Appendix E2: Capital Strategy Report 2022/23

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. It has been written in an accessible style to enhance members' understanding of these sometimes technical areas.

Decisions made this year on capital and treasury management will have financial consequences for the Authority 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 Authority 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 Authority has some limited discretion on what counts as capital expenditure, for example assets costing below £10,000 are not capitalised and are charged to revenue in year.

The council committed to a new Corporate Asset Strategy in March 2020. The strategy aims to establish a bold new approach that ensures investment is directly linked to core council ambitions around fairness and community wealth building. It is designed to deliver a strategic, long-term approach to managing and enhancing our community asset base.

In 2022/23, the Authority is planning capital expenditure of £215m (including expected reprofiling as at month 8 in 2021/22) as summarised below:

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

	2020/21 actual	2021/22 forecast	2022/23 budget	2023/24 budget	2024/25 budget
General Fund services	27.134	43.851	67.234	77.777	74.440
Council housing (HRA)	84.503	115.422	146.375	134.525	111.160
TOTAL	**111.637**	**159.273**	**213.610**	**212.302**	**185.600**

The capital programme will deliver £613m of capital investment over the next three years to support the achievement of council objectives. Key projects contributing to these objectives are summarised below along with spend over the next three years.

Decent and Genuinely Affordable Homes for All:
- Housing New Build Programme – the continuation of our major programme of investment in new social housing in Islington.
- Housing major works and improvements programme – ongoing investment in council homes and estates, including cyclical improvements, mechanical and electrical works, fire safety and energy efficiency improvements.
- New investment to support the redevelopment of Finsbury Leisure Centre, including over 100 new genuinely affordable homes.

Children and Young People:
- Improving our early years, schools, youth and play provision.

A Safer Borough for All:
- Upgrade to the council's core CCTV network and investment in CCTV-enabled vehicles to increase coverage for hot spots.

A Greener and Cleaner Islington:
- Continuing investment to support the council's Net Zero Carbon strategy.
- Vehicle electrification charging infrastructure and replacement of vehicles.
- People Friendly Streets and School Streets – borough-wide programmes to reduce car trips and improve neighbourhoods for walking, cycling and living.
- Investment in the borough's parks, open spaces and leisure facilities.

In addition to these programmes, the capital programme will support the effective management of Islington's infrastructure and estate. This includes:
- Structural maintenance of the highways infrastructure including carriageways, footways and drainage.
- Compliance and modernisation improvements to deal with urgent property compliance issues.
- Use of Community Infrastructure Levy and S106 payments to make targeted investment across the borough spending decisions led and managed by local ward councillors.

The capital programme also includes a new £10m investment pot to support key community priorities across the borough. Officers will work with members to agree how the pot is used, which may include:
- Tackling urgent maintenance and improvement backlogs.
- Providing top-up funding to ensure that in-flight schemes are completed or accelerated.
- Delivering new schemes.

Further work will be required to allocate this additional capital investment pot and plan delivery timescales. Once this work has been completed, the proposed revised capital programme will be set out in a report to Full Council during 2022/23. In the meantime, the £10m additional capital budget is currently profiled equally between 2023/24 and 2024/25.

Full details of the authority's capital programme are found at **Appendix E1**.

Governance: Oversight and governance of the capital programme is supported by a comprehensive framework of advisory boards with member and officer involvement:

- The Corporate Asset Delivery Board, comprised of officers and members, is accountable for the overall delivery of the corporate asset strategy, with oversight of all material asset and capital related decisions. It reviews the 10-year capital strategy and supporting annual programmes, subject to formal budget approval.
- The Major Projects Board, comprised of officers, is accountable for initiating and monitoring delivery of significant mixed-use developments including those led by development partners, as well as smaller but complex schemes cutting across different directorates and/or with complex stakeholder management issues.
- The Housing Delivery Board, comprised of officers and members, integrates governance of new homes delivery and major works across the council's existing stock.
- The Borough Investment Panel, comprised of officers and members, is accountable for recommending approval of all CIL/s106 investment decisions and spend oversight.
- A series of Directorate level programme delivery boards, comprised of officers, are accountable for all other asset development and capital programme activity and linked to wider Directorate governance arrangements.

In relation to the annual capital programme, service managers submit capital submission bid requests annually to include projects in the authority'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) and assess the overall affordability of the capital programme. This includes an assessment of the revenue implications of the projects as part of the revenue budget setting process.

