasury investments at an average rate of 2.18%. Where possible internal borrowing is used before borrowing externally. However, this is under constant review, to ensure it is still an appropriate funding source.

1.17 **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 the future. These objectives are often conflicting, and the Council therefore seeks to strike a balance between cheap short-term loans (currently available at around 0.10%) and long-term fixed rate loans where the future cost is known but higher (currently 1.50 to 2.50%).

1.18 Projected levels of the Council's total outstanding debt comprising external borrowing and other long-term liabilities identified in the balance sheet (including PFI liabilities, leases, etc) are shown below, compared with the capital financing requirement (see above) and the resulting balance funded from internal borrowing (cash balances).

Table 6: Prudential Indicator 3: Gross Debt and the Capital Financing Requirement in £millions

	31.3.2020 actual	31.3.2021 forecast	31.3.2022 budget	31.3.2023 budget	31.3.2024 budget
Other Long-term Liabilities	245.2	245.2	245.2	245.2	245.2
External Borrowing	883.8	853.7	826.0	802.5	776.9
Total Debt	1,129.0	1,098.9	1,071.2	1,047.7	1,022.1
Capital Financing Requirement	1,284.5	1,310.3	1,402.5	1,404.2	1,345.7
Internal Borrowing (cash balances)	155.5	211.4	331.3	356.5	323.6

1.19 Statutory guidance is that total 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.

1.20 **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. Both limits are set with reference to the Council's plans for capital expenditure and financing. The authorised limit provides headroom over and above the operational boundary sufficient for unusual cash movements.

Table 7: Prudential Indicator 4: Authorised limit and operational boundary for external debt in £millions

	2020-21 limit	2021-22 limit	2022-23 limit	2023-24 limit
Authorised limit – borrowing	1,050	1,016	988	965
Authorised limit – PFI and leases	246	245	245	245
Authorised limit – total external debt	1,296	1,261	1,233	1,210
Operational boundary – borrowing	995	991	963	940
Operational boundary – PFI and leases	246	245	245	245
Operational boundary – total external debt	1,241	1,236	1,208	1,185

It is likely that the lease liability figure on the balance sheet will increase as a result of IFRS16, however the implementation of this has been deferred until the 2022-23 financial reporting year. Under this new IFRS standard the treatment of leases will change from the current distinction between operating and finance leases, leading to more leases being recognised on the balance sheet. Work is ongoing to determine the implications of this for the Council.

- Further details on borrowing are in the Treasury Management Strategy – see Appendix K.

1.21 **Treasury Investment strategy:** Treasury investments arise from receiving cash before it is paid out again, including balances of reserves. Investments made for service reasons or for pure financial gain are not generally considered to be part of treasury management.

1.22 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, in particular in Money Market Funds, 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, equity and property funds, 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.

Table 8: Treasury management investments in £millions

	31.3.2020 actual	**31.3.2021 forecast**	**31.3.2022 budget**	**31.3.2023 budget**	**31.3.2024 budget**
Near-term investments	140.5	95.9	100	100	100
Longer-term investments	266.3	250	250	200	200
TOTAL	**406.8**	**345.9**	**350**	**300**	**300**

- Further details on treasury investments are in the Treasury Management Strategy at Appendix K.

1.23 **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.

1.24 **Governance:** Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Corporate Director of Finance and finance staff, who must act in line with the treasury management strategy approved by Council. Quarterly reports on treasury management activity are presented at Governance and Audit Committee with half-yearly and annual reports presented at County Council. The Treasury Management Advisory Group (TMAG) is responsible for scrutinising treasury management decisions. This is a Member group supported by officers and chaired by the Deputy Leader and Cabinet Member for Finance, Corporate and Traded Services.

Investments for Service Purposes

1.25 The Council makes investments to assist local public services, including making loans to or buying shares in other organisations (service investments). 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 surplus after all costs.

