Cabinet

12 December 2017

Title	Supplementary Capital Programme Provision for Asset Acquisitions		
Purpose of the report	To make a recommendation to Council		
Report Author	Chief Finance Officer		
Cabinet Member	Councillor Howard Williams	**Confidential**	No
Corporate Priority	Financial Sustainability		
Recommendations	**Cabinet is asked to recommend to Council:** **To approve supplementary capital estimate for property acquisitions within the Borough of £200m for 2017/18 to support the economic development and well-being of the Borough and investment purposes** **To agree the revised set of prudential indicators which include increasing the operational boundary and authorised limit for external debt by £200m (Appendix 1)** **To reconfirm the Council's Minimum Revenue Provision policy to ensure prudent provision is made to cover repayment of loans (Appendix 2)**		
Reason for Recommendation	In order to ensure the ongoing financial sustainability of the Council and its ability to provide services to residents in the face of funding reductions and pressures, the Council needs to be able to continue to generate additional ongoing income through making further income generating asset acquisitions.		

1. Key issues

1.1 The Council has been progressing its transformation programme- known as 'Towards a Sustainable Future' (TaSF). A key strand is the use of assets and income generation. The TaSF programme has been developed to ensure Spelthorne Borough Council is in a strong position to withstand significant financial challenges. Since 2013/14 the Council's Revenue Support Grant (RSG) has fallen from £2.5m and stands at zero for 2017/18. Beyond this, the

Council will be responsible from 2019-20 for paying back at least an estimated £750,000 each year to central government.

1.2 As part of its TaSF strategy, the Council has said that it effectively needs to be fully self-financing by 2020 in order to continue to deliver the services that it currently provides.

1.3 Financial Sustainability is one of the four key priorities under Spelthorne's Corporate Plan for 2016 -19 and highlights the Council's plans to invest in commercial properties to obtain ongoing, sustainable revenue streams and capital appreciation.

1.4 Cabinet will be aware that the recent acquisition of the BP main site meant that we were able to balance the budget for year 2017/18. However, as a result partly of knock on effects of Surrey County Council spending reductions and other pressures we are facing a budget gap of potentially over £1m in 2018-19.By 2021-22 we will be facing, if we do not delivering additional income generation streams or find additional efficiencies a £3m deficit per annum due to a number of factors (paying negative grant to central government, SCC funding reductions, reduced New Homes Bonus, impact of Universal Credit, increased pressure on homelessness and additional statutory housing responsibilities, increased provision for maintenance of assets, and reduction in recycling credits to name a few).

1.5 The reductions in RSG have been on-going for a number of years, and this, combined with the need to 'stand on our own two feet' financially, means it is imperative that the Council focuses on the most effective ways of increasing on-going income streams. One of the identified ways of doing this is through property investment and since summer 2016 the Council has made several significant acquisitions including the BP International Campus at Sunbury which together have delivered an additional £5m per annum in ongoing long term income available to support the provision of services for our residents. These income streams are net after taking account of interest, debt repayments, supervision costs for managing the assets and set aside sums to build up prudent sinking funds to cover future potential refurbishment requirements and to cover future rent free and void risk.

1.6 The Council with all its acquisitions undertakes thorough due diligence using an appropriate range of professional advisers to address legal, property, treasury management, taxation, environmental risks and issues. We minimise future risk with respect to commercial acquisitions by focusing on assets with strong covenant tenants, long term leases, and ensuring we understand the risks associated with the assets.

1.7 On this agenda there is a report setting out an updated Property Acquisition Strategy setting out clearly the parameters within which future acquisitions will be evaluated and approved.

1.8 As per the report to Council in February 2017 we had originally identified that to ensure its financial sustainability it should aim to generate an additional £7m per annum. However with additional pressures such as knock on impacts of Surrey County Council funding reductions, we now believe we should be aiming to generate a total of £9m, i.e. a further increase of £2m per annum in order to achieve this we potentially need the ability to spend a further £200 million.

2. Options analysis and proposal

2.1 In order to enable the Council to be able to bid for high quality investment opportunities which may arise over the coming months it is recommended that Council:

(a) Agree a £200m supplementary capital estimate to enable the Council to pursue further significant opportunities

(b) Agree a revised set of prudential indicators which include increasing both the operational boundary and authorised limit for external debt by £200m

(c) Confirm the Council's Minimum Revenue Provision policy to ensure prudent provision is made to cover repayment of loans

2.2 The proposal to increase the borrow limits is on the basis that the additional borrowing would be prudentially affordable as any borrowing would be fixed long term and would be used to fund high quality assets which will generate net revenue surpluses which will more than cover the financing costs. When evaluating acquisitions we will ensure that we able to generate sufficient sinking fund to cover risk of future refurbishments and rent free/void periods to ensure that we minimise financing cost and risk of future forced sale of assets.

3. Financial implications

3.1 Councils are in a strong financial position to acquire property due to their ability to access capital, coupled with the low cost of borrowing (for example Spelthorne can borrow at 2.25 to 2.75% long term at fixed rates from the Public Works Loans Board (effectively the Bank of England) depending on the amount and length of a loan, whereas a developer would be likely to pay 5 - 6%). The Council is also able to borrow at cheaper rates from other councils. Whilst the Bank of England base rate has recently increased by 0.25% we are still able to access relatively cheap borrowing. However, the potential that rates may rise further and eