APPENDIX A

Capital Strategy 2023/24

1 Introduction

1.1 The CIPFA 2021 Prudential and Treasury Management Codes require all local authorities to prepare a capital strategy report which will provide the following:

- A high level long term overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services.
- An overview of how associated risk is managed
- The implications for future sustainability

2 Capital Expenditure and Financing

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

2.2 As at the end of January 2023, the Council has incurred capital expenditure of £7.65 million and will incur further capital expenditure by the end of March 2023. The Council's capital expenditure is summarised below:

Capital expenditure	2021/22 Actual	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate	2025/26 Estimate
Services	3,991,000	10,669,000	12,312,000	2,363,000	1,500,000
Total	**3,991,000**	**10,669,000**	**12,312,000**	**2,363,000**	**1,500,000**

Housing projects

2.3 Full Council approved the recommendations made on 25th November 2021 relating to the St Ann's Chapel Housing Project. £4.2million was approved to deliver 8 affordable homes, 3 open market units and 2 serviced plots. Completion is expected Summer 2023.

Plymouth and South Devon Freeport

2.4 At the Council meeting on 31 March 2022, Members considered a report on the Plymouth and South Devon Freeport (minute CM73/21). It was resolved that PWLB borrowing of up to £5 million was approved (funded from the retained business rates income generated by the Freeport), to match fund the Freeport Government seed funding relating to the delivery of the Langage site.

Regeneration and Investment Strategy

2.5 The Council has approved a Regeneration and Investment Strategy (Minute Reference CM 75/21, Council 31/3/2022). To date, Investment Properties have a value of £18.61 million in aggregate as at 31 March 2022.

Overall Borrowing Limit

2.6 In September 2019, Council approved an overall Borrowing Limit (for all Council Services) of £75 million. As at the end of January 2023, the Council's current level of external borrowing is £14.3m.

2.7 Local Authorities are required to submit a summary of their planned capital spending and PWLB borrowing for the following three years. This is updated on at least an annual basis. PWLB borrowing is permitted in the future for the four categories of regeneration, service delivery, housing and refinancing.

Governance

2.8 The Head of Finance Practice invites bids for capital funding from all service managers annually on the strict proviso that all bids must go towards meeting a strategic priority. All capital bids are ranked against a prescribed priority criteria which is set out in the bid process. Submitted capital bids are assessed against the categories in each priority. Priority 1 categories include meeting strategic priorities and statutory obligations (e.g. Health and Safety, Disability Discrimination Act etc.) and other capital works required to ensure the existing Council property assets remain open. Priority 2 categories link to good asset management whereby the capital work proposed would either generate capital/revenue income or reduce revenue spending. A capital bid that will enable rationalised service delivery or improvement is also considered a Priority 2 category to meet the Council's aims and objectives. The final capital programme is then presented to Executive and to Council in February each year.

2.9 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 capital expenditure is as follows:

Financing of capital expenditure	2021/22 Actual	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate	2025/26 Estimate
Capital Expenditure	**3,991,000**	**10,669,000**	**12,312,000**	**2,363,000**	**1,500,000**
Financed by:					
External sources (Capital grants, NHB, S106)	1,156,000	2,656,000	1,604,000	1,200,000	0
Own resources (Capital receipts, Earmarked reserves)	1,815,000	1,494,000	3,478,000	1,163,000	1,500,000
Net financing need for the year (This is the prudential borrowing required)	**1,020,000**	**6,519,000**	**7,230,000**	**0**	**0**

2.10 Debt is only a temporary source of finance, since loans 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:

Replacement of debt finance	2021/22 Actual	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate	2025/26 Estimate
MRP	344,000	488,000	545,000	745,000	751,000
Use of capital receipts	0	0	0	*1,400,000	0

**Capital receipts generated from the sale of houses (St Ann's Chapel housing scheme)*

Treasury Management

2.11 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.

