Appendix 1

Capital Strategy

Introduction

1.1 This capital strategy was a new requirement 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 highly technical areas. To complement this new presentation, the fuller Capital Programme Strategy has been published separately in Appendix 6 of the County Council report.

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* and not capitalised and are 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".

1.5 In 2020-21, the Council is planning capital expenditure of £471.9m as shown in the following table:

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

	2018-19 Actuals	**2019-20 Forecast**	**2020-21 budget**	**2021-22 budget**	**2022-23 budget**
General Fund services	200.5	253.7	429.9	310.6	197.8
Capital investments	0.1	37.0	42.0	34.0	0.0
TOTAL	200.6	290.7	471.9	344.6	197.8

1.6 The main General Fund capital projects include investments in additional school places to increase capacity (£168m), highways, structures & waste enhancement (£82m), highways and other transport improvements (£76m), modernisation and improved utilisation of council premises (£31m), other school projects (£31m), economic development initiatives (£26m), community projects (£10m) and adults projects (£5m).

1.7 The Council has up to £42m available in 2020-21 for acquisition of strategic properties.

1.8 **Governance**: Service managers bid to include projects in the Council's capital programme. Bids are collated by the Capital Team in Corporate Finance who review the bids and calculate the financing cost (which can be nil if the project is fully externally financed). The Infrastructure Commissioning Board (ICB) appraised all the bids for the 2020-23 capital programme against the Capital Strategy Drivers and made recommendations for inclusion in the final capital programme. Going forward there will be a revised governance process which will undertake this function. The final capital programme is then presented to Cabinet in January and to County Council in February each year for approval.

- Full details of the Council's capital programme are set out in Sections 1 and 2 of the draft Budget Book (white combed) for Council approval.

1.9 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

	2018-19 actual	**2019-20 forecast**	**2020-21 budget**	**2021-22 budget**	**2022-23 budget**
External sources*	153.9	178.9	248.0	238.3	134.9
Own resources	24.7	36.2	30.7	11.6	10.9
Borrowing	22.0	75.6	193.2	94.7	52.0
TOTAL	**200.6**	**290.7**	**471.9**	**344.6**	**197.8**

*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.

1.10 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

	2018-19 actual	2019-20 forecast	2020-21 budget	2021-22 budget	2022-23 budget
MRP	60.0	59.3	60.2	64.8	64.6

- The Council's full minimum revenue provision statement is at Appendix 3.

1.11 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 £133.0m during 2020-21. Based on the above figures for expenditure and financing, the Council's estimated CFR is as follows:

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

	31.3.2019 actual	31.3.2020 forecast	31.3.2021 budget	31.3.2022 budget	31.3.2023 budget
TOTAL CFR	1,284.5	1,300.8	1,433.8	1,463.8	1,451.2

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

1.12 **Asset management:** 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 read here: https://www.kent.gov.uk/about-the-council/strategies-and-policies/corporate-policies/asset-management-strategy

1.13 **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.

1.14 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	2020-21 budget	2021-22 budget	2022-23 budget
Application of asset sales	37.7	20.1	2.1	1.4
Loan repayments	31.6	13.9	14.6	12.7

- The Council's Flexible Use of Capital Receipts Policy is at Appendix 4.

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 2019 the Council had £898m external borrowing, at an average interest rate of 4.51% and £382m treasury investments at an average rate of 2.71%.

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 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%).

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

	31.3.2019 actual	31.3.2020 forecast	31.3.2021 budget	31.3.2022 budget	31.3.2023 budget
Other Long-term Liabilities	254.9	254.9	254.9	254.9	254.9
External Borrowing	906.2	884.0	944.0	915.0	891.6
Total Debt	1,161.1	1,138.9	1,198.9	1,169.9	1,146.5
Capital Financing Requirement	1,284.5	1,300.8	1,433.8	1,463.8	1,451.2
Internal Borrowing (cash balances)	123.4	161.9	234.9	293.9	304.7

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

	2019-20 limit	**2020-21 limit**	**2021-22 limit**	**2022-23 limit**
Authorised limit – borrowing	1,013	1,020	992	959
Authorised limit – PFI and leases	263	246	246	246
Authorised limit – total external debt	1,276	1,266	1,238	1,205
Operational boundary – borrowing	988	995	964	935
Operational boundary – PFI and leases	263	246	246	246
Operational boundary – total external debt	1,251	1,241	1,210	1,181

It is likely that the lease liability figure on the balance sheet will increase as a result of IFRS16. If this results in the expectation that the Council will exceed the authorised limit during 2020-21, then a revised limit will be brought back to County Council for approval.

