Cherwell District Council

Capital Strategy 2020/21

Including Minimum Revenue Provision (MRP) Statement

1 Introduction

1.1 The capital strategy was a new report introduced in 2019/20, giving a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of local public services along with an overview of how associated risk is managed and the implications for future financial sustainability. It has been written in an accessible style to enhance members' understanding of these sometimes technical areas.

1.2 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.

2 Capital Expenditure and Financing

2.1 Capital expenditure is where the Council spends money on assets, such as property or vehicles, which will be used for more than one year. In local government this includes spending on assets owned by other bodies, and loans and grants to other bodies enabling them to buy assets. The Council has some limited discretion on what counts as capital expenditure, for example assets costing below £10,000 are not capitalised and are charged to revenue in year.

For details of the Council's policy on capitalisation, see Financial Regulations

In 2020/21, the Council is planning capital expenditure of £47.1m 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
Services	9.7	15.0	0	0	0
Capital investments	20.1	35.5	47.1	1.7	1.0
TOTAL	29.8	50.5	47.1	1.7	1.0

2.2 The main capital projects include the Build! Programme, Castle Quay 1 and 2 and the Sunshine Centre.

Governance

2.3 Service managers bid as part of the annual budget setting process, and throughout the year, to include projects in the Council's capital programme. Bids are collated by the Finance and a calculation of the financing cost is undertaken (which can be nil if the project is fully externally financed). The Budget Planning Committee appraises all bids based on a comparison of service priorities against financing costs and makes recommendations to the Executive. The final capital programme is then presented to Council in February each year.

2.4 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	3.2	1.3	1.0	1.0	1.0
Own resources	5.4	5.5	5.0	4.0	4.0
Debt	21.2	43.7	41.1	(3.3)	(4.0)
TOTAL	**29.8**	**50.5**	**47.1**	**1.7**	**1.0**

2.5 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**
Own resources	5.4	5.5	5.0	4.0	4.0

The Council's full minimum revenue provision (MRP) statement is included at Appendix A below.

2.6 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 £38.8m 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

	2018/19 actual	**2019/20 forecast**	**2020/21 budget**	**2021/22 budget**	**2022/23 budget**
TOTAL CFR	**146.2**	**187.8**	**226.6**	**219.7**	**211.9**

Asset management

2.7 To ensure that capital assets continue to be of long-term use, the Council has an asset management strategy in place. This is a multi-level approach structured as follows:

- At a tenancy level the Comprehensive Asset Register (a database of key lease events) is being updated and used to identify forthcoming lease events such as expiries, rent reviews and breaks. These are allocated to specific asset managers to progress whose work schedules are reviewed periodically.
- At a property level this can comprise the preparation of asset specific management plans which are then subject to periodic review and updating. This process is ongoing and informs the portfolio strategy as a whole.
- At a portfolio level the make-up of the portfolio is considered annually in terms of its sector weighting and suitability to meet the Council's longer term objectives of providing a secure risk weighted income stream. One such review is ongoing.

Asset disposals

2.8 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 is currently also permitted to spend capital receipts on service transformation projects until 2021/22. Repayments of capital grants, loans and investments also generate capital receipts.

3 Treasury Management

3.1 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.

At 31 December 2019 the Council had borrowing of £123m at an average interest rate of 1.58%, and treasury investments of £41.1m at an average interest rate of 0.66%.

Borrowing strategy

3.2 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%-1.0%) and long-term fixed rate loans where the future cost is known, but higher (currently 2.5 to 3.0%).

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

Table 5: Prudential Indicator: Gross Debt and the Capital Financing Requirement in £ millions

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
Debt (incl. leases)	111.0	154.7	195.8	192.5	188.5
Capital Financing Requirement	146.2	187.8	226.8	219.7	211.9

3.3 Statutory guidance is that debt should remain below the capital financing requirement, except in the short-term. As can be seen from table 5, the Council expects to comply with this in the medium term.

Affordable borrowing limit

3.4 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 6: Prudential Indicators: Operational boundary and Authorised limit for external debt in £m

	2019/20 limit	2020/21 limit	2021/22 limit	2022/23 limit
Operational boundary total external debt	205	215	215	215
Authorised limit total external debt	225	240	240	240

Further details on borrowing can be found in the treasury management strategy.

Treasury Investment strategy

3.5 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.

3.6 The Council's policy on treasury investments is to prioritise security and liquidity over yield. 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 7: Treasury management investments in £millions

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
Near-term investments	15.3	15	15	15	15
Longer-term investments	0	0	0	0	0
TOTAL	**15.3**	**15**	**15**	**15**	**15**

Further details on treasury investments can be found in the treasury management strategy.

