



CAPITAL STRATEGY  
& CAPITAL RECEIPTS STRATEGY

February 2020

## **CONTENTS**

1. Introduction
  2. Guiding Principles
    - 2.1 Approaches to Borrowing
    - 2.2 Long Term Liabilities
    - 2.3 Grant Allocations
    - 2.4 Capital Receipts and Capital Contributions
    - 2.5 Capital Receipts Strategy
    - 2.6 Revenue and Reserves
    - 2.7 Prioritisation and Approval
    - 2.8 Affordability and Sustainability of Proposals
    - 2.9 Management and Monitoring of Capital Plan
    - 2.10 Alternative Funding and Delivery Opportunities
    - 2.11 Investment Opportunities
    - 2.12 Proportionality of Council investments
    - 2.13 Asset Disposal Strategy
    - 2.14 Loans for capital purpose
    - 2.15 Capital expenditure and assets held by subsidiary companies
    - 2.16 Training and Skills
    - 2.17 Treasury Management Links
    - 2.18 Balance Sheet issues
  3. Head of Finance's Statement on Delivery, Affordability and Risk of Capital Strategy
- Appendix 1 - Summary of Assets financed from borrowing
- Appendix 2 - Definition of Capital Expenditure

## 1. Introduction

The Council has a range of capital resources at its disposal, which it uses to deliver services and to achieve its strategic objectives. These resources will include land and buildings, such as offices, schools, parks and open spaces, highways and much more.

The Council's ability to maintain these assets so as to ensure and to enhance their role in the delivery of services is crucial to its financial resilience. If assets fall into disrepair, they are no longer able to fulfil their primary purpose, then the Council's ability to deliver the associated services is impaired and it has resources tied up in assets that it cannot use.

Consequently, planning and managing the use of the Council's capital resources is vital. This includes understanding the role that these assets play in the delivery of services and ensuring that the authority's asset base remains fit for purpose.

The Corporate Asset Management Plan and the Transport Asset Management Plan provides information on the sustainability of these assets and the efficient use of the asset portfolio to provide value for money. These Plans are available on the Council's website at:

<https://www.torbay.gov.uk/council/policies/corporate/amp/>  
<https://www.torbay.gov.uk/council/policies/highways/transport-asset-management-plan/>

When incurring capital expenditure there is an element of risk that needs to be managed by the Council. This risk could be:

- whether an asset will deliver benefits projected
- the accuracy of the estimates of running costs and income at the time of acquisition
- and whether it is prudent to borrow for this expenditure.

Over the last few years local authorities, including Torbay, have been purchasing property to make an investment return. This investment has provided an income stream to the revenue budget and helped to offset some of the budget pressures arising from increased demand and reduced funding from central government. These assets will have different characteristics and risk especially where an authority has funded the acquisition through borrowing.

This Strategy and the Investment and Regeneration Fund Strategy show how this risk is managed. The relevant legal powers are identified in the Investment Strategy. The Investment and Regeneration Strategy is available on the Council's website at:

<https://www.torbay.gov.uk/council/policies/corporate/investment-strategy/>

Therefore the Capital Strategy provides a high level overview of how capital expenditure, capital financing, investments, liabilities and treasury management activity contribute to the provision of services, together with an overview of how associated risk is managed and the implications for future financial sustainability.

### 1.1 Regulation

Authorities are required by regulation to have regard to the **Prudential Code for Capital Finance in Local Authorities** when carrying out their duties in England and Wales under Part 1 of the Local Government Act 2003. **The key messages from the Code is, in relation to capital expenditure, the consideration of Prudence, Affordability and Sustainability.**

CIPFA's Prudential Code provides a framework for the self-regulation of the authority's capital financing arrangements. It requires local authorities to determine that capital expenditure and investment decisions are affordable, prudent and sustainable, and to set limits on the amount they can afford to borrow in the context of wider capital and revenue planning.

A Capital Strategy is part of the Prudential Code requirements and sets out the long-term context in which capital expenditure and investment decisions are made and that gives due consideration to both risk and reward and to the impact of the strategy on the achievement of the authority's priority outcomes.

The Capital Strategy will reflect the standards outlined in the **CIPFA Financial Management Code of Practice**. The first full year of compliance to the Financial Management Code will be 2021/22. The Council has started to work towards meeting the compliance date.

The Financial Management Code of Practice has been issued by CIPFA 'to provide guidance for good and sustainable financial management in local authorities and will provide assurance that authorities are managing resources effectively'. The Financial Management Code applies to all local authorities and brings together statutory requirements and Codes of Practice into one document.

In 2019 CIPFA issued a further publication regarding the provisions in the Prudential Code relating to the acquisition of investment properties. This is not new guidance but an explanation for existing guidance and considerations for undertaking such activity.

## 1.2 Objectives of the Capital Strategy

The Capital Strategy is one of the Council's key documents in providing a long/medium term plan. It will be consistent with the plans and strategies shown below. This Strategy should be considered with the following plans to provide a fully integrated transparent Plan for the Council:-

- The Corporate Asset Management Plan
- Transport Asset Management Plan
- The Medium Term Financial Plan
- The Capital Plan
- The Annual Revenue Budget
- The Treasury Management Strategy
- The Investment and Regeneration Fund Strategy

The Capital Strategy is therefore the policy framework document that sets out the principles to be used to guide the allocation of capital investment across all the Council's services and informs decisions on capital spending priorities within the Council's 4-year Capital Plan. In addition as part of the Strategy the Head of Finance reports explicitly on the affordability and risk associated with the capital strategy.

Inevitably the full picture of the control system around the Council's wide range of capital expenditure and its funding is reflected in a range of documents, monitoring and management arrangements. A summary of five key aspects of capital activities are shown in the table below

| Capital Expenditure  | Debt and Borrowing<br>Treasury<br>Management (TM)   | Commercial Activity   | Other Long-Term<br>Liabilities (e.g. PFI<br>schemes)  | Knowledge, Skills<br>and competence   |
|--|---|---|---|---|
| <ul style="list-style-type: none"> <li>•strategic service plans + asset management plans + capital strategy</li> <li>•pipeline process</li> <li>•capitalisation rules</li> <li>•long-term forecasts</li> <li>•basis of estimating future costs and sensitivity to risk</li> <li>•sustainability of the asset base</li> </ul> | <ul style="list-style-type: none"> <li>•projections of external debt and internal borrowing</li> <li>•how debt will be repaid</li> <li>•authorised limit and operational boundary</li> <li>•how TM decisions are made and how they are scrutinised</li> </ul> | <ul style="list-style-type: none"> <li>• proportional and affordability i.e. dependency of budget on commercial activity</li> <li>•proportionality on the balance sheet</li> <li>•policies for approval and scrutiny</li> <li>•on-going management</li> <li>•implications of borrowing</li> </ul> | <ul style="list-style-type: none"> <li>•identification and approval</li> <li>•on-going monitoring</li> <li>•creation of liabilities on the balance sheet</li> </ul> | <ul style="list-style-type: none"> <li>•knowledge and skills available</li> <li>• Professional Competence in specialist areas</li> <li>•use of advisers</li> <li>•training plans</li> </ul> |
| <b>Key Documents</b>   |   |   |   |   |
| <p>Capital Strategy</p> <p>Asset Management Plan</p> <p>Transport Asset Management Plan</p> <p>Council Reports</p> <p>Capital Budget</p> <p>Quarterly Budget Monitoring Reports</p> <p>Statement of Accounts</p>   | <p>Treasury Management Strategy</p> <p>TM Mid-Year Review</p> <p>TM Outturn Report</p> <p>Revenue Budget</p> <p>Medium Term Resource Plan</p>   | <p>Capital Strategy</p> <p>Investment and Regeneration Strategy</p> <p>Capital Budget</p> <p>Revenue Budget</p> <p>Medium Term Resource Plan</p> <p>Statement of Accounts</p>   | <p>Treasury Management Strategy</p> <p>Statement of Accounts</p>  | <p>Treasury Management Strategy</p> <p>Investment and Regeneration Strategy</p>   |
| <b>Key Committees and Meetings</b>   |   |   |   |   |
| <p>Council</p> <p>Cabinet</p> <p>Capital &amp; Growth Board</p>  | <p>Audit Committee</p> <p>Council</p>   | <p>Audit Committee</p> <p>Cabinet</p> <p>Council</p>  | <p>Audit Committee</p> <p>Council</p>   | <p>Audit Committee</p> <p>Cabinet</p>   |

Capital investment is technically described as: **Expenditure on the acquisition, creation, or enhancement of 'non-current assets' i.e. items of land, property and plant which have a useful life of more than 1 year.** A fuller definition is attached at Appendix 2. Expenditure outside this definition will be revenue expenditure.

Most non-current assets are properties that are used in service delivery. The Council's land, buildings and infrastructure asset base of some 3,700 asset records has a Balance Sheet value as at the 31<sup>st</sup> March 2019 of approx. £504 million (£445m as at 31/3/18), of which £149 million (£115m as at 31/3/18) are Investment Properties. Investment properties are 30% of the non-current asset base. The outstanding borrowing as at 31/12/19 was £375m with £18m of long term liabilities in relation to PFI schemes. The borrowing for investment properties is 57% of the outstanding borrowing as at 31.12.19

The Capital Strategy is presented to Council as a Policy Framework document, and links with both the Treasury Management Strategy, Medium Term Resource Plan and the Corporate Asset Management Plan which is the key **operational** asset plan covering repairs and maintenance.

In considering the principles, the Council needs a balance between guidance and prescription to allow a flexible approach to be taken but reflective of times of uncertainty. This Strategy focuses on the key policies for the allocation of capital resources to schemes in line with Council priorities and statutory responsibilities.

The management of the Capital Plan is also supported by the Council's approved Financial Regulations.

## **2. Guiding Principles**

### **2.1 Approach to Borrowing**

The Council is able to borrow money on the money market or from the Public Works Loans Board to fund capital schemes or, on a short term basis, use its own internal resources (i.e. cash flow). However for all capital schemes initially funded from borrowing, the Council will have to fund the principal repayment and interest costs, these ongoing borrowing costs are unavoidable.

The Council is only able to borrow under the guidance contained in the CIPFA Prudential Code whereby, in summary, the Council is required to ensure that all borrowing is both prudent and affordable. All schemes funded from prudential borrowing are approved by full Council, although in some cases approval of individual schemes within an overall allocation by Council have an alternative approval process (such as by Cabinet).

The Prudential Code was revised in December 2017 and requires authorities to ensure that decisions for capital expenditure and investment plans are made with sufficient regard to the long run financing implications and potential risks to the authority and include effective due diligence.

Based on the Council's latest Capital Plan update (Quarter 3 2019/20) the 2020/21 Treasury Management Strategy recognises the potential need to take an additional £255m (2020/21 to 2022/23) of borrowing in years (net of MRP) to support a number of capital projects, potentially increasing the Council's overall debt to be £635m.

Based on current economic forecasts a borrowing cost 3.5% should be assumed for new borrowing in 2020/21.

A summary of the Council's current and projected borrowing position identifying the approved schemes that have/will resulted in the borrowing are listed in Appendix 1. This is a useful summary for Members to understand the assets financed from borrowing.

The Council takes a prudent approach to new borrowing, paying particular regard to the robustness of the business case to include forward predictions of affordability, with the aim that projects should be self-funding (i.e. create a revenue stream so that the cost of borrowing is cost neutral on Council Tax). However the Council has changed its risk appetite in recent years and is now approving a significant number of projects that are more commercial in nature. All new proposals for a self-funding or invest to save scheme supported by borrowing must have a robust business case that is presented to senior members and officers prior to approval by Council.

Each business case, as appropriate, must clearly identify and consider the ongoing revenue implications of:-

- fixed interest and principal repayment costs
- associated income stream and sensitivity
- volatility of the income stream
- the contribution to the general fund or breakeven point
- the sensitivity of the that contribution
- achieve the target return linked to the purpose of the spend
- ensuring asset value exceeds outstanding debt
- Demonstrates value for money
- Project sustainability
- Exit strategy and costs

All of the above need to be considered for the whole life of the asset.