A rigorous assurance and prioritisation exercise is then undertaken, assessing capital projects against their contribution to council priorities and their deliverability. The prioritisation process supports the council in making decisions about which project to progress, especially in an environment of challenging financial resources. All bids are appraised at Corporate Management Board who then make recommendations to members. The final capital programme is then presented to the Executive in January and to council in February each year.

- For full details of the Authority's capital programme, including the project appraisals undertaken, see **Appendix E1**.

All capital expenditure must be financed, either from external sources (government grants and other contributions), the Authority's own resources (revenue, reserves and capital receipts) or debt (borrowing, leasing and Private Finance Initiative).

The main sources of capital funding the council uses are summarised below:

- Capital Grants: predominantly government grants and are usually provided to the council for the specific use of funding capital expenditure for certain schemes and programmes (e.g. Department for Education funding for schools' condition works).
- Section 106/CIL: developer contributions towards infrastructure; Section 106 contributions relate to specific projects and outcomes.
- Capital receipts: 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 primarily generates capital receipts from the open market sale homes used to finance the building of the council homes.
- Other capital contributions: specific contributions received for projects from third parties who may have a specific output or benefit achieved through the capital works the council is providing (e.g. landlord/tenant contributions to modernisation works).
- Revenue contributions: direct revenue contributions towards capital expenditure, a minimal source of funding due to pressures on the revenue budget.
- HRA Reserves: direct funding from the HRA to support its capital programme through the use of the Major Repairs Reserve and revenue contribution to capital works.
- Borrowing: typically, Public Works Loan Board (PWLB) loans to support capital expenditure. This form of capital funding has revenue implications (i.e. interest and provision to pay back loan) which are accounted for as part of the budget setting process.

The planned financing of the above expenditure is as follows:

Table 2: Capital financing in £ millions

	2020/21 Actual £m	**2021/22 Forecast £m**	**2022/23 Budgeted £m**	**2023/24 Budgeted £m**	**2024/25 Budgeted £m**
General Fund					
Capital Grant	10.404	2.741	3.704	5.400	5.650
S106/CIL	0.849	1.880	6.919	7.094	0.104
Capital Receipts	4.923	12.328	16.139	15.558	0.573
General Fund Borrowing	10.958	26.902	40.475	49.725	68.113
Total General Fund	**27.134**	**43.851**	**67.234**	**77.777**	**74.440**
HRA					
Capital Grant	0.702	6.575	5.725	0.000	0.000

S106/CIL	6.547	0.826	3.143	0.500	0.500
Capital Receipts	22.718	19.705	39.681	61.003	42.323
Revenue Contributions	8.424	23.739	5.694	8.669	16.506
HRA Reserves	46.112	30.674	32.357	33.159	28.232
HRA Borrowing	0.000	33.902	59.776	31.194	23.599
Total HRA	**84.503**	**115.421**	**146.376**	**134.525**	**111.160**
Total Capital Programme	**111.637**	**159.272**	**213.610**	**212.302**	**185.600**

The largest risk in relation to capital financing relates to capital receipts, of which the council expects to generate £55m in 2022/23. All these projected capital receipts are from the open market sales of housing and are intrinsically linked with the housing new build capital programme. Given present economic conditions there is uncertainty around the timing and value of these receipts. To mitigate these risks the council maintains a regular review of the property market and has been prudent in its financial assumptions. Timing delays can largely be managed using HRA reserves. In the event of a decrease in projected capital receipts, the new build programme would need to be re-assessed in line with the overall available funding.

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 prior years' debt finance in £ millions

	2020/21 actual	**2021/22 forecast**	**2022/23 budget**	**2023/24 budget**	**2024/25 budget**
MRP	2.463	3.222	4.437	6.199	8.363
Use of Capital Receipts	0.000	10.939	0.000	0.000	0.000
Repayment of PFI/Leases	14.304	13.312	4.597	4.454	4.872
TOTAL	**16.767**	**27.473**	**9.034**	**10.653**	**13.235**

- The Authority's full minimum revenue provision statement is at **Appendix E4.**

Each year the council is required to agree a 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). 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 2021/22 is £3.222m.