Risk management

3.6 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

3.7 Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Director of Finance and staff, who must act in line with the treasury management strategy approved by Council. Reports on treasury management activity are presented to the Accounts, Audit & Risk Committee. The Accounts, Audit & Risk Committee is responsible for scrutinising treasury management decisions.

4 Investments for Service Purposes

4.1 The Council makes investments to assist local public services, including making loans to and buying shares in the Council's subsidiaries, providing loans to local charities and businesses where there is demonstrable public benefit. 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 at least break even.

Governance

4.2 Decisions on service investments are made by the relevant service manager in consultation with the Section 151 Officer and must meet the criteria and limits laid down in the Investment Strategy. Most loans and shares are capital expenditure and purchases will therefore also be approved as part of the capital programme.

Further details on service investments are in the Investment Strategy.

5 Commercial Activities

5.1 With central government financial support for local public services declining, the Council invests in commercial property mainly for financial gain but also for strategic economic regeneration. Total commercial investments are currently (31 March 2019) valued at £72m with the largest being Castle Quay.

5.2 With financial return being an objective, the Council accepts higher risk on commercial investment than with treasury investments. The principal risk exposures are listed below together with an outline of how those risks are managed:

Illiquidity:	The council acknowledges illiquidity as a risk in property and whilst it cannot be avoided the risk is mitigated by the following strategies: a) The council invests across a range of sectors. Illiquidity is to an extent fluid and at any given time varies across sectors. This allows the Council the opportunity to effect sales, if required, in the more liquid sectors. b) The Council's assets are likewise diversified in terms of lot size. This affords the Council the ability to access a range of purchaser types e.g. small local investors, listed property companies or institutions. c) The Council does not invest in high risk assets which can be the most illiquid of all. d) The Council's investments are not what is termed 'Investment Grade', but they are fundable – i.e. if sold they could be suitable for debt backed investors. e) The Council does not invest in specialist properties, where the market tends to be most illiquid. f) The Council's assets are uncharged. It is often lenders who require assets to be sold and whilst gearing does not increase illiquidity per se, it can expose an owner to greater risk of selling an illiquid asset at an inopportune time.
Tenant default:	The Council's portfolio is not populated by large national concerns and tenant default risk is managed in two ways: 1. Tenants are vetted when entering the portfolio either as new tenants when property is let or as replacement tenants when existing tenants assign their leases. It has to be acknowledged that there is less control when a tenant applies for consent to assign, though guarantees may be sought. 2. Risk is managed by diversification as only a small proportion of tenants will fail in any given year.

Obsolescence:	A significant proportion of the Council's portfolio comprises industrial / warehouse buildings and simple retail assets which have relatively low obsolescence compared to offices where there are substantial amounts of plant and machinery. Where we have offices we try to introduce sinking / replacement funds where we are able to collect from tenants an annual sum to put towards high cost items such as the replacement of lifts or air conditioning. An example of this is the Banbury Health Centre which has a renewals fund set at £10,000 per annum. In other leases we will try to negotiate terms which allow for the replacement of obsolete plant when it is beyond economic repair. Where matters of public policy override commercial concerns our portfolio is more vulnerable. For example, at Banbury Museum, the Council may be responsible for significant capital outlay on plant and machinery as it nears the end of its useful economic life.
Capital expenditure	Please see above but also note that the Council aims to let space on Full Repairing terms which either makes the tenant either explicitly responsible for maintaining the asset or allows CDC to recover the cost of repairs through the service charge provisions of the relevant lease.
Market risk:	Two key market risks are falling rents in response to declining economic conditions and extended marketing voids when leases end or tenants fail. These risks are mitigated in three main ways: 1. Lease lengths should be 3 – 5 yrs + which obviates most market risks during the period of the tenancy. 2. Rents are reviewed in an upwards only direction. This means that they cannot fall during the term of a lease. 3. Tenant failure – see above under Tenant Default, re: vetting and diversification policies. An additional risk is over-exposure to town centre retailing as the portfolio's largest assets are Castle Quay Shopping Centre in Banbury and Pioneer Square in Bicester. These are both strategic investments and in respect of Castle Quay we rely heavily on external advisors, particularly Montague Evans, to identify and manage both upside and downside risks.
Returns eroded by inflation:	All investment assets incorporate periodic rent reviews which provide a hedge against inflation. Property is generally accepted as performing better than fixed income assets in times of inflation.

Rising interest rates:	The portfolio is ungeared and therefore un-mortgaged

Governance

5.3 Decisions on commercial investments are made by Members and Statutory 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 and purchases will therefore also be approved as part of the capital programme.