Each business case must clearly identify and consider the ongoing balance sheet implications of:-

- the change in the level of Council debt
- address how changes in asset value will be funded i.e. capital appreciation and impairment and the total of assets funded by borrowing
- Maintenance of asset to ensure sustainable use

To ensure all member are fully informed of the risks and rewards associated with borrowing reporting will include:-

- Total debt of the Council
- The underlying assets funded by that debt
- Affordability - Ongoing revenue costs of principal and interest
- Income Streams associated with that asset
- Implications of changes in asset values or income streams

To support its revenue budget the Council will continue to evaluate any capital investment projects either acting alone or with partners that will produce an ongoing revenue income stream for the Council.

There may be the need for borrowing that has no identifiable future revenue stream, for example, to repair or construct infrastructure assets. Here a broader view can be taken of the value of repairing the asset to the overall economy of the Bay. The cost of such borrowing falls on the tax payer through payments of debt interest on the Council's revenue account

and repayment of debt over a specified period of time. There may still be a need for such borrowing but each proposal should be reviewed on a case by case basis with the project evaluation clearly stating how the borrowing is to be afforded. Given the significant ongoing financial challenges facing this Council over the next few years it is likely that such schemes will be an “exception”.

The Council’s Treasury Management Strategy provides further information on the Council’s borrowing strategy for the coming financial year:-

<https://www.torbay.gov.uk/council/policies/finance-policies/treasury-management/>

## **2.2 Long Term Capital Liabilities**

The Council can also finance capital expenditure by means of a long term PFI contract, whereby the private sector company will build and then supply an asset (usually with services as well) back to the Council for a specified number of years. At the end of the contract the asset transfers to the ownership of the council. The value of the asset and the associated liability over the life of the contract to fund that asset is reflected on the Council’s balance sheet. As with borrowing, any Council decisions on agreeing contracts that result in a long term liabilities are made with sufficient regard to the long run financing implications and potential risks to the authority and include effective due diligence.

Council’s may also lease in assets for service delivery rather than purchase. Depending on the lease terms, including the length of lease, these assets and the associated liability over the life of the lease to fund that asset is reflected on the Council’s balance sheet. Changes in International Financial Accounting Standards (IFRS16) in relation to lease recognition from 2020/21 (with a restated comparative year of 2019/20) may result in more leased in assets and liabilities being reflected on the Council’s balance sheet.

## **2.3 Grant Allocations**

The Council receives capital grant funding from government and is able to bid for grant funding direct to particular government departments or from other grant awarding bodies. The funding from central government tends to be un-ring fenced and without conditions, however this funding is at a significantly lower level than in the last decade.

Any un-ring fenced capital grants received will be reported to Council. The presumption is that the grants will be allocated in line with the service intentions of the identified government body awarding the grant, however Council has the option to reallocate. Once capital grants have been allocated to a specific service, individual schemes within that allocation are subject to each individual scheme being approved by the relevant Director in consultation with the Leader of the Council and Head of Finance.

The Council continues to bid for additional external grant funding but restricts schemes to those which support corporate priorities or statutory service objectives and where it can be proved that the project is sustainable, and requirements for match-funding and future revenue consequences have been considered and approved. All bids are to be agreed with the Leader of the Council and Head of Finance prior to submission. Where external grants are used the grant conditions of linking to the capital grant and future use of the asset need to be adhered to.



In October 2019 Cabinet strengthened the governance around capital bids and acceptance of capital funding by resolving:

- (i) that Council Directors ensure that all bids submitted for their portfolio are checked by them for accuracy;
- (ii) significant decisions made by Officers should have formal Record of Decisions, irrespective of whether or not the legal test for their preparation is met;
- (iii) meetings, such as ones where the Leader and Group Leaders were consulted, should be minuted in the future;
- (vi) all future bids for Government money must be made and submitted in accordance with the Constitution; and
- (vii) that Officers ensure that the submission of all future bids are in accordance with Council Policies.

## **2.4 Capital Receipts and Capital Contributions**

The Council receives capital receipts and capital contributions from:

- Asset Disposals
- Right to Buy Clawback
- S106 and Community Infrastructure Levy (CIL)
- Repayment of loans for a capital purpose

### **Asset Disposals**

The policy is to pool all receipts from the sale of all assets sold to support the Capital Plan in line with funding the Council's priorities. The current Capital Plan has a capital receipts target to support previously incurred expenditure that has not yet been met. All capital receipts received should be allocated to support this target and not allocated to new schemes, subject to any potential use of capital receipts under the Capital Receipts Strategy and any loan repayment. An asset disposal will be deemed to occur when the Council transfers the freehold or a long lease (usually for leases over 40 years).

The Council will consider exceptions to this policy where rationalisation of assets used for service delivery is undertaken and in respect of school sites where the Secretary of State has approved the disposal – such exceptions will require Council decision.

The Council will aim to maximise its capital receipts, where possible, by enhancing the land prior to disposal; e.g. by obtaining planning permission or providing a development plan. As appropriate the Council may dispose of assets by tender or by public auction.

### **Asset Disposals at nil consideration or below market value**

In considering asset disposals, the Council will comply with its Asset Management Plan and the need to take into account the policy on Community Asset Transfers where the Council will consider, on a case by case basis, the potential transfer of assets to an alternative provider after a full assessment of the long term (full life) risks and rewards of the transfer, including the achievement of best value including potential market value, linked to the Council's aims and objectives.

The Localism Act 2011 introduced the “Community Right to Bid” and placed a duty upon local authorities in England to maintain a list of assets of community value. Once an asset is “Listed” any disposal will be under the Community Asset Transfer policy or for market value by tender/auction.

Where the Council proposes to dispose of, or grant a long lease, at nil consideration or at a value below market value this is required to be approved by Council. This will also apply where the disposal is for a community or service benefit.

### **Right-to-Buy Clawback**

100% of these receipts are currently used to support the provision of the approved Housing Strategy, although this policy could be reviewed to provide additional resources for projects in other service areas.

### **S106 contributions and Community Infrastructure Levy (CIL)**

S106 monies come from developer contributions through the planning system. Unless there are service specific conditions on the use of the S106, the monies should be used to support existing Council priorities and commitments rather than be allocated to new schemes. Any S106 monies received without a service or scheme specific allocation within the planning agreement will be allocated in line with Council’s capital scheme priorities.

