Isle of Wight Council

Capital Strategy

2019-20

1. Document Information

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2. Contents

3. Legislative Framework

The Local Government Act 2003 supported by the Local Authorities Regulations 2003, define the environment within which bodies including local authorities should capitalise expenditure:

- Expenditure which results in the acquisition of, or the construction of, or the addition of subsequent costs to non-current assets (tangible and intangible) in accordance with proper practices (Proper Practices are those contained in the Code of Practice on Local Authority Accounting in the UK – The Code)

- The expenditure meets one of the definitions specified in regulations made under the 2003 Act (otherwise known as revenue expenditure funded by capital statute or REFCUS for short)

- The Secretary of State makes a direction that the expenditure can be treated as capital expenditure

The Local Government Act 2003 and subsequent regulations also require the council to set out its annual strategy with regard to both borrowing and the repayment of external debt. These are set out in the Treasury Management Strategy and the policy on the Minimum Revenue Provision (MRP) respectively. The Act and subsequent regulations require the council to have regard to CIPFA's revised Code of Practice for Treasury Management in Local Authorities, and Treasury Management Practices (TMPs).

The council is also required to have regard to the CIPFA Prudential Code for Capital Finance and to set Prudential Indicators for the next three years to ensure that the council's investment plans are affordable, prudent and sustainable. With regard to its capital investment plans the council also has a duty to determine a prudent MRP. This strategy reflects the new requirements of the Prudential code for Capital Finance in Local Authorities (Prudential Code), and the Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes (Treasury Management Code) which were updated in December 2017.

4. Purpose of Strategy

The council's capital strategy is a high level document setting out the long term context in which capital expenditure and investment decisions are made. It gives an overview of how capital investment, financing and treasury management contribute to the provision of services and achievement of the council's corporate plan priorities, and underpins the Medium Term Financial Strategy (MTFS).

The capital strategy does not directly allocate resources to capital investment priorities as this is done annually as part of the council's budget setting process. However, as a key document for the council, and an integral part of the councils overall medium term financial planning framework, annual decisions made as part of budget setting take into account the content of this strategy. This strategy is tailored to the council's individual circumstances and includes sufficient detail to enable readers to understand how stewardship, value for money, prudence, sustainability and affordability will be secured. It provides an overview of how associated risk is managed and the implications for future financial sustainability.

5. Context

Since 2011, the council has had to find a way of balancing a savings requirement of approximately £82m (equating to circa 40% of the councils controllable spending) as a result of both cuts in Government funding and increasing costs. Many of the increasing costs relate to the Islands higher population of people over 65 (27.1% compared to the national average of 17%) plus the 'living longer' population more generally and the demands that confers onto adult social care, as well as the unique costs of providing public services on an island known as the 'island factor'.

This financial challenge is seen as the single biggest risk to sustainable public services on the Island and is expected to continue in future years. These financial pressures cannot be managed by reducing services or the costs of services alone and the council adopted a Medium Term Financial Strategy which also includes Improving the Island Economy as a means to raise prosperity generally through increasing economic growth, jobs and housing to transform the financial position of the council bringing in increased council tax, and business rates over 10 years.

The overall aim of the MTFS is illustrated below:

"In year" expenditure matches "in year" income over the medium term whilst regenerating the Island Economy and providing essential Value for Money services for our Businesses and Residents

The 6 Themes of the Medium Term Financial Strategy are described below:

SHORT TERM

Theme 1	Create Financial and Operating Capacity to Transform
Theme 2	Increasing Efficiency & Effectiveness

SHORT TO MEDIUM TERM

Theme 3	Entrepreneurial, Commercial and Collaborative Activities (with managed risk)
Theme 4	Withdraw from or offer Minimal Provision for Low Impact Services
Theme 5	Improving the Island Economy

MEDIUM TO LONGER TERM

Theme 6	Public Service Transformation

The themes within the MTFS have been designed as a comprehensive and complimentary package of measures to support the council to navigate through the financial challenge that it faces. Theme 1, "Create Financial and Operating Capacity to Transform" remains the critical building block to enable all other activities to take place.