The Authority'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 £91.217m during 2022/23. Based on the above figures for expenditure and financing, the Authority's estimated CFR is as follows:

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

	31/3/2021 actual	**31/3/2022 forecast**	**31/3/2023 budget**	**31/3/2024 budget**	**31/3/2025 budget**
General Fund services	141.096	153.837	189.875	233.401	293.151
Council housing (HRA)	466.254	500.156	559.932	591.126	614.725
PFI Liabilities	96.370	83.058	78.461	74.007	69.136
TOTAL CFR	**703.720**	**737.051**	**828.268**	**898.534**	**977.012**

Asset management: To ensure that capital assets continue to be of long-term use, the Authority plans to update the asset management strategy in Autumn 2022 following the results of stock condition surveys which are currently underway.

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 Authority plans to receive £52.549m of capital receipts in the coming financial year as follows:

Table 5: Capital receipts receivable in £ millions

	2020/21 actual	**2021/22 forecast**	**2022/23 budget**	**2023/24 budget**	**2024/25 budget**
Right To Buy (Gross)	9.473	11.968	12.265	12.570	12.882
Open Market Sales	0.618	23.268	27.784	28.471	17.843

Non-Right to Buy Sales	1.109	3.198	12.500	17.500	0.000
TOTAL	**11.200**	**38.434**	**52.549**	**58.541**	**30.724**

- The Authority's Flexible Use of Capital Receipts Policy (approved by Full Council in September 2021) is available here: Flexible Use of Capital Receipts Policy

Treasury Management

Treasury management is concerned with keeping sufficient but not excessive cash available to meet the Authority'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 Authority 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, the Authority currently has as at 31st January 2021, £278.275m borrowing at an average interest rate of 4.01% and £150.5m treasury investments at an average rate of 0.18%.

Borrowing strategy: The Authority'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 Authority 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 1.5 to 2.5%).

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

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

	31/3/2021 actual	31/3/2022 forecast	31/3/2023 budget	31/3/2024 budget	31/3/2025 budget
Debt (incl. PFI & leases)	467.979	356.333	441.987	518.452	605.293
Capital Financing Requirement	703.720	737.051	828.268	898.534	977.011

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 Authority expects to comply with this over the medium term.

Liability benchmark: To compare the Authority'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 was £229.909m as at 31st Match 2021 and is forecast to rise to £430.657m over the next three years.

Table 7: Borrowing and the Liability Benchmark in £ millions

	31/3/2021 actual	31/3/2022 forecast	31/3/2023 budget	31/3/2024 budget	31/3/2025 budget
Outstanding borrowing	371.609	273.275	363.526	444.445	536.157
Liability benchmark	229.909	388.775	479.026	559.945	430.657

The table shows that the Authority expects to remain borrowed below its liability benchmark in the short term and only rising above it in the last year of the strategy. This is because cash outflows to date have been below the assumptions made when the loans were borrowed.

Affordable borrowing limit: The Authority 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 8: Prudential Indicators: Authorised limit and operational boundary for external debt in £m

	2021/22 limit	2022/23 limit	2023/24 limit	2024/25 limit
Authorised limit – borrowing	323.275	463.526	494.445	586.157
Authorised limit – PFI and leases	93.058	88.461	84.007	79.136
Authorised limit – total external debt	416.333	551.987	578.452	665.293
Operational boundary – borrowing	298.275	413.526	469.445	561.157
Operational boundary – PFI and leases	88.058	83.461	79.007	74.136
Operational boundary – total external debt	386.333	496.987	548.452	635.293

- Further details on borrowing are available in the treasury management strategy (**Appendix E5**).

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 Authority'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 Authority may request its money back at short notice.

Table 9: Treasury management investments in £millions

	31/3/2021 actual	**31/3/2022 forecast**	**31/3/2023 budget**	**31/3/2024 budget**	**31/3/2025 budget**
Near-term investments	151.700	105.500	95.500	95.500	95.500
Longer-term investments	0.000	10.000	10.000	10.000	10.000
TOTAL	**151.700**	**115.500**	**105.500**	**105.500**	**105.500**

- Further details on treasury investments are available in the treasury management strategy (**Appendix E5**).

Risk management: The effective management and control of risk are prime objectives of the Authority'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 Director of Resources 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.