Any monies received for infrastructure from the Community Infrastructure Levy will not be allocated to a specific service but will be allocated under the CIL arrangements (“the Regulation 123 List”) in line with Council’s capital scheme priorities including any specific funding requirements such as the South Devon Highway with the allocation of the “neighbourhood proportion” made after the funds have been received.

The current policy is to pool all capital contributions to support the Capital Plan in line with funding the Council’s priorities. The current Capital Plan has a capital contributions target to support the approved Plan that has not yet been met. All capital contributions received should, where possible, be allocated to support this target and not allocated to new schemes.

### **Repayment of loans for a capital purpose**

Where the Council provides a loan for a capital purpose this will be approved by full Council and accounted for as capital expenditure. The repayment of a loan by the borrower will be treated as a capital receipt; however any receipts of this nature will be specifically applied to reduce the value of the Council’s outstanding loan.

## **2.5 Capital Receipts Strategy**

MHCLG have revised their statutory guidance in relation to the Local Government Act 2003 on the use of capital receipts for the period from April 2016 to March 2022. This provides Councils with the flexibility to use capital receipts for “the revenue costs of service reform”. This flexibility is subject to a Strategy for the use of capital receipts being approved by full Council. By approving this document Council will be approving this flexibility to be used as appropriate with any use reported to Council as an amendment to the Council’s capital plan.

Potential uses for capital receipts, (subject to the capital receipts being received and Council approval of changes to capital plan), would be to support any implementation costs for the Council’s transformation programme. MHCLG within their statutory guidance have included a number of examples of the type of expenditure that would meet the definition of “revenue costs of service reform”.

The Council has used this flexibility in the past but there is no plan for its use in the 2020/21 revenue budget due to the lack of anticipated capital receipts.

## 2.6 Revenue & Reserves

The Council is able to use revenue funding and reserves for capital schemes. However, as a result of competing revenue budget pressures and the continued reduction in government support for revenue expenditure, the Council's policy is generally not to budget to use revenue or reserve funds to directly fund capital projects after the feasibility stage.

Once a revenue contribution has been applied to a capital project it cannot be returned to revenue. However the Council would be able, subject to the approval of the Head of Finance, to use prudential borrowing to replace any revenue or reserve funding used or proposed to be used. This will result in a **one off** return of revenue funding to the Council's revenue budget offset by higher MRP and interest costs to fund the prudential borrowing costs in future years.

## 2.7 Prioritisation and Approval

It is always difficult to make choices between competing priorities within a top tier Council that delivers so many varied services. It is the responsibility of senior officers and members to consider and prioritise the competing demands for capital resources in the context of the limited central government funding now awarded.

The Council maintains and reports on a rolling four year capital plan (including its funding) that is updated and reported to Senior Leadership Team and Members on a quarterly basis. The capital plan will include any capital expenditure approvals by Council in the previous quarter.

The key stages in the Council's prioritisation and approval process are as follows:

- 1) A service can submit a capital business case for consideration by the Head of Finance and the officer Capital and Growth Board at any stage of a financial year. The capital business case will be linked to that service's needs.
- 2) For a specific scheme to be approved/funded there will be a requirement for a detailed capital business case. The capital business cases are to be initially submitted to both the Head of Finance and the officer Capital and Growth Board prior to wider consultation with the Council's senior leadership team and the Executive.

If a scheme is to be funded from (previously approved by Council) allocations the scheme will be approved as stated in the approval or, if the approval process not stated, by the Chief Executive in consultation with the Cabinet Lead for Finance and Head of Finance and progressed when funding confirmed or,

if new (confirmed) funding is to be used for a scheme to be funded by, say, a specific grant and if the scheme is supported by the Chief Executive, in consultation with the Cabinet Lead for Finance and Head of Finance, it will be reported to Council.

If funding has been allocated by Council to a service without individual schemes being identified at the time of approval, (such as a general allocation to schools for "basic need" projects), individual schemes within that allocation are subject to each individual scheme being approved by the Chief Executive in consultation with the Cabinet lead for Finance.

- 3) Proposals for invest to save or self-financing schemes, (usually financed from prudential borrowing), will also require a detailed capital business case. The capital business case are to be initially submitted to the Head of Finance and the officer Capital and Growth Board. If the scheme is supported it will be recommended to Council for approval.
- 4) Any recommendations for schemes to be approved by Council will be included in the next quarterly Capital Plan Update Report.
- 5) Other schemes that do not require financial support but include the use of Council assets as a Council contribution to a scheme will also be subject to the Council's approval process.
- 6) Where there is a proposal to transfer capital resources from a previously approved scheme to a new scheme and there is a change of "policy", the new scheme will be approved by Council.
- 7) Where specific approval process has been set up and approved by Council e.g. Cabinet for Investment Fund or Regeneration Fund purchases or Head of Finance for Housing Company loans that process will apply.

## **2.8 Affordability and Sustainability of Proposals**

The Prudential Code also requires that, in making its capital investment decisions, the Council should have explicit regard to option appraisal and risk, asset management planning, strategic planning for the authority and achievability of the forward plan.

The Capital Business Case will identify the projected running costs and financing costs of the relevant asset and assessed the affordability of the proposals both for the initial investment and over the life of the asset. In all cases the capital expenditure and any ongoing costs must be sustainable in relation to the Council's medium term financial plans.

These to include consideration of:

- service objectives, e.g. strategic planning for the authority;
- stewardship of assets, e.g. asset management planning;
- value for money, e.g. option appraisal;
- prudence and sustainability, e.g. risk, implications for debt and whole life costing;
- affordability, e.g. implications for council tax/district rates; and
- practicality, e.g. achievability of the forward plan.

Where an asset is directly linked to generating an income or rental stream, such as an Investment Property, the initial Capital Business case (or Council report) will need to consider the future risks to those revenue returns and how these will be mitigated. This may result in the creation of an earmarked reserve for both income volatility and future asset related expenditure.

## **2.9 Management and Monitoring of Capital Plan**

The key objective of the Council's management and monitoring of the Capital Plan is to ensure that all Members and the Council's senior leadership team, have visibility of the capital plan and the approval of individual capital projects to encourage collective responsibility for the capital expenditure on a project and the success of the schemes themselves.