Embedded within Theme 1 in particular are the following that are critical to the success of the overall Strategy:

- "Smoothed out" savings requirements to avoid 'front loading' and buy time
- Rebuilding Reserves and balances to improve resilience
- Funding to provide for 'invest to save' initiatives
- Maximum use of capital resources to stimulate economic regeneration, jobs and housing
- Targetting of other resources to regeneration and transformational change
- A financial framework that promotes longer term planning, responsible spending, improves decision making and aligns financial accountability and discipline

Reflecting on this shift to a longer term view focusing on opportunities and growth, and in conjunction with the manifesto commitments of the new administration elected in May 2017, the council adopted a new Corporate Plan in October 2017 including a vision

‘for the Isle of Wight to be an inspiring place in which to grow up, work, live and visit.’

The new Corporate Plan sets out the outcomes the council aims to achieve, where our resources will be prioritised and the values that will underpin everything we do. Outcomes have been grouped into 3 areas:

As a key part of the council’s medium term financial strategy, the development of a capital strategy considers investments that will be made in the acquisition, creation, or enhancement of tangible or intangible fixed assets, that will yield benefits to the council for a period of more than one year. It also considers how stewardship, value for money, prudence, sustainability and affordability will be secured. The capital strategy therefore has 3 core aims:

Aim 1 - To support a medium term outlook:

- Allocating known resources to future years for critical capital investment, ensuring that in years where capital resources are limited, critical investment can continue to be made
- Aligning known resources and spending, ensuring that we do not apply uncertain or forecast resources to current investment, thus leaving potentially unfunded obligations in the future
- Smoothing out any significant gaps between capital investment needs and capital resources available by utilising contributions from revenue

Aim 2 - To maximise the capital resources available and the flexibility of their application:

- Setting aside capital funding for "match funding" opportunities, where these are aligned with the council's strategic objectives in order to take advantage of "free" funding
- Reviewing contractually uncommitted schemes against newly emerging capital investment priorities
- Avoiding ring-fencing of capital resources, except where such ring fencing is statutory
- Using prudential borrowing for "invest to save" schemes, or schemes which generate income

Aim 3 - Targeted capital investment:

- Annual review of all contractually uncommitted capital schemes which rely on non-ring-fenced funding to ensure that they remain a priority in the context of any newly emerging needs and aspirations
- Investment in programmes of a recurring nature that are essential to maintain operational effectiveness
- Invest in specific schemes that:
    - Have a significant catalytic potential to unlock the regeneration of the Island
    - Are significant in terms of the council strategies that they serve
    - Are significantly income generating or efficiency generating
    - If not implemented would cause severe disruption to service delivery

For 19/20 onwards, the capital programme comprises a balanced set of proposals which:

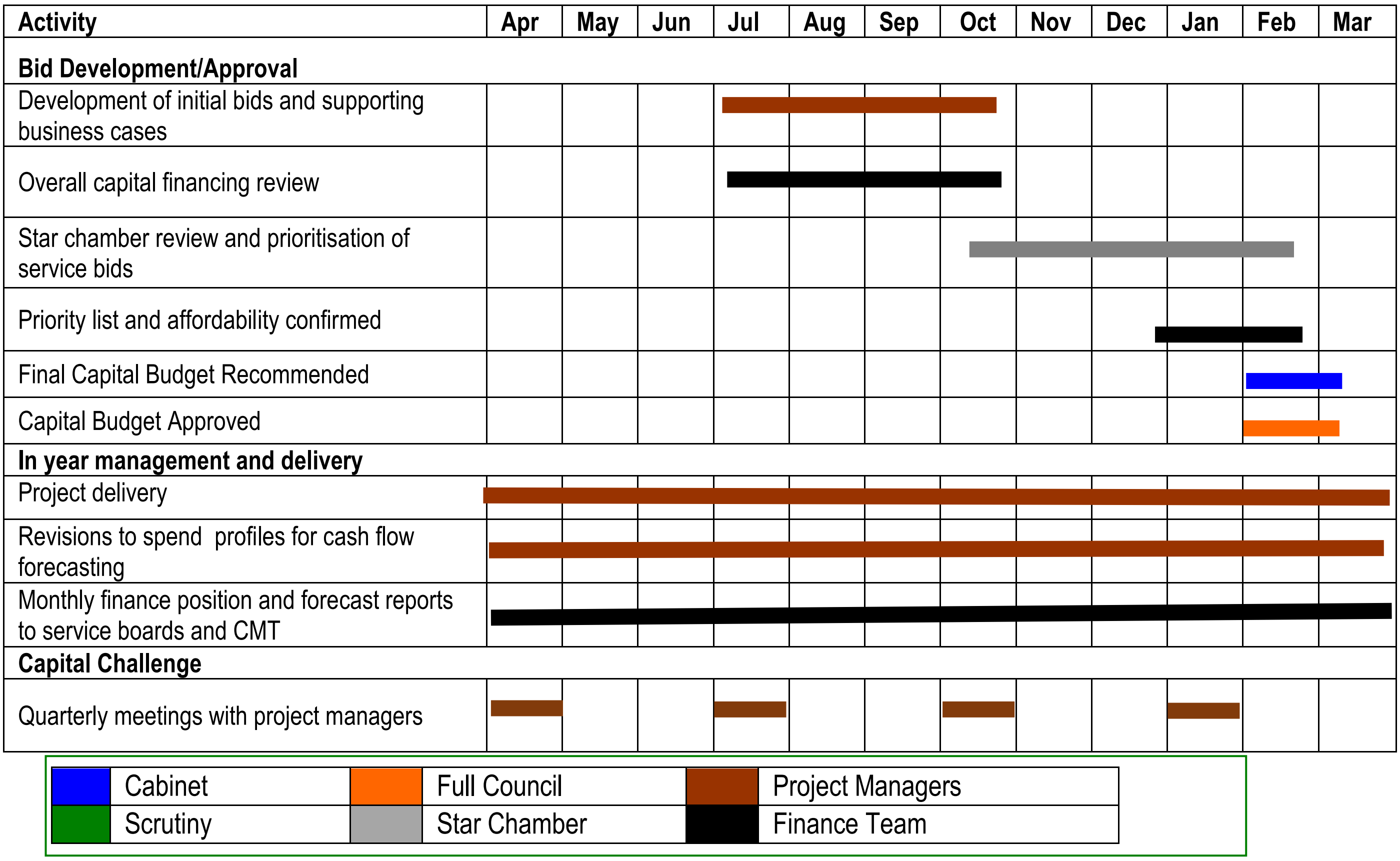
- Ensure the medium term resilience of essential core services
- Continue support to schools and education facilities
- Invest in adapting people’s homes supporting the council’s care close to home agenda
- Transform council services, including investment into providing adults’ re-ablement and learning disability facilities
- Provide substantial investment into the Island Economy to:
    - Acquire strategic employment sites for the Island providing enabling infrastructure where necessary to make them viable allowing existing business to emerge and expand
    - Providing affordable homes for key workers and residents in general
- Investment in digital technology to support agile working and further progressing the aspirations to be recognised as a Digital Island and a Digital Council.

6. Governance

Although the council follows the Government's Green Book and 5 case model for larger capital programmes, smaller projects are unlikely to require a full business case but would be expected to have completed options appraisals and a cost benefit review as part of the due diligence in preparing the bid. They should also have considered what external funding can be applied for to fund the projects and take advice from the finance team to ensure that the longer term financial implications of the project (e.g. revenue requirements/savings) are accurately reported. This information is essential to inform the decision to fund the project.

The Director of Finance will report explicitly on the affordability and risk associated with the overall capital strategy. Where appropriate he will have access to specialised advice to enable him to reach his conclusions. However, it is important to identify the appetite for risk by each scheme and for the capital programme as a whole, especially when investing in capital assets held primarily for financial returns. An assessment of risk should therefore be built into every capital project and major risks recorded in a risk register.

The councils MTFS takes a longer term view of financial planning and is working towards a 5 year rolling capital programme developed, approved and monitored as below:



7. Capital Investments

Capital investments are made in the acquiring, creating, enhancing or adding life or value to an existing tangible or intangible fixed asset, that will yield benefits to the council for a period of more than one year. The council's capital investment programme balances the need to fund:

Service investments - These are investments held clearly and explicitly in the course of the provision, and for the purposes, of operational services, including regeneration. These could include the costs of maintaining existing assets, as well as short term transformational projects. However, the council also looks at the longer term such as regeneration and the purchase or provision of new assets for service delivery.

Commercial investments - These are investments arising as part of business structures, such as shares and loans in subsidiaries or other outsourcing structures, or investments explicitly taken with the aim of making a financial surplus for the council including fixed assets which are held primarily for financial benefit, such as investment properties. Total current commercial investments are currently valued at £35m and further details on commercial investments and limits can be found in the commercial investment strategy.