1.26 **Governance:** Decisions on service investments are made by the relevant service manager after consultation with and approval of the Corporate Director of Finance and must meet 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.

- Further details on service investments are in the Investment Strategy at Appendix L.

Commercial Activities

1.27 With central government financial support for local public services declining, the Council has, in the past, strategically invested in commercial property purely or mainly for financial gain. A number of purchases, some of which are still held, were made through the Property Investment and Acquisition Funds (PIF1 and PIF2) and the Acquisition of Strategic Assets.

1.31 With financial return being the main objective, the Council accepts higher risk on commercial investment than with treasury investments. The principal risk exposures include void periods when properties are empty and reductions in market value. These risks are managed by a rigorous appraisal process prior to any acquisition decision. Total commercial investments as at 31st March 2020 were valued at £33.1m with the largest being the two office buildings at Kings Hill.

1.32 **Governance:** Decisions on commercial investments and disposals have been made by the Director of Infrastructure in accordance with the Council's constitution, and more relevantly the Property Management Protocol, and following consultation with and approval of the Corporate Director of Finance. Property and most other commercial investments are also capital expenditure and purchases have also been approved as part of the capital programme.

- Further details on commercial investments and limits on their use are included in the investment strategy – Appendix L.
- The Council also has commercial activities in several trading companies, details of which are included in the investment strategy – Appendix L.

1.33 In line with Government expectations, the Council will not be pursuing commercial investments going forward and has removed the remainder of the Property Investment Funds and Acquisition of Strategic Assets from the Capital Programme.

Liabilities

1.34 In addition to debt of £853.7m detailed above, the Council is committed to making future payments to cover its pension fund deficit (valued at £1,363.2m). It has also set aside £51.1m in general reserves to cover unforeseen risks as identified in the Reserves Policy – Appendix N to this document. The Council has identified a number of budget risks but has not put aside any money because the Council has sufficient reserves to cover these eventualities should they arise. These risks are identified in the Budget Risks Register at Appendix H to this document.

1.35 **Governance:** Decisions on incurring new discretional liabilities are taken by service managers after consultation with and approval of the Corporate Director of Finance. The risk of liabilities crystallising and requiring payment is monitored by Corporate Finance and included in monitoring reports.

Revenue Budget Implications

1.36 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 5: Proportion of financing costs to net revenue stream

	2019-20 actual	2020-21 forecast	2021-22 budget	2022-23 budget	2023-24 budget
Proportion of net revenue stream	10.8%	10.04%	9.58%	10.14%	9.43%

1.37 In light of the one-year revenue spending round for 2021, the future year net revenue budgets are likely to change significantly, which will impact on future years' indicators.

1.38 **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 Corporate Director of Finance is satisfied with the rigour that has been applied to the appraisal of schemes and the application of an affordable future borrowing strategy based on an absolute fiscal limit that the costs of borrowing cannot exceed 15% (working towards 10% over the medium term) of the annual revenue budget. The Capital Programme will be reviewed and revised to ensure that it is prudent, affordable and sustainable in the medium term.

<u>Knowledge and Skills</u>

1.39 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 of Finance is a Fellow of the Association of Chartered Certified Accountants (FCCA) with 20 years' post-qualification experience, and the Council's finance team at the last review included a number of qualified accountants who are members of professional accountancy bodies including ACCA, CIMA, CIPFA and ICAEW. In addition, KCC Finance is an approved employer with professional accreditations from ACCA and CIPFA.

1.40 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, Amey/Kier/Skanska as property consultants/facilities management contractors. The Council will use the services of other specialists and consultants as necessary. 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.

1.41 The Council's policy on the use of external advisers is that where a contract for a consultant is estimated to cost £50,000 or more; details of the proposed award must be forwarded to the relevant Cabinet Member prior to the appropriate officer making the award.

Governance Arrangements

1.42 The governance arrangements for the capital programme are as set out in the Council's constitution.