Further details on commercial investments and limits on their use can be found in the Investment Strategy

5.4 The Council also has commercial activities in trading companies, exposing it to normal commercial risks. These risks are managed by the governance structure in place. The Shareholder Committee is regularly informed of the progress of each company. The Shareholder meets with the directors both formally and informally to ensure there is a consistent dialog between the companies and the council.

6 Liabilities

6.1 In addition to debt of £123m detailed above, the Council is committed to making future payments to cover its pension fund deficit (valued at £98m – as at 31 March 2019). The pension liability is the underlying commitments that the authority has in the long run to pay retirement benefits, less the fair value of the assets held within the scheme.

However, statutory arrangements for funding the deficit mean that the financial position of the authority remains healthy, because:

- the deficit on the local government scheme will be made good by increased contributions over the remaining working life of employees (i.e. before payments fall due), as assessed by the scheme actuary,
- finance is only required to be raised to cover discretionary benefits when the pensions are actually paid

The Council has also set aside £4.9m in its 2018/19 accounts to cover the risk of business rates appeals provisions. The Council is also at risk of having to refund the NHS for business rates if the on-going legal case is found in their favour.

Governance

6.2 Decisions on incurring new discretional liabilities are taken by service managers in consultation with Statutory Officers. The risk of liabilities crystallising and requiring payment is monitored by Finance and reported monthly to the Budget Planning and

Executive committees. New liabilities are reported to full council for approval/notification as appropriate.

Further details on liabilities and guarantees are on page 72 and 76 of the 2018/19 statement of accounts

7 Revenue Budget Implications

7.1 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 8: Prudential Indicator: Proportion of financing costs to net revenue stream

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
Financing costs (£m)	£3.1m	(£0.4m)	£0.1m	£2.6m	£3.9m
Proportion of net revenue stream	(14%)	(2%)	0%	16%	24%

Further details on the revenue implications of capital expenditure are in the 2020/21 revenue budget

Sustainability

7.2 Due to the very long-term nature of capital expenditure and financing, the revenue budget implications of expenditure incurred in the next few years will extend for up to 50 years into the future, which aligns with the attached MRP Statement. The Section 151 Officer is satisfied that the proposed capital programme is prudent, affordable and sustainable.

8 Knowledge and Skills

8.1 The Council employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. For example, the Section 151 Officer is a qualified accountant with many years' experience, the Assistant Director of Property and Investments is a chartered surveyor with over twenty years' experience of asset management and commercial property investment. The Council pays for junior staff to study towards relevant professional qualifications including CIPFA and RICS.

8.2 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, and a range of the current property advisors is as follows:

- Banbury based surveyors White Commercial and Bankier Sloane provide advice on the local property market, and assistance with new lettings, lease renewals, smaller valuations and rent reviews.
- Where specialist advice is required we ask for competitive quotes. For example we have asked three surveyors (one local, two national) to quote for rent review work in connection with a number of supermarkets within our portfolio.
- The day to day management of three asset is currently being tendered as we feel their management can be better achieved using external suppliers.
- Montague Evans supply asset management and facilities management in respect of Castle Quay.
- GVA Grimley also supply specialist accounting services in respect of Castle Quay.
- Montague Evans and Colliers both provide property valuation services
- BWD and Jackson Criss assist with Castle Quay lettings
- Gardiner Theobald provide project management, QS, CDM and Design services on Castle Quay
- Broomfield Property Ltd and Prime Project Management Ltd provide service relating to Castle Quay

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.

Appendix A – Minimum Revenue Provision (MRP) Statement

Where the Council finances capital expenditure by debt, it must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP), although there has been no statutory minimum since 2008. The Local Government Act 2003 requires the Council to have regard to the Ministry of Housing, Communities and Local Government's Guidance on Minimum Revenue Provision (the MHCLG Guidance) most recently issued in 2018.

The broad aim of the MHCLG Guidance is to ensure that capital expenditure is financed over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.

The MHCLG Guidance requires the Council to approve an Annual MRP Statement each year and recommends a number of options for calculating a prudent amount of MRP. The following statement incorporates options recommended in the Guidance as well as locally determined prudent methods.

- For unsupported capital expenditure incurred after 31st March 2008, MRP will be determined by charging the expenditure over the expected useful life of the relevant asset in equal instalments, starting in the year after the asset becomes operational. MRP on purchases of freehold land will be charged over 50 years. MRP on expenditure not related to fixed assets but which has been capitalised by regulation or direction will be charged over 20 years.

- For capital expenditure loans to third parties that are repaid in instalments of principal, the Council will make nil MRP, but will instead apply the capital receipts arising from principal repayments to reduce the capital financing requirement instead.

Capital expenditure incurred during 2020/21 will not be subject to a MRP charge until 2021/22.