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Capital Strategy Report 2020/21

Introduction

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.

Decisions made this year on capital 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.

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 £10k are not capitalised and are charged to revenue in year.

In 2020/21, the Council is planning capital expenditure of £168m as summarised below:

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

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
General Fund services	48.593	55.893	46.443	36.899	24.003
Council housing (HRA)	64.480	75.980	121.927	126.965	122.681
Capital investments	0.000	0.000	0.000	0.000	0.000
TOTAL	**113.073**	**131.873**	**168.370**	**163.864**	**146.684**

Capital expenditure for 2020/21 and subsequent years is likely to increase due to a change in the accounting for leases and the Private Finance Initiative. The implications of this are still being worked through and are not reflected in this version of the Capital Strategy. If necessary, the Capital Strategy will be revised in-year to reflect this change in accounting policy.

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The capital programme will deliver £479m of capital investment over the three years 2020/21 to 2022/23 and includes the continuation of the following ongoing major programmes:

- Housing new build programme (£252m);
- Housing major works and improvements programme (£150m);
- Property acquisition programme to reduce the reliance on expensive private sector temporary accommodation and improve the quality of temporary accommodation (£24m);
- Fleet replacement programme to help meet all new emissions standards in London (£5m); and
- Structural maintenance of the highways infrastructure including carriageways, footways and drainage (£4.2m).

In addition to these existing ongoing programmes, the capital programme at Appendix F1 includes a new £10.2m investment pot that is focused on the Council's non-housing assets and shaped around the following three themes:

- Tackling urgent maintenance and improvement backlogs;
- Providing top-up funding to ensure that in-flight schemes are completed or accelerated; and
- Delivering new schemes.

Governance: Service managers bid annually to include projects in the Council's capital programme. Bids are collated by corporate finance who calculate the financing cost (which can be nil if the project is fully externally financed). The bids are appraised and further worked up as part of the overall budget setting process. The final capital programme is then presented to the Executive in January and to Council in February each year.

Full details of the Council's capital programme are at **Appendix F1**.

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 in £ millions

	2018/19 actual	**2019/20 forecast**	**2020/21 budget**	**2021/22 budget**	**2022/23 budget**
External sources	21.287	27.699	18.850	17.517	9.200
Own resources	69.591	71.710	73.224	89.147	95.350
Debt	22.195	32.464	76.296	57.200	42.134

TOTAL	**113.073**	**131.873**	**168.370**	**163.864**	**146.684**

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 in £ millions

	2018/19 actual	**2019/20 forecast**	**2020/21 budget**	**2021/22 budget**	**2022/23 budget**
MRP	1.283	1.893	2.519	3.455	3.699
Use of Capital Receipts	0.000	3.466	0.000	17.027	0.000
Repayment of PFI/Leases	11.193	12.471	15.144	13.312	4.597
TOTAL	**12.476**	**17.830**	**17.663**	**33.794**	**8.296**

Each year the Council is required to agree a minimum revenue provision (MRP) policy for the 'prudent' annual repayment of debt associated with the financing of capital expenditure. The guiding principle of the regulations and statutory guidance is that MRP is charged over a period that is reasonably commensurate with the period over which the capital expenditure which gave rise to the debt provides benefits.

Since 2017/18, the Council has adopted the asset life (annuity) method (based on a prudent assessment of average asset life) for both 'supported' and 'unsupported' borrowing. In calculating the asset life (annuity) MRP, the average interest rates published by the Public Works Loans Board in the relevant financial year for new annuity loans will be used. Based on this policy, the estimated MRP in the 2019/20 is £2.519m.

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 by £58m 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 in £ millions

	31.3.2019 actual	**31.3.2020 forecast**	**31.3.2021 budget**	**31.3.2022 budget**	**31.3.2023 budget**

General Fund services	144.625	138.287	171.361	156.076	154.452
Council housing (HRA)	442.261	475.704	516.194	568.197	608.256
PFI/Leases	122.429	109.963	94.819	81.507	76.910
TOTAL CFR	**709.315**	**723.949**	**782.582**	**805.988**	**839.826**

The capital financing requirement for 2020/21 and subsequent years are likely to increase due to a change in the accounting for leases and the Private Finance Initiative. The implications of this are still being worked through and are not reflected in this version of the Capital Strategy. If necessary, the Capital Strategy will be revised in-year to reflect this change in accounting policy.

Asset management: To ensure that capital assets continue to be of long-term use, the Council is currently developing a new property/asset management strategy. This work is underpinned by the Council's ambition to:

- Establish an asset-enabled model of policy and service delivery that more effectively aligns the Council's asset base to the creation of a fairer place;
- Unlock maximum value from the Council's asset base for residents, staff & partners;
- Establish a unified governance framework and joined-up decision-making;
- Build an effective operating model to support delivery;
- Ensure we fully understand and tackle the maintenance backlog across our current asset base;
- Turbo-charge our house-building capacity; and
- Make public commitment to invest in a community asset base as a key part of the Council's civic leadership role.