The Council's senior leadership team should ensure that progress against the programme – in terms of expenditure and timescales – is in line with what has previously been agreed. Where projects are exhibiting cost overruns or delays in the completion schedule, these should be addressed promptly.

Arrangements to include:-

- 1) Overview and Scrutiny Board and Cabinet will receive 3 quarterly monitoring report and one outturn report each year.
- 2) A Capital budget for forthcoming year will be part of each financial year's budget proposals
- 3) The officer Capital and Growth Board now reviews the Council's Capital Plan and the governance arrangements associated with its various projects
- 4) Senior Leadership Team and the Cabinet to have responsibility for the oversight and challenge on the delivery of the capital plan including slippage and outcomes.
- 5) Capital business cases are to be initially submitted to both the Head of Finance and the officer Capital and Growth Board prior to wider consultation with the Council's senior leadership team and the Executive.

## **2.10 Alternative Funding and Delivery Opportunities**

As Council capital funding is reduced the Council will continue to consider other methods of supporting capital expenditure within the Bay, using alternative funding, such as social investment, private sector finance and third sector funding or by other bodies delivering capital schemes instead of the Council.

The Council can use its assets to support schemes or aim to maximise funding from any source possible, such as Local Enterprise Partnership funding.

The Council continues to bid for additional external funding and/or work with other bodies to secure capital investment or consider use of its own assets in a development, but restricts schemes to those which support corporate priorities or statutory service objectives and where it can be proved that the project is sustainable, and requirements for match-funding and future revenue consequences have been considered and approved along with an assessment of the opportunity costs of alternative options. All schemes are to be agreed with the Cabinet Lead for Finance and Head of Finance prior to submission and/or contractual commitment.

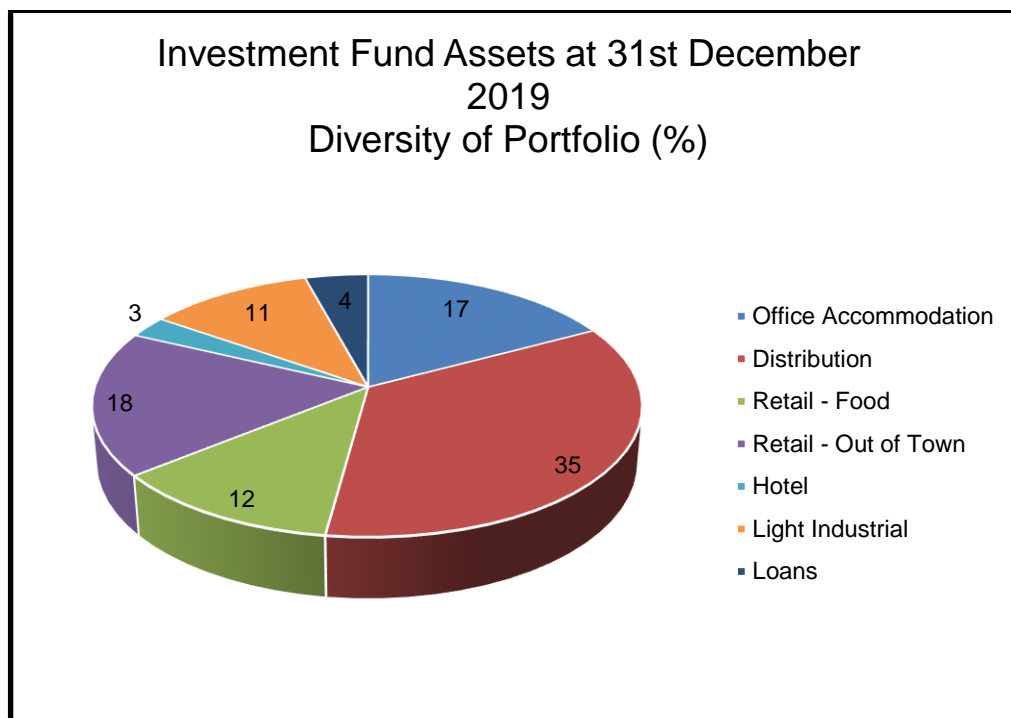
## 2.11 Investment Opportunities – Non Treasury Investments

Linked to its approach to borrowing and the Council's Investment and Regeneration Strategy the Council will consider, if the opportunities arise and there is a "multiple benefit", the purchase of land and property as an investment – to both generate an ongoing income stream or to realise an increased capital value in the future. CIPFA has classified investment properties as a Non Treasury Investment for reporting purposes and included in the Treasury Management Code of Practice.

The Council will continue to review the both the MHCLG statutory guidance and any sector led commentary and opinions associated with this activity.

The risks associated with investment properties and the Council's strategy in mitigating these risks are outlined and described in the Council's Investment and Regeneration Fund Strategy last update approved by Council in July 2019. Council has now set the investment boundary to the Greater South West peninsula and the Functional Economic Market Area (FEMA). The Council has received counsel opinion that it could purchase investment properties on a national basis with the diversification of the Council's property portfolio, and therefore its risks, over a range of sectors and geographical locations. This approach has yet to be formally agreed with the Council's external auditor.

At the 31<sup>st</sup> December the Council had invested of the approved Investment Fund in the following sectors to ensure diversification.



The Council's Treasury Management Strategy Statement also includes references to the monitoring and reporting of the Council's Non Treasury Investments (NTI). The Strategy is available on the Council's website at:-

<https://www.torbay.gov.uk/council/policies/finance-policies/treasury-management/>

## **2.12 Proportionality of Non Treasury Investments**

Throughout this Strategy the impact of Non treasury Investments have been considered but in this section specific indicators are provided in relation to proportionality. There are two main aspects to the proportion of investment property held:-

### Income (see 3.2)

To monitor the reliance of the revenue budget on income generated from these investments an indicator should be set based on, the ratio of commercial income to net service expenditure.

It is considered that the revenue account could reasonably absorb in year unexpected shortfalls at this level:-

- as any known potential rental shortfalls have been built into the revenue budget
- considering the diversification within the Council's portfolio it is unlikely all properties would be affected at the same time
- a reserve is held for rental "events" such as void period or rent free periods.

It should be noted that if an investment property is sold the funds received will be a capital receipt and cannot be taken to the revenue account e.g. to offset the loss of an income stream.