Investments for Service Purposes

The authority makes investments to assist local public services, including making loans to and buying shares in local service providers, local small businesses to promote economic growth, the authority's subsidiaries that provide services. In light of the public service objective, the authority is willing to take more risk than with treasury investments, however it still plans for such investments to break even after all costs.

Total investments for service purposes are currently valued at £2m with the largest being soft loans to employees of £0.952m providing a net return after all costs of 0%. This also includes loans to and equity investments in:

- Islington Limited (iCo), a wholly owned subsidiary providing local services, a loan of £0.05m;

- Three private companies responsible for managing schools under the Building Schools for the Future programme (a loan of £0.661m);
- A local charity (a loan of £0.090m);
- Equity investment in a private company responsible for managing schools under the Building Schools for the Future programme (fair value of £0.096m)

Governance: Decisions on service investments are made by the relevant service manager in consultation with the 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 can be found within the Investment Strategy at **Appendix E3**.

Commercial Activities

The council hold investment property (value of £32.6m as at 31/03/2021) in order to generate income to spend on services in Islington. The council has consistently taken a prudent approach to this – no new commercial properties have been purchased in recent years and there are no current plans to invest in commercial properties over the medium term. In November 2020 PWLB guidance was updated and PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield. The authority intends to avoid this activity in order to retain its access to PWLB loans.

The council also has a wholly owned subsidiary – Islington Limited (iCo), the purpose of which is to trade for profit with public bodies, private organisations and members of the public to provide a return to the council. The services provided by iCo are in activities related to municipal functions in which relevant expertise is held (for instance Commercial Waste, Tree Maintenance and Memorials). The council has loaned iCo £0.050m, which is due to be repaid in 2021/22.

Governance: If and when the council does engage in further commercial activity, the council will consider fully its risk exposure against financial returns in order to ensure that commercial investments remain proportionate to the size of the authority with appropriate contingency plans in place should expected yields not materialise. If the council did decide to make a commercial investment it is unlikely that the council would invest in assets outside of the borough and would only do so where there were strategic benefits for the council (e.g. in respect of regeneration).

Decisions on commercial investments are to be made by senior officers in line with the criteria and limits approved by council in the Investment Strategy. Property and most other commercial investments are also capital expenditure.

➢ Further details on commercial investments and limits on their use are available in the Investment Strategy (**Appendix E3**).

Liabilities

In addition to debt of £384m detailed above, the authority is committed to making future payments to cover its pension fund deficit (£249m as at the last valuation setting contributions – 31st March 2019). The council has also set aside provisions to cover probable liabilities that can be measured reliably. The most significant of these are the NNDR appeals provision (£9.9m as at 31/03/202 in terms of the council's share, £33.2m in total including the central government and GLA shares) and the insurance fund provision (£16.7m as at 31/03/2021). 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 Director of Finance and Director of Resources/Section 151 Officer. The risk of liabilities crystallising and requiring payment is monitored by corporate finance and reported as part of the annual closing of accounts process and as appropriate during the financial year. Corporate risks and risk management are also reported to Executive.

- Further details on liabilities and guarantees in the 2020/21 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.

Table 10: Prudential Indicator: Proportion of financing costs to net revenue stream

	2020/21 actual	2021/22 forecast	2022/23 budget	2023/24 budget	2024/25 budget
Financing costs (£m)	TBC	TBC	TBC	TBC	TBC
Proportion of net revenue stream	TBC	TBC	TBC	TBC	TBC

***The detailed estimates behind this prudential indicator are currently being updated and will be reflected in the final version of this document to Full Council on 3 March 2022.**

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 many years into the future. The Section 151 Officer is satisfied that the proposed capital programme is prudent, affordable and sustainable because revenue costs of borrowing have been fully incorporated in the 2022/23 revenue budget and MTFS. Additionally, the council is moving towards the development of a ten-year capital programme, and indicative requirements to 2031/32 are known. This enhanced long term budgetary planning will continue to be developed.

Knowledge and Skills:

The Authority employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. The Authority pays for junior staff to study towards relevant professional qualifications including CIPFA (Chartered Institute of Public Finance and Accountancy).

Where Authority staff do not have the knowledge and skills required, use is made of external advisers and consultants that are specialists in their field. The Authority currently employs Arlingclose Limited as treasury management advisers. This approach is more cost effective than employing such staff directly and ensures that the Authority has access to knowledge and skills commensurate with its risk appetite.