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. Repayments of capital grants, loans and investments also generate capital receipts. The Council plans to receive £10m of capital receipts in the coming financial year as follows:

Table 5: Capital receipts receivable in £ millions

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
Asset sales	24.974	19.028	10.265	51.793	33.724
Loans etc. repaid	0.000	0.000	0.000	0.000	0.000

TOTAL	**24.974**	**19.028**	**10.265**	**51.793**	**33.724**

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

Due to decisions taken in the past, as at the end of January 2020, the Council had £297.6m long-term borrowing at an average interest rate of 3.90%, £39.0m short-term borrowing at an average interest rate of 0.79% and £117.5m treasury investments at an average rate of 1.11%.

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 6: Prudential Indicator: 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**
Debt (incl. PFI & leases)	415.649	412.073	473.225	517.113	554.650
Capital Financing Requirement	709.315	723.954	782.374	805.780	839.618

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.

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

	2019/20 limit	**2020/21 limit**	**2021/22 limit**	**2022/23 limit**
Authorised limit – borrowing	0.347	0.496	0.586	0.647
Authorised limit – PFI and leases	0.110	0.095	0.082	0.077
Authorised limit – total external debt	0.457	0.591	0.668	0.724
Operational boundary – borrowing	0.341	0.466	0.556	0.616
Operational boundary – PFI and leases	0.110	0.095	0.082	0.077
Operational boundary – total external debt	0.451	0.561	0.638	0.693

The authorised limit and operational boundary for 2020/21 and subsequent years are likely to increase due to a change in the accounting for leases and the Private Finance Initiative. The implications of this are still being worked through and are not reflected in this version of the Capital Strategy. If necessary, the Capital Strategy will be revised in-year to reflect this change in accounting policy.

Further details on borrowing are in the treasury management strategy (**Appendices G1-G3**).

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.

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.

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	105.0	70.0	70.0	70.0	70.0
Longer-term investments	10.0	5.0	5.0	5.0	5.0
TOTAL	**11.0**	**75.0**	**75.0**	**75.0**	**75.0**

Further details on treasury investments are in the treasury management strategy (**Appendices G1-G3**).

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.

Governance: Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Chief Financial Officer and staff, who must act in line with the treasury management strategy approved by Council. The audit committee is responsible for scrutinising treasury management decisions. Treasury management monitoring will be included, as appropriate, in the regular financial monitoring reports (including the financial outturn report) to the Executive. The Executive Member for Finance and Performance is also regularly briefed on treasury management activities.

Investments for Service Purposes

The Council makes investments to assist local public services, including making loans to and buying shares in subsidiaries that provide services. 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 break-even or generate a profit after all costs.

The Council's investments for service purposes currently total around £1.7m and include loans to and equity investments in Islington Limited (iCo), a wholly owned subsidiary providing local services, and three private companies responsible for managing schools under the Building Schools for the Future programme.

Governance: Decisions on service investments are made by the relevant service manager in consultation with the Chief Financial Officer. Further details on service investments are in the Investment Strategy (**Appendix G4**).

Commercial Activities

With central government financial support for local public services declining, the Council invests in commercial property purely or mainly for financial gain Total commercial property investments are currently valued at £32.7m.

With financial return being the main objective, the Council accepts higher risk on commercial investment than with treasury investments. Compared with other investment types, property is relatively difficult to sell and convert to cash at short notice, and can take a considerable period to sell in certain market conditions. To ensure that the invested funds can be accessed when they are needed, for example to repay capital borrowed, the Council ensures dwellings are of a type and location that is marketable and has proven demand. The Council also has scope to continue to generate an income stream whilst they are being marketed.

Governance: Decisions on commercial investments are made by senior officers in line with any 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.

Further details on commercial investments are in the Investment Strategy (**Appendix G4**).

Liabilities

The Council is committed to making future payments to cover its pension fund deficit (valued at £916.4m as 31.03.2019). This liability shows the underlying commitments that the Council has in the long run to pay retirement benefits. The Council has also set aside provisions to cover probable liabilities that can be measured reliably, the most significant of which is the insurance fund provision (£13.9m as at 31.03.2019). The insurance fund provision covers anticipated liabilities for Errors and Omissions, Libel and Slander, Motor (Third Party), Employers' Liability, Public Liability, Fire and other risks – up to a specific limit for any one claim. External policies cover claims in excess of these limits.

Governance: Decisions on incurring new discretional liabilities are taken by service managers in consultation with the Chief Financial Officer. The risk of liabilities crystallising and requiring payment is monitored by corporate finance and reported, as appropriate, in the regular financial monitoring reports to the Executive. There were no significant new liabilities incurred in 2018/19.

Further details on liabilities (including contingent liabilities that cannot be measured reliably) and guarantees are in the 2018/19 Statement of Accounts.
https://www.islington.gov.uk/~/media/sharepoint-lists/public-records/finance/financialmanagement/adviceandinformation/20192020/20190806lbislingtonstatementofaccounts201819.pdf

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 General Fund financing costs to net revenue stream

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
General Fund net financing costs (£m)	4.181	5.075	6.874	8.058	8.628
Proportion of net revenue stream	2.0%	2.4%	3.0%	3.5%	3.8%

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 could extend for up to 50 years into the future. The Acting Section 151 Officer is satisfied that the proposed capital programme is prudent, affordable and sustainable because the revenue costs of borrowing have been fully incorporated in the 2020/21 revenue budget and Medium Term Financial Strategy.

Knowledge and Skills

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

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.

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