### Financing Costs- affordability (see 3.2)

Ratio of financing costs to net revenue stream. This indicator identifies the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream For Torbay investment income includes income from investment fund properties and the effect of this is also shown.

## **2.13 Asset Disposal Strategy**

Purchases of assets are primarily to be retained in the long term. However the benefit of selling the assets will be regularly reviewed by Director of Place in consultation with the TDA Head of Estates for potential disposal at which point any outstanding debt will be repaid. The review will need to consider the resulting impact on the Council's revenue budget and any impact of operational delivery from the lost income stream and any costs of disposal.

## **2.14 Loans for Capital Purposes**

Loans for a capital purpose can also be approved by full Council subject to a business case and due diligence on the borrower including as appropriate guarantees and bonds to secure the repayment of the loan. The loan value should not exceed the value of the underlying asset and there should be no third parties legal charge on the asset. Interest will be charged on the loan at a market rate, this will include loans to Council subsidiary companies. This will ensure compliance with State Aid regulation.

## **2.15 Capital expenditure and assets held by wholly owned subsidiary companies**

The Council has overall control of these entities and therefore is ultimately responsible for the companies' assets and liabilities. The controls of any subsidiary's activities are controlled by the Council's through 'reserved matters' listed within the memorandum and articles of

association of the company. These 'reserved matters' cover capital expenditure and the making of any borrowing. The assets and liabilities of all council companies would be consolidated into the Council's group accounts.

As these capital assets and liabilities are part of the council's overall financial position the Council will report on the total group assets and liabilities and the associated risk and reward.

## **2.16 Training and Skills**

The Council needs to ensure that all decisions in relation to capital are properly informed.

Linked to the Treasury Management Strategy a list of officers and members and their relevant qualifications and training undertaken will be maintained. Training will be provided as required.

In relation to skills the Head of Finance, Monitoring Officer and Director of Place will ensure that the appropriate expertise is always resourced in relation to any financial, legal and asset related due diligence required.

Due to the complexities associated with commercial property investment training has been provided to officers and members to provide sufficient competence to understand and evaluate the advice they are being given and to enable decision making within the authority's risk appetite.

The Council's knowledge and skills will be complemented by the use of advisers and agents as required.

## **2.17 Treasury Management Links**

All capital decisions to be funded by prudential borrowing will directly impact on the Council's Treasury Management activities. The level and timing of the capital expenditure will be reflected in the capital plan once approved and in the strategic cash flow forecasts to plan for the required borrowing. The resulting costs (Interest and MRP, an average cost of 5% of capital cost) and any income to fund those costs will be included in the standard budget monitoring and budget setting process.

Total borrowing will also be monitored by the annual setting of both the Operational and Authorised Limits (for borrowing).

## **2.18 Balance Sheet Issues**

The impact of capital projects and any prudential borrowing used have an impact on the Council's balance sheet.

- 1) Increase in the value of the Council's non-current assets
- 2) Increase in the value of Council's long term debtors (if capital loan provided)
- 3) Increase in the Council's long term borrowing
- 4) Maturity profile of borrowing and repayment of borrowing
- 5) Profile of capital loan repayments
- 6) Increase/decrease in Capital Financing Requirement (CFR) - borrowing offset by MRP.
- 7) Annual depreciation on operational assets
- 8) Annual revaluation or impairment on operational assets
- 9) Annual valuations of investment properties
- 10) Impact on Council's cash flow in delivery stage or on purchase
- 11) Impact on Council's cash flow at time of borrowing



The value of non-current assets should always aim to exceed the value of the outstanding liabilities. In addition the value of the outstanding liabilities should not exceed, in the medium term, the Capital Financing Requirement (which is the measure of a Council's underlying need to borrow).

### 3. Head of Finance Statement on Delivery, Affordability and Risk of Capital Strategy

#### 3.1 Background

The current guidance for a council's level of borrowing is the Prudential Code (December 2017) and as "proper practice" must be adhered to. The following extracts from the Code summarise the Code's approach to level of borrowing (self-regulating) and the governance that should apply.

"the local authority shall ensure that all its capital and investment plans are affordable, prudent and sustainable.

'A local authority shall determine and keep under review how much money it can afford to borrow.'

"the level of capital investment that can be supported will, subject to affordability and sustainability, be a matter for local discretion"

"a local authority must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed"

#### 3.2 Torbay Council Borrowing Position

| All borrowing  | Estimate 20/21<br>as at 31/12/19 | Projected as at<br>31/3/23 |
|--|----------------------------------|----------------------------|
|  | £m                               | £m                         |
| External Borrowing including PFI                     | 394                              | 635                        |
| <i>Of which investment fund</i>                      | 235                              | 300                        |
|  | 2020/21                          | 2022/23                    |
| Revenue budget                                       | £116m                            | £116m                      |
| Interest and repayment of principal costs per annum  | 21                               | 31                         |
| Interest repayment cost as a % of net revenue budget | 18%                              | 27%                        |
| Investment Fund Rental Income (estimate)             | (£15m)                           | (£18m)                     |

#### Potential impact of investment market fluctuations

1. Value of rental income on investment properties decreases by 10%. Assuming £300m invested, revenue budget will have a shortfall of £3.0m pa.
2. Value of underlying asset decreases by 10%. Assuming £300m invested and no capital appreciation, balance sheet value will fall of £30m as an unrealised loss.
3. General economic conditions may affect the both the rental income and asset values such as economic downturn, post Brexit sentiment and the retail environment. Locally tenants may choose not renew leases or re-negotiate a lower rental.

### 3.3 Summary of the borrowing position

It can be seen that the risk principally lies in the Council's investment portfolio. The remainder of the borrowing is linked to a range of operational assets which are expected to be used in the long term and have a full provision for the full recovery of principal over the asset life. All operational assets are supported by a robust business case and while there is a risk in income returns not being achieved overall these are not significant.

In relation to investment properties these are more sensitive to the market fluctuations identified above. A MRP is applied to repay the borrowing over the estimated asset life (up to the maximum 50 year asset life identified in the MHCLG Statutory Guidance). An Investment Fund reserve is used (funded from rental income) to mitigate against future income volatility on these assets which is reviewed by the Chief Finance officer for adequacy on an annual basis.