Local investments – The council makes investments to assist local public services, including making loans, giving grants, and buying shares in local service providers and local small businesses to promote economic growth and support the development of services where there is a market gap. Decisions on local investments are made as part of the overall capital programme but the Director of Finance may require additional due diligence to be undertaken to fully understand risks. Further details on loans can be found in the Loans Policy.

In 2019/20, the council is planning capital expenditure of £106m as summarised below:

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

	2018/19 forecast	2019/20 estimate	2020/21 estimate	2021/22 estimate	2022/23 estimate
Adult Social Care, Public Health & Housing Needs	1.3	2.2	0.9	1.0	0.2
Children's Services	8.8	4.9	1.5	1.3	0.0
Community Safety & Public Protection	0.1	0.7	0.3	0.0	0.0
Environment & Heritage	2.0	1.7	0.5	0.4	0.1
Infrastructure & Transport	1.4	6.7	4.1	0.0	0.0
Planning & Housing Renewal	2.4	2.5	0.5	0.0	0.0
Procurement, Projects & Forward Planning	17.3	1.8	0.0	0.0	0.0
Regeneration & Business Development	1.5	32.2	0.3	0.0	0.0
Resources	54.2	53.3	0.2	0.0	0.0
TOTAL	**89.0**	**106.0**	**8.3**	**2.7**	**0.3**

Further details on investments are in the appendix to the February 2019 budget setting report.

8 Financing the Capital Programme

Financing for the capital investment programme can be funded from a variety of sources including:

Capital Grants – unless grants are ringfenced (conditions or restrictions for their use are attached to the grant) they will be available to finance the overall capital programme. Where ringfenced, the council will consider carefully any obligations or liabilities before accepting the grant, but this should not prevent services from seeking to attract external funding which can help support delivery of the councils priorities. See the council's Grants Policy for further information.

Other external contributions - the council may be able to deliver its priorities by entering into partnerships or joint ventures where the council can provide land or buildings, with other parties contributing the funding to develop. Wherever possible and subject to the usual risk assessments, services should look for innovative ways of extending the number of capital schemes which are completed on a jointly funded or partnership basis and continually look for areas where joint projects can be implemented.

Capital Receipts - the council's policy is to allocate an amount of capital receipts as part of the financing plan for capital investments based on the asset disposal plan and planned repayment of loans. Any ringfencing of receipts to service areas e.g. schools, has been removed so that receipts from the disposal of all premises should be pooled to finance the overall programme. This provides maximum flexibility for the council's competing priorities (which may change according to prevailing circumstances) to be realised. Should receipts exceed that amount in year, the council's policy is to consider the options of either extending the capital programme or using the opportunity to reduce prudential borrowing and make revenue savings. See Strategic Asset Management Plan and Annual Disposal Plan for further information.

Reserves or Revenue contributions - some services in the past have funded capital expenditure from their revenue budgets and invest to save bids are often built around additional income generation or savings which pay for the capital investment. A revenue reserve for capital has been established as approved in the MTFS and the S151 Officer has delegated authority to transfer year end savings to this reserve.

Borrowing - The Director of Finance will make an assessment of the overall prudence, affordability and sustainability of the total borrowing requested. The impact of this borrowing will be reported in the Treasury Management Strategy alongside the Prudential Indicators required by CIPFA's Prudential Code for Capital Finance. Prudential Borrowing (PB) is available for 'invest to save' schemes only where those savings must accrue directly to the council on a sustained basis. A PB limit is set as part of the annual Treasury Management Strategy (TM strategy) which will form part of the financing plan for capital investment. See the treasury management section of this strategy below or the full Treasury Management Strategy for further information.

The Code gives authorities options to either capitalise borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets as part of the costs of those assets, or to expense borrowing costs as they are incurred. The council's policy is not to capitalise borrowing costs and to charge them in year to revenue.