2.12 The Council is typically more 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.

2.13 As at 31 January 2023, the Council had external borrowing of £14.309 million.

2.14 As at 30 September 2022, the Council held £54.116m of Investments.

3 Borrowing Strategy

3.1 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.

3.2 These objectives are often conflicting, and the Council therefore will seek to strike a balance between cheap short-term loans and long-term fixed rate loans where the future cost is known but higher.

3.3 Projected levels of the Council's total outstanding debt which comprises borrowing is shown below, compared with the capital financing requirement.

	2021/22 Actual	**2022/23 Estimate**	**2023/24 Estimate**	**2024/25 Estimate**	**2025/26 Estimate**
Debt at 31 March	14,381,000	14,284,000	18,465,000	17,804,000	17,140,000
Capital Financing Requirement	13,536,000	19,568,000	26,253,000	24,109,000	23,358,000

3.4 The Capital Financing Requirement is the measure of the Council's underlying need to borrow for the capital programme. This has been projected to be £26.3 million for 2023/24. This includes borrowing for leisure, an investment property in Dartmouth, waste, housing, Batson Creek (Salcombe) commercial units, Batson Creek (Salcombe) Harbour Depot, Dartmouth Health and Wellbeing Hub and the Plymouth and South Devon Freeport (see 2.4).

4 Investment Strategy

4.1 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.

4.2 The Council's policy on treasury investments is to prioritise security and liquidity over yield, i.e. to focus on minimising risk rather than maximising returns. Cash that is likely to be spent in the near term is invested securely, for example with the government, other local authorities or selected high-quality banks, to minimise the risk of loss.

4.3 Money that will be held for longer terms is invested more widely including in collective investment schemes (pooled funds whose underlying assets are company shares, bonds, property etc.). Examples of which are the CCLA Local Authorities' Property Fund and the CCLA Diversified Income Fund in which the Council is invested to balance the risk of loss against the risk of receiving returns below inflation.

4.4 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.

4.5 Further details on treasury investments can be found in the treasury management strategy (Appendix B).

Governance

4.6 Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Corporate Director for Strategic Finance (S151 Officer) and finance staff (where appropriate), who must act in line with the treasury management strategy approved by Council.

4.7 Semi-annual reports on treasury management activity are presented to the Audit and Governance Committee which is responsible for scrutinising treasury management decisions.

5 Investments for Service Purposes

5.1 Decisions on service investments are made by the relevant service manager in consultation with the Corporate Director for Strategic Finance (Section 151 Officer) and must meet pre-approved criteria and limits. Most loans and shares are capital expenditure and purchases will therefore also be approved as part of the capital programme.

6 <u>Risk Management and Due Diligence</u>

6.1 The Council accepts there is a higher risk on property investments than with treasury investments. Financial risk will be weighed up against social and economic benefits of the investment. The principal risk exposures include variances resulting in a disruption or fall in income streams, fall in capital value which is either site-specific or due to general market conditions, deterioration in the credit quality of the tenant.

6.2 The Council assesses the risk of loss before entering into and whilst holding property investments/property opportunities by carrying out appropriate due diligence checks and implementing mitigation measures in managing risk:

- The tenants need to be of good financial standing (this is assessed using Dun & Bradstreet credit rating reports and annual accounts). The number of tenants e.g. sole tenant or multi tenanted will be assessed.

- The property condition such as date of construction and any imminent or significant refurbishment or modernisation requirements (forecast capital expenditure).

- How the property investment, financial or non-specified investment meets the Council's multiple objectives as set out in the Council's strategy.

- The lease must meet certain standards, such as being in a commercial popular location and have a number of years left on the lease providing a certain and contractually secure rental income stream into the future. Any break clauses will be assessed along with the number of unexpired years, bank guarantees and rent reviews.

- The location will be within the South Hams District Council's boundary as set out in the Investment Strategy. The population of the catchment area, the economic vibrancy and known or anticipated market demand as well as proximity to travel infrastructure and other similar properties will be assessed.

- Rental income paid by the tenant must exceed the cost of repaying the borrowed money from the Public Works Loan Board (which is itself funded by the Government). The surplus is then an ancillary benefit which supports the Council's budget position and enables the Council to continue to provide services for local people.

- Future borrowing from the Public Works Loan Board must meet one of the four permitted categories of borrowing of regeneration, service delivery, housing or re-financing of existing debt.

- The gross and net yield are assessed against the Council's criteria.

- The prevailing interest rates for borrowing at the time.

- Debt proportionality considerations.

- The life and condition of the property is assessed by a valuer and the borrowing is taken out over the life of the asset. The amount of management and maintenance charges are assessed as well as the ease of in-house management. 10% of all rental income (or an amount as deemed prudent) is put into a Maintenance and Management Reserve to cover any longer-term maintenance issues.

- The potential for property growth in terms of both revenue and capital growth will be assessed.

- The risks are determined by the property sector e.g. office, retail, industrial, associated with specific properties and the mix of sectors within the Council's portfolio.

- Details of acquisition costs e.g. stamp duty land tax, legal costs

- The documented exit strategy for a purchase/new build.

- The legal and technical due diligence checks will also identify any specific problems such as anomalies in the title deed, restrictive use classes, indemnities, local competition, construction or refurbishment requirements.

- The Council engages the use of external advisors to assist in undertaking elements of the due diligence checks such as technical, legal, accounting, property and taxation advice.

- The Council undertakes sensitivity analysis of the interest repayments on its borrowing requirements as a percentage of its available reserves to ensure there is sufficient coverage in the event that rental income is below that forecasted. This ensures that the Council has the available reserves to enable service delivery to be maintained in the short to medium term, whilst alternative solutions are implemented.

6.3 Risk of loss shall be assessed on a case by case basis as part of the acquisition due diligence and will be a criteria considered throughout the approval process. Risk of loss during the management phase of the investment shall be reported in accordance with the criteria below. In accordance with Para 23-25 of Statutory Guidance on Local Government Investments, quantitative indicators or risk and portfolio performance will be reported to Audit Committee. The frequency of this reporting is anticipated to be every 6 months and will include the following indicators (as applicable):

- Rental value by property
- Rental value by tenant
- Sector split by purchase price
- Purchase price
- Rental income profile
- Tenant lease length
- Gross Yield
- Management, Maintenance and Risk Mitigation Reserve (MMRM)
- Current value

Governance

6.4 Acquisitions must conform to the adopted Regeneration and Investment Strategy. Any deviation from the agreed Strategy will require Council approval.

6.5 The Council's Senior Leadership Team will initially consider each proposal as an initial step and recommend that the proposal proceeds in principle.

6.6 When any decision to proceed with a development or acquisition is being considered, local Ward Members will be consulted at the earliest opportunity and be able to share their views with Executive Members and be consulted before the final decision is made.

6.7 Executive Members, along with the Head of Paid Service and S151 officer, will consider each and every proposal on its own merits and specifically how each proposal meets the Council's multiple objectives and desired outcomes.

6.8 Executive Members will consider debt proportionality (the amount borrowed to date against the net service expenditure ratio) on a case by case basis for each acquisition as part of the decision making process, with information provided to them as well as the S151 officer, the Head of Paid Service and the Leader of the Council. Investment indicators are set out within the Council's Treasury Management Strategy.

6.9 The Council undertakes sensitivity analysis of the interest repayments on its borrowing requirements as a percentage of its available reserves to ensure there is sufficient coverage in the event that rental income is below forecast. The Council also sets aside 10% annually of all rental income into a Maintenance, Management and Risk Mitigation (MMRM) Reserve. This is part of the Council's contingency arrangements.

6.10 Officers, working with their specialist advisors in the market will sift opportunities and only present to Executive Members, opportunities that closely meet the Strategy. They will then lead the Executive Members into debate over specific benefits and risks of each opportunity before the Executive Members make a decision. In this way, risk will be transparent through the process.

6.11 Projects and their outcomes will be kept under constant review by officers and reported to Executive and Audit Committee.

Regeneration and Investment Strategy

6.12 The Council has approved a Regeneration and Investment Strategy (Minute Reference CM 75/21, Council 31/3/2022). To date, Investment Properties have a value of £18.61 million in aggregate as at 31 March 2022.

Debt Proportionality

6.13 The investment strategy considers the risks of investment and the Council engaged Treasury Management advisors to analyse the level of debt proportionality to the Council's finances (e.g. levels of reserves, asset base and level of interest costs as a percentage of income).

6.14 Investment Property acquisitions expand the Council's balance sheet and interest costs will form a higher percentage of locally derived income. It would absorb some reserves if there are shortfalls in or disruption to the income stream required to meet the additional expenditure.

6.15 Sensitivity analysis on the level of debt interest against the Council's level of reserves is considered as part of the Medium Term Financial Strategy and as part of the budget proposals each year. This ensures that the Council has the available reserves to enable service delivery to be maintained in the short to medium term, whilst alternative solutions are implemented.

6.16 In order that property investments remain proportionate to the size of the Council, borrowing for the Investment Strategy is subject to an overall limit (for all Council services) of £75 million.

6.17 The Council set an upper limit on External Borrowing (for all Council services) as part of the Medium Term Financial Strategy of £75 million. Interest payments at 4% would equate to 18.9% of available reserves (Appendix G to the Budget Proposals report for 2023/24 – Council 16th February 2023).

Liquidity

6.18 Compared with other investment types, property is relatively difficult to sell and convert to cash at short notice and can take a considerable period to sell in certain market conditions. To ensure that the invested funds can be accessed when they are needed, for example to repay capital borrowed, the Council will spread its liquidity profile across its portfolio and also have a spread of the sector in which the Council invests. The Council also documents potential exit strategies as part of its due diligence checks.

6.19 Liquidity will be a factor in determining the amount of rent set aside in the Maintenance Management and Risk Mitigation Reserve for each investment which has a balance of £95,000 as at 31 March 2023. This will be reviewed with the same frequency as the risk reporting procedure set out in the Council's Commercial Investment Strategy.

7 Asset Management

7.1 To ensure that capital assets continue to be of long-term use, the Council has an asset management strategy in place.

7.2 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.

7.3 Repayments of capital grants, loans to third parties for capital expenditure and investments also generate capital receipts.

7.4 The Council estimates to receive £200,000 capital receipts in the coming financial year as follows:

Capital Receipts	2021/22 actual	2022/23 forecast	2023/24 budget	2024/25 budget	2025/26 budget
Asset sales	357,000	200,000	200,000	*1,400,000	200,000
Loans repaid	0	0	0	(1,400,000)	0
TOTAL	**357,000**	**200,000**	**200,000**	**0**	**200,000**

**Capital receipts generated from the sale of the houses*

8 Liabilities

Governance

8.1 Decisions on incurring new discretional liabilities are taken by Head of Practice in consultation with the Corporate Director for Strategic Finance (Section 151 Officer).

8.2 The risk of liabilities crystallising and requiring payment is monitored as part of the budget monitoring and reported to the Executive quarterly.

9 Revenue Budget Implications

9.1 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.

Proportion of financing costs to net revenue stream

	2021/22 actual	**2022/23 forecast**	**2023/24 budget**	**2024/25 budget**	**2025/26 budget**
Financing costs	711,514	*(257,136)	98,845	414,499	406,858
Proportion of net revenue stream	7.2%	(2.5%)	0.8%	3.6%	3.5%

* the financing costs are a net income stream in 22/23 due the level of projected treasury management income

9.2 Further details on the revenue implications of capital expenditure are included in the Revenue Budget.

Sustainability

9.3 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.

9.4 The Corporate Director of Strategic Finance (S151 Officer) is satisfied that the proposed capital programme is prudent, affordable and sustainable and it is fully integrated with the Council's 2023/24 Medium Term Financial Strategy, Treasury Management Strategy and Investment Strategy and other strategic plans. The Capital Strategy is compiled in line with the requirements of the 2021 CIPFA Prudential Code and 2021 Treasury Management Code. The risks associated with the Investment Strategy are covered within the Strategy.

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

9.6 Members, via the Executive meetings, receive quarterly budget monitoring reports on the Council’s Capital Programme as well as quarterly integrated performance management reports. Through these updates, which are driven by the requirement of financial reporting, Members can review and challenge the delivery of projects and any changes to both the timing and expenditure of the capital project.

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

9.8 The Council’s Senior Leadership Team has oversight for the delivery of and challenge to the Capital Strategy and Capital Programme.

Affordability

9.9 Affordability is critical in applying the capital strategy and approving projects for inclusion in the capital programme. This is either demonstrated by a report on the project being presented to Executive/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, or by delegated procedures set out within the commercial investment strategy (containing this information).

9.10 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.

9.11 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.

9.12 Where borrowing is to be used the affordability is of greater importance and the affordability has to include the interest costs of that borrowing and the provision for the repayment of the borrowing (MRP). 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 are outlined in the Prudential Code (as summarised above).

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

Risks

9.14 The risks associated with a significant Capital Programme and a significant level of borrowing can be mitigated through all capital projects being supported by a business case, having 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, 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.

9.15 There are clear links from the capital strategy 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 the Audit Committee and Council. For any new borrowing, and this is a greater risk as the value of borrowing increases, this does increase the Council's overall liabilities that will need to be repaid in the future.

9.16 In addition, this increases the Council's level of fixed interest and repayment costs that it will incur each year. In 2023/24 the borrowing liability is estimated at a maximum of £18m with ongoing financing costs of the borrowing of approx. £0.9m. This is a clear risk that all Members need to be aware of.

9.17 However, this risk for assets is mitigated by a robust business case and a MRP that will repay the borrowing costs over a (prudent) asset life. Any variations from this are set out in the MRP Policy (section 2.5 of the Treasury Management Strategy). Any variation in expected income is an issue, however given the wide range of operational assets and different income streams this helps to mitigate this risk.

9.18 As outlined above in the position statement, investment properties have 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 which has included member training, second opinion on asset values, due diligence, site visits, surveys etc. The Council currently owns one investment property in Dartmouth.

9.19 There are risks (and rewards) associated with the purchase of these type of assets.

10 Knowledge and Skills

10.1 The Council employs professionally qualified and experienced staff in senior positions with responsibility for recommending capital expenditure, borrowing and investment decisions to Members.

10.2 The Director of Place & Enterprise is a Chartered Civic Engineer with 19 years of experience. In addition, the Director of Place & Enterprise holds a MSc in Construction Law.

10.3 The Corporate Director of Strategic Finance (S.151 Officer) is a Chartered Accountant (ICAEW) with 19 years of experience of being a S151 Officer (Chief Finance Officer). In addition, the Corporate Director for Strategic Finance holds a BSc in Mathematics and has previously worked in the private sector for accountancy firms.

10.4 The Principal Estates Specialist is a Chartered Surveyor, with over 15 years post qualification experience.

10.5 The Monitoring Officer is a qualified solicitor with over 20 years public sector experience as a Monitoring Officer.

10.6 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 appropriate expertise is always resourced in relation to any financial, legal and asset related due diligence required. A list is below of advisors the Council has used in the past:-

- Link Group – Treasury Management Advice
- Savills – Property Agents
- JLL – Property and Technical Consultants
- Arcadis – Building Surveyors and Engineers
- Womble Bond Dickinson - Solicitors

10.7 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.

10.8 External treasury management training (by Link Group) for Members will be carried out every two years to ensure the up to date skills are in place to make capital and treasury management decisions. Training was last completed in March 2021 and it is planned that the next session will be carried out in the late Summer of 2023 as part of the Member Induction programme.