Due to the current low borrowing rates the Council has fixed all of its loans and adopted a flat maturity profile, this mitigates the risk of increasing rates in the long term. However borrowing will increase the council's fixed interest and borrowing costs to be in excess of £20m in 20/21, which will be an annual charge to the revenue budget. This fixed cost is partially offset by income streams from the assets funded from borrowing.

### 3.4 Head of Finance Report

Within the Prudential Code It is the responsibility of the Chief Finance Officer to explicitly report on the delivery, affordability and the risks associated with this Strategy.

#### Delivery

The delivery of the individual schemes on the plan are directly linked to the original approval of the capital project supported by each project having a client officer and an project manager who are responsible for the delivery of the project (appropriate skills, contracting, planning etc.) and the subsequent achievement of the objectives of that project.

Members, via Overview and Scrutiny and Cabinet receive quarterly updates to the capital plan. These updates are driven by the requirement by financial reporting, however in doing so Members can review and challenge the delivery of projects and any changes to both the timing and value of the capital plan.

If subsequent to the capital project being completed there are variations to the income expected to be generated from that asset, these will be reported as a variance in the quarterly revenue budget reporting and if ongoing be included in the following years revenue budget proposals.

The Council's senior leadership team has oversight for the delivery of and challenge to the capital plan.

#### Affordability

Affordability is critical in applying the capital strategy and approving projects for inclusion in the capital plan. This is mostly demonstrated by a specific report on the project being presented to council for approval supported by a business case identifying the expenditure and funding, appraisal of alternative options and the risks and rewards for the approval of the scheme.

All projects need to have a clear funding source. If external funding such as an external grant is to be used there needs to be a clear funding commitment.

Affordability of each project needs to be clear, not only for the funding of the capital spend, but also to cover any ongoing costs of the operation and funding of that capital spend.

Where borrowing is to be used the affordability is key and that affordability has to include the interest costs of that borrowing and the provision for the repayment of the borrowing. This repayment is matched to a prudent asset life and any income streams estimated to fund this asset must be sustainable. The “rules” around the governance of this borrowing is outlined in the prudential code (as summarised above).

At no stage should the asset value be lower than the value of outstanding debt, other than for a short period, unless there is a clear plan to mitigate that shortfall or to sell that asset.

### Risks

The risks associated with a significant capital plan and a significant level of borrowing can be mitigated and indeed should be mitigated as “business as usual”. I.e. all capital projects are supported by business plan, have adequate project management and/or project boards, suitable skills for the delivery of the project, tax planning, cash flow, clear operational plan for the use of the asset, use of specific committees, security and due diligence on loans and purchases, use of external advice where appropriate, project contingencies, full tender process and regular and transparent reporting to members.

There are clear links from the capital plan to both the treasury management strategy, prudential indicators, authorised borrowing limits and the revenue budget. These are also subject to review and oversight by members at Audit Committee and Council.

For any new borrowing, and this is a greater risk as the value of borrowing increases, this does increase the councils overall liabilities that will need to be repaid in the future. In addition this increases the Council’s level of fixed interest and repayment costs that it will incur each year. This is currently increasing rapidly and could exceed a borrowing liability of £635m and ongoing fixed costs of approx. £31m per annum by 2022/23. This is a clear risk that all members need to be aware of.

However this risk for all assets is mitigated by a robust business case and a full MRP that will repay the borrowing costs over a (prudent) asset life. Any variation in expected income is an issue however given the wide range of operational assets and different income streams this is not a significant risk.

As outlined above in the position statement, investment properties are a different type and level of risk. Risk arises from both variations in income streams (tenant non-renewal etc.) and from asset values (impact economic conditions and retail trends etc.). The Council has established a clear strategy, criteria and a governance route for these purchases (Cabinet and Council) which has included member training, second opinion on asset values, due diligence, site visits, surveys etc.

The Council is aware of the risks relating to investment into commercial property and ensures appropriate advice is sought before, during and after investment decision making. Due to the nature of commercial investment, advice has been sought from advisers and agents with specialist knowledge and the experience required.

There are risks (and rewards) associated with the purchase of this type of assets, therefore all members need to have sight of, and understand the risks and rewards inherent in these commercial investments.

## **Conclusion**

The current system of borrowing is still a self-regulatory system which means that responsibility for borrowing decisions, and the level of borrowing incurred by a Council are determined at a local level. In particular elected members have a key role.

“..the responsibility for decision making and ongoing monitoring in respect of capital expenditure, investment and borrowing, including prudential indicators, remains with full Council”. Prudential Code December 2017

The Head of Finance’s personal view is that borrowing decisions result in a long term commitment to fund that borrowing, and that all decision making should be as transparent as possible both to all Members and the residents of Torbay.

The pace and level of change in the council’s borrowing is significant. The Council’s capital financing requirement, its underlying need to borrow, by the end of 2022/23 could be £635m with a £31m ongoing revenue cost (assuming a 5% annual cost of MRP and interest) offset by rental or interest income from capital expenditure with a revenue stream.

Therefore all members need to be fully informed as to all implications of its capital investment decisions, in particular those funded from borrowing.

