Cherwell District Council

Capital Strategy 2021/22

Including Minimum Revenue Provision (MRP) Statement

1 Introduction

1.1 The Prudential Code for Capital Finance sets out that in order to demonstrate that the authority takes capital expenditure and investment decisions in line with service objectives and properly takes account of stewardship, value for money, prudence, sustainability and affordability, authorities should have in place a capital strategy. The capital strategy should set out the long-term context in which capital expenditure and investment decisions are made and gives due consideration to both risk and reward and impact on the achievement of priority outcomes. The Strategy must be approved by full Council.

1.2 The objectives of the Prudential Code are to ensure that the capital expenditure plans of local authorities are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice and in full understanding of the risks involved. This strategy should be read alongside and in conjunction with the Treasury Management Strategy and the Investment Strategy.

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[1]. 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. In 2021/22, the Council is planning capital expenditure of £36.2m as summarised below:

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

	2019/20 actual	**2019/20 forecast**	**2020/21 budget**	**2021/22 budget**	**2022/23 budget**
Services	16.3	15.0	11.0	0	0
Capital investments	25.5	64.7	25.2	1.4	0
TOTAL	41.8	81.2	36.2	1.4	0

2.2 The main capital projects across the period include the Build! Programme, Castle Quay 1 and 2 and the Bretch Hill Reservoir Phase 2.

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

2.3 Capital project bids linked to corporate or service priorities plus essential need are brought forward by Service Managers as part of the Budget & Business Planning process. These are considered by the senior officer leadership team, both in terms of priority and affordability. The Finance team undertake a calculation of the financing cost of proposals and recommend the level of investment based on affordability. Projects proposed to be included in the Council's capital programme are then considered and appraised by the Budget Planning Committee and provide comments to the Executive on the proposals. The Executive then, taking into consideration any comments propose which schemes to include in the Capital Programme ahead of the final capital programme being proposed 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

	2019/20 actual	**2020/21 forecast**	**2021/22 budget**	**2022/23 budget**	**2023/24 budget**
External sources	3.4	0.8	1.0	1.0	1.0
Own resources	4.0	1.9	4.0	6.0	23.0
Debt	34.4	78.5	31.2	(5.6)	(24.0)
TOTAL	**41.8**	**81.2**	**36.2**	**1.4**	**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). In addition, 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

	2019/20 actual	**2020/21 forecast**	**2021/22 budget**	**2022/23 budget**	**2023/24 budget**
Own resources	4.0	1.9	4.0	6.0	23.0

The Council's 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 £29.2m during 2021/22. 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

	2019/20 actual	2020/21 forecast	2021/22 budget	2022/23 budget	2023/24 budget
TOTAL CFR	**178.7**	**255.2**	**284.4**	**275.0**	**247.3**

Asset management

2.7 To ensure that capital assets continue to be of long-term use, the Council has a property 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. In addition, there are currently no plans to utilise capital receipts on services transformation projects for 2020/21 and 2021/22. Receipts from capital grants, loan repayments and investments also generate capital receipts.

3 Treasury Management

3.1 Treasury management is concerned with the management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

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 typically has surplus cash in the short-term as revenue income is received before it is spent, but insufficient cash 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 2020 the Council had borrowings of £123m at an average interest rate of 1.58%, and treasury investments of £41.1m at an average interest rate of 0.66%. The borrowing position is reported regularly to Accounts, Audit & Risk Committee as part of the Treasury Management Reports.

Borrowing strategy

3.2 The Council's main objective when borrowing is to achieve a low but certain cost of finance while retaining flexibility should plans change in future. This objective often conflicts, and the Council therefore seeks to strike a balance between lower cost short-term loans (currently available at around 0.75% to1.0%) and long-term fixed rate loans where the future cost is known, but higher cost (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

	31 March 2020 actual	**31 March 2021 forecast**	**31 March 2022 budget**	**31 March 2023 budget**	**31 March 2024 budget**
Debt (incl. leases)	141.0	219.5	250.7	192.5	188.5
Capital Financing Requirement	178.7	255.2	284.4	275.0	247.3

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 above 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

	2020/21 limit	**2021/22 limit**	**2022/23 limit**	**2023/24 limit**
Operational boundary total external debt	215	270	270	270
Authorised limit total external debt	240	300	300	300

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

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, after all costs are taken into consideration.

4.2 Decisions on service investments are made by Members and Statutory Officers in line with the criteria and limits approved by Council 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 investments for service purposes are in the Investment Strategy.

5 Commercial Activities

5.1 To drive leadership of place within Cherwell, stimulate growth, pursue economic regeneration and helping to return confidence to the local economy through investment and facilitating inward investment, the Council invests in commercial property which may also provide some financial gain. Total commercial investments are currently (31 March 2020) valued at £62m with the largest being Castle Quay.

5.2 From a financial perspective, the Council recognises that commercial investments can be higher risk than 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 and market sector. 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'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. d) 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 includes both large national concerns and small local businesses (mainly retail or industrial type tenants). Tenant default risk is managed in two ways: a) 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. b) Risk is managed by diversification as only a small proportion of tenants will fail in any given year. c) A commercial risk earmarked reserve is held to meet any shortfall in income which may arise in year due to default.

Obsolescence:	A significant proportion of the Council's portfolio comprises industrial / warehouse buildings and simple retail assets which have relatively low obsolescence compared to industrial premises where there are substantial amounts of plant and machinery. Where the Council has offices a sinking / replacement fund is put in place with annual sums collected from tenants 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 the Council will try to negotiate terms which allow for the replacement of obsolete plant when it is beyond economic repair. Where matters of Council policy override commercial concerns, the Council's 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 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 plus earmarked reserves held. 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, the Council relies 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

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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 Revenue Budget Implications

6.1 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 7: Prudential Indicator: Proportion of financing costs to net revenue stream

	2019/20 actual	**2020/21 forecast**	**2021/22 budget**	**2022/23 budget**	**2023/24 budget**
Net Financing costs/(Income)(£m)	(£0.6m)	(£0.1m)	(£2.7m)	(£1.2m)	(£1.1m)
Proportion of net revenue stream	(3%)	(0%)	(11%)	(7%)	(7%)

Further details on the revenue implications of capital expenditure are in the 2021/22 revenue budget.

Sustainability

6.2 Due to the very long-term nature of capital 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.

7 Knowledge and Skills

7.1 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.

7.2 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, the Council will ask for competitive quotes.
- 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 services 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

1. 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). The Council is required by statute to charge a MRP to the General Fund Revenue account each year for the repayment of debt. The MRP charge is the means by which capital expenditure which has been funded by borrowing is paid for by council tax payers.

2. Legislation[2] requires local authorities to draw up a statement of their policy on the annual MRP, for full approval by Council before the start of the financial year to which the provision will relate.

3. The Council is recommended therefore to approve the following statement:
   - 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.

[2] Statutory Instrument 2008 no. 414 s4

- 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.

4. Capital expenditure incurred during 2021//22 will not be subject to a MRP charge until 2022/23.