- Further details on borrowing are in the Treasury Management Strategy – see Appendix 2.

1.21 **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.

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

	31.3.2019 actual	31.3.2020 forecast	31.3.2021 budget	31.3.2022 budget	31.3.2023 budget
Near-term investments	217	179	100	100	100
Longer-term investments	261	268	300	300	300
TOTAL	**478**	**447**	**400**	**400**	**400**

- Further details on treasury investments are in the Treasury Management Strategy at Appendix 2.

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 staff, who must act in line with the treasury management strategy approved by Council. Quarterly reports on treasury management activity are presented to Governance and Audit Committee with half-yearly and annual reports going to County Council. The Treasury Management Advisory Group (TMAG) is responsible for scrutinising treasury management decisions.

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 5.

Commercial Activities

1.27 With central government financial support for local public services declining, the Council has strategically invested in commercial property purely or mainly for financial gain. The capital programme for Strategic and Corporate Services has included provision for Property Investment and Acquisition Funds (PIF1 and PIF2) for a number of years. PIF1 was funded from capital receipts, PIF2 is funded by internal borrowing (cash balances). The objectives of PIF are threefold: to create a pipeline of capital assets for future disposal to support the capital programme; to deliver a return to the Council through income from the assets and/or capital growth; to support regeneration of the Kent economy.

1.28 This strategy also makes provision for the acquisition of strategic assets, where business cases will be subject to approval by external review to ensure that these generate an income stream and will not create a financial burden on the County Council. That is, income streams must cover the total debt costs, including the minimum revenue provision over the medium term, and the short term consequences will have to be reflected in the medium term revenue budget. The external advisors will be appointed by the S151 Officer.

1.29 The approval process and tests that need to be satisfied for the business case to proceed are as follows:

a) That the rate of return meets the set criteria
b) That all revenue costs are identified including debt costs and are covered by the income stream
c) Signed approval of business case by external company review
d) Sign off by S151 Officer
e) Sign off by Head of Paid Service
f) Sign off by Monitoring Officer
g) Approval through the appropriate formal governance route

1.30 As and when these business cases are agreed, they will be added to the capital programme.

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 2019 were valued at £9.2m with the largest being the former Royal Mail site in Maidstone and Eurogate Business Park in Ashford.

1.32 **Governance:** Decisions on commercial investments and disposals are made by the Director of Infrastructure in accordance with the Councils 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 will therefore also be approved as part of the capital programme.

- Further details on commercial investments and limits on their use are included in the investment strategy – Appendix 5

- The Council also has commercial activities in a number of trading companies, details of which are included in the investment strategy – Appendix 5.

Liabilities

1.33 In addition to debt of £883.4m detailed above, the Council is committed to making future payments to cover its pension fund deficit (valued at £1,333.8m). It has also set aside £37.1m in general reserves to cover unforeseen risks as identified in the Assessment of Reserves – Appendix B to the draft Budget Book (white combed) for Council approval. 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 a separate risk register published as Appendix C to the draft Budget Book (white combed) for Council approval.

1.34 **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

1.35 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

	2018-19 actual	**2019-20 forecast**	**2020-21 budget**	**2021-22 budget**	**2022-23 budget**
Proportion of net revenue stream	11.8%	10.9%	10.3%	10.9%	10.7%

1.36 In light of the one year revenue spending round for 2020, the future year net revenue budgets are likely to change significantly, which will impact on future year's indicators.

1.37 **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 that the proposed capital programme is prudent, affordable and sustainable because of the rigour which 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% of the annual revenue budget.

Knowledge and Skills

1.38 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 43 qualified accountants who are members of professional accountancy bodies including ACCA, CIMA, CIPFA and ICAEW. In addition, KCC Finance are an approved employer with professional accreditations from ACCA and CIPFA.

1.39 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.

1.40 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.