Summary of Assets funded by Council Borrowing

Appendix 1

|  | Borrowing Cost | Total Repayment period | Income Stream or saving to cover Debt |
|--|----------------|------------------------|---------------------------------------|
|  | £m (rounded)   | years                  |                                       |
| <b>DCC Transferred Debt</b> from 1998  | 18             | 50                     |                                       |
|  |                |                        |                                       |
| <b>Supported Borrowing</b> – mostly schools and transport spend from 1998 to 2010. | 73             | 50                     |                                       |
| <b>Sub Total:</b>  | <b>91</b>      |                        |                                       |
| <b>Individual Schemes funded or part funded from borrowing (&gt;£1m rounded)</b>   |                |                        |                                       |
| Beach Chalets  | 2              | 10/25                  | Yes                                   |
| Brixham Regeneration   | 4              | 40                     | Yes                                   |
| Car Parks  | 1              | 25                     | No                                    |
| Haldon pier  | 2              | 25                     | No                                    |
| Inner harbour pontoons   | 1              | 25                     | Yes                                   |
| Office Rationalisation   | 7              | 25                     | Yes                                   |
| Paignton Library   | 3              | 40                     | Yes (Part)                            |
| Princess Promenade   | 2              | 25                     | No                                    |
| South Devon Highway  | 15             | 40                     | No                                    |
| Street Lighting  | 1              | 4                      | Yes                                   |
| Toilets  | 1              | 25                     | No                                    |
| Torquay Town Dock  | 1              | 25                     | Yes                                   |
| Capital loan – Kings Ash House   | 1              | 25                     | Yes                                   |
| Wren Park – Investment   | 21             | 50                     | Yes                                   |
| Ferndown – Investment  | 27             | 50                     | Yes                                   |
| Gadeon House – Investment  | 17             | 50                     | Yes                                   |
| Fugro House – Investment   | 21             | 50                     | Yes                                   |
| Capital Loan - South Devon College   | 4              | 100                    | Yes                                   |
| Capital Loan – Care Home   | 1              | 25                     | Yes                                   |
| Employment Space – White Rock  | 7              | 25                     | Yes                                   |
| Medway – Investment  | 32             | 50                     | Yes                                   |
| Clennon Valley Improvements  | 2              | 12                     | Yes                                   |
| Woodwater House – Investment   | 10             | 50                     | Yes                                   |
| Twyver House - Investment  | 13             | 35                     | Yes                                   |
| The Range - Investment   | 9              | 35                     | Yes                                   |
| Factory Unit Bodmin - Investment   | 3              | 35                     | Yes                                   |
| Edginswell Business park - Land  | 3              | 40                     | Yes                                   |
| Brixham Breakwater   | 1              |                        |                                       |
| <b>Sub Total:</b>  | <b>212</b>     |                        |                                       |
| <b>Total Borrowing Requirement – as at 1/4/19 (Actual debt £303m)</b>              | <b>303</b>     |                        |                                       |

|   |              |       |            |
|---|--------------|-------|------------|
| <b>2019/20 Individual Schemes funded or part funded from borrowing</b>  |              |       |            |
| Torwood Street – Loan – Investment                                      | 9            | 10    | Yes        |
| Distribution Depot, Exeter – Investment                                 | 15           | 50    | Yes        |
| Hotel, Chippenham - Investment  | 6            | 35    | Yes        |
| Distribution Centre, Didcot - Investment                                | 35           | 40    | Yes        |
| Cinema, Taunton - Investment  | 11           | 40    | Yes        |
| Fleet Vehicles  | 3            | 7     | No         |
| Capital Loan – Business Units   | 2            | 25    | Yes        |
| Toilet Reprovision  | 1            | 25    | Yes        |
| Paignton Harbour Lights   | 1            | 25    | Yes        |
| Retail Property   | 17           | 35    | Yes        |
| Town Centre Regeneration  | 2            | 35    | Yes        |
| Investment Fund   | 4            | TBC   | Yes        |
| MRP in year   | (5)          |       |            |
| Sub Total:  | <b>101</b>   |       |            |
| <b>Total Borrowing Requirement – as at 31/12/19 (Actual debt £375m)</b> | <b>£404m</b> |       |            |
|   |              |       |            |
| <b>Borrowing approved but due to be spent in future years</b>           |              |       |            |
| Old Toll House  | 1            | 35    | Yes        |
| Claylands Redevelopment   | 7            | 25/40 | Yes        |
| Edginswell Business park - building                                     | 4            | 25/40 | Yes        |
| Major Structural Repairs  | 1            | 25    | No         |
| South Devon Highway (Remainder)   | 1            | 40    | No         |
| Town Centre Regeneration (TCR)  | 14           | 25    | Yes        |
| Harbour View Car Park – TCR   | 9            | 35    | Yes        |
| Capital Loan – Housing Company  | 25           | 25    | Yes        |
| Regeneration Fund   | 99           | TBC   | Yes        |
| Balance of Investment Fund  | 65           | TBC   | Yes        |
| Crossways   | 10           | TBC   | Yes        |
| Fleet Vehicles  | 2            | 7     | No         |
| RICC Improvements   | 2            | 25    | Yes/(part) |
| Sub Total:  | <b>240</b>   |       |            |
| <b>Estimated Borrowing Requirement – as at 31/3/21</b>                  | <b>644</b>   |       |            |
|   |              |       |            |
| <i>PFI Schemes – EFW &amp; Schools</i>                                  | 18           | 25    | No         |
| <i>MRP and Debt Repayment</i>   | (27)         |       |            |
| <b>Estimated Capital Financing Requirement – as at 31/3/23</b>          | <b>635</b>   |       |            |

Note: The **capital financing requirement** is a calculation based on the Council's balance sheet to reflect the Council's underlying need to borrow to finance its capital expenditure. This calculation also includes any other long term financing of its assets such as PFI schemes and finance leases. Actual borrowing may be higher or lower than the capital financing requirement at a point in time, but in the medium term actual council borrowing and asset related liabilities should not exceed this value.

## Appendix 2 – Definition of Capital Expenditure

Capital investment is simply described as:

**Expenditure on the acquisition, creation or enhancement of “non-current assets”**

(non-current assets are items of land & property which have a useful life of more than 1 year)

This definition of capital expenditure that the Council has to comply with for the classification and, therefore, the funding of capital expenditure is linked to International Financial Reporting Standards. “Qualifying Capital Expenditure” under s25 of Local Government Act 2003 is defined when:

***“The expenditure results in the acquisition, construction or enhancement of fixed assets (tangible and intangible) in accordance with “proper practices””***

“Proper Practice” (from 01/04/10) is under International Financial Reporting Standards (IFRS) rules. The relevant standard is IAS16 which has the following definition of capital expenditure:

**“Expenses that are directly attributable to bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by management”.**

“Directly attributable” i.e. if building a school – costs linked to the actual construction of the building, not temporary accommodation, moving people around etc.

Subsequent Capital Expenditure on an asset is defined as:

**“Expenses that make it probable that future economic benefits will flow to the authority and whose cost can be measured reliably”** Subject to..... “if the expenditure is to replace a component, the old component must be written out of the balance sheet”.

Future economic benefits i.e. it is not necessary for the expenditure to improve the condition of the asset beyond its previously assessed standard of performance – the measurement is against the actual standard of performance at the date of expenditure; e.g. if service potential or asset life is increased.