The planned financing of the above expenditure summarised in table 1 is as follows:

Table 2: Capital financing in £ millions

	2018/19 forecast	2019/20 estimate	2020/21 estimate	2021/22 estimate	2022/23 estimate
Unsupported borrowing	56.1	82.8	0.6	0.3	0.0
Corporate reserves (including capital receipts)	19.8	9.0	1.0	1.0	0.2
Grants	12.7	14.0	6.7	1.5	0.1
External contributions	0.4	0.2	0.0	0.0	0.0
TOTAL RESOURCES AVAILABLE	**89.0**	**106.0**	**8.3**	**2.8**	**0.3**

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

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
Own resources	2.2	10.0	21.6	0.9	6.4

The council has made judgements on the application of a 'prudent amount' definition in the setting aside of sums for the repayment of debt (MRP). The council has judged that the accounting policy for charging the MRP can be interpreted so that the calculation considers all of the assets of the council in totality and considers them in the context of the maturity profile of the council's debt. As a result, the annuity method has been adopted as the most appropriate method for the setting aside of its MRP. The council has adopted the following principles for the charging of the Minimum Revenue Provision (MRP):

- The Local Government Act 2003 requires the council to have regard to the Department for Communities and Local Government's (now Ministry of Housing, Communities and Local Government) Guidance on Minimum Revenue Provision (the CLG Guidance) most recently issued in 2018.

- The broad aim of the CLG Guidance is to ensure that debt is repaid 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 CLG 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 statement incorporates options recommended in the Guidance as well as locally determined prudent methods.

- The council has adopted the annuity method for capital expenditure. This method will ensure the repayment of the debt better reflects the consumption of these assets financed. MRP will be determined by charging the expenditure over the expected useful life of the relevant asset. This being equal to the principal repayment on an annuity with an annual interest rate equal to the relevant PWLB rate for the year of expenditure, starting in the year after the asset becomes operational. MRP on purchases of freehold land will be charged over 40 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 finance leases and the Highways PFI contract, the MRP charge will be equal to the repayment of the liability in year, in line with the council's accounting policy.

- For Investment Properties with a holding period of less than 50 years - MRP will not be provided for Investment Properties. Upon sale of these assets the capital receipt will be set aside to repay the borrowing that has financed these assets. Where the fair value of the property falls below acquisition cost, MRP will be provided on an annuity method over the remainder of the life of asset.

- For Investment Properties with a holding period of greater than 50 years - MRP will be provided on an annuity method over the life of asset.

- For capital expenditure loans to third parties the income received has an interest and principal element. No MRP will be charged on these loans unless the loan is deemed to be impaired in line with IFRS 9.

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 repay debt. The CFR is expected to increase by £54.9m during 2019/20. 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 £'000

	31.3.2018 actual	31.3.2019 forecast	31.3.2020 budget	31.3.2021 budget	31.3.2022 budget
General Fund services	299.8	352.3	418.4	494.0	495.8
Capital investments	60.9	86.9	75.7	7.4	1.0
TOTAL CFR	**360.7**	**439.2**	**494.1**	**501.4**	**496.8**

ISLE of WIGHT COUNCIL

9. Treasury Management

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. Due to decisions taken in the past, the council had at 10.1.2019, £202.6m borrowing at an average interest rate of 3.07% and £16.4m treasury investments at an average rate of 0.87%.

Borrowing strategy: The council's main objectives when borrowing is 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 1%) and long-term fixed rate loans where the future cost is known but higher (currently 2.0 to 3.0%).

Projected levels of the council's total outstanding debt (which comprises borrowing, PFI liabilities, 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

	31.3.2018 actual	31.3.2019 forecast	31.3.2020 budget	31.3.2021 budget	31.3.2022 budget
Debt (incl. PFI & leases)	149.9	227.3	288.8	297.1	295.9
Capital Financing Requirement	360.7	439.2	494.1	501.4	496.8

Statutory guidance is that debt should remain below the capital financing requirement, except in the short-term. As can be seen from table 6, the council expects to comply with this in the medium term.

Liability benchmark: To compare the council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes that cash and investment balances are kept to a minimum level of £10m at each year-end. This benchmark is currently £236.9m and is forecast to rise to £305.9m over the next three years.

Table 6: Borrowing and the Liability Benchmark in £ millions

	31.3.2018 actual	31.3.2019 forecast	31.3.2020 budget	31.3.2021 budget	31.3.2022 budget
Outstanding borrowing	149.9	227.3	288.8	297.1	295.9
Liability benchmark	159.9	237.3	298.8	307.1	305.9

The table shows that the council expects borrowing to remain below its liability benchmark. This is because the council has previously financed the capital programme by utilising internal borrowing.

Affordable borrowing limit: 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 7: Prudential Indicators: Authorised limit and operational boundary for external debt in £m

	2018/19 limit	2019/20 limit	2020/21 limit	2021/22 limit
Authorised limit - borrowing	360.0	430.0	440.0	440.0
Authorised limit - PFI and leases	120.0	110.0	110.0	110.0
Authorised limit - total external debt	**480.0**	**540.0**	**550.0**	**550.0**
Operational boundary - borrowing	331.7	392.9	400.9	399.7
Operational boundary - PFI and leases	107.5	101.2	100.5	97.1
Operational boundary - total external debt	**439.2**	**494.1**	**501.4**	**496.8**

- Further details on borrowing are in pages 8 to 10 of the Treasury Management Strategy

Treasury Management Investment strategy: Treasury investments arise from receiving cash before it is paid out again. Investments made for service reasons or for pure financial gain are not generally considered to be part of treasury management.

The council's policy on treasury investments is to prioritise security and liquidity over yield, that is to focus on minimising risk rather than maximising returns. Cash that is likely to be spent in the near term is invested securely, for example with the government, other local authorities or selected high-quality banks, to minimise the risk of loss. Money that will be held for longer terms is invested more widely, including in bonds, shares and property, to balance the risk of loss against the risk of receiving returns below inflation. Both near-term and longer-term investments may be held in pooled funds, where an external fund manager makes decisions on which particular investments to buy and the council may request its money back at short notice.

Table 8: Treasury management investments in £millions

	31.3.2018 actual	31.3.2019 forecast	31.3.2020 budget	31.3.2021 budget	31.3.2022 budget
Near-term investments	18.2	10.0	10.0	10.0	10.0
Longer-term investments	0.0	0.0	35.0	40.0	45.0
TOTAL	**18.2**	**10.0**	**45.0**	**50.0**	**55.0**

- Further details on treasury investments are in pages 10 to 14 of the Treasury Management Strategy.

Governance: Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Director of Finance and S151 Officer and staff, who must act in line with the treasury management strategy approved by Isle of Wight council. A Treasury Management group of officers meets regularly to review decisions and performance. Half Yearly reports on treasury management activity are presented to Audit committee. The Audit Committee is responsible for scrutinising treasury management decisions.

10. Liabilities

In addition to debt of £202.6m detailed in section 9, the council is committed to making future payments to cover its PFI liabilities and finance leases. The council has placed a £1m deposit with Lloyds Bank to guarantee first time buyer loans under the Local Authority Mortgage scheme but there have been no defaults on the payments to date.

Governance: Any new liabilities will be approved by full council.

- Further details on liabilities and guarantees are on page 18 of the 2017/18 statement of accounts.

11. Revenue Budget Implications

Although capital expenditure is not charged directly to the revenue budget, interest payable on loans and MRP are charged to revenue, offset by any investment income receivable. The net annual charge is known as financing costs; this is compared to the net revenue stream i.e. the amount funded from Council Tax, business rates and general government grants.

Table 9: Prudential Indicator: Proportion of financing costs to net revenue stream

	2017/18 actual	2018/19 forecast	2019/20 budget	2020/21 budget	2021/22 budget
Financing costs (£m)	5.8	6.3	7.9	9.7	9.0
Proportion of net revenue stream	3.85%	4.31%	5.30%	6.36%	5.82%

- Further details of the revenue budget are available in the annual budget setting report.

Sustainability: Due to the very long-term nature of capital expenditure and financing, the revenue budget implications of expenditure incurred in the next few years will extend for up to 50 years into the future. The Director of Finance and S151 Officer is satisfied that the proposed capital programme is prudent, affordable and sustainable because:

- Any prudential borrowing undertaken has been for "Invest to Save Schemes" only
- The timing of borrowing decisions have been taken on the basis of the expected optimum time to minimise the overall cost of borrowing - determined on a net present value basis and informed by expert external advisors forecasts of interest rate projections
- The council has a robust Medium Term Financial Strategy to support the delivery of its future savings requirements

12. Knowledge and Skills

The council employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. For example, the Director of Finance and S151 officer is a qualified accountant provided under a partnership arrangement from Portsmouth City Council. The council pays for junior staff to study towards relevant professional qualifications, including CIPFA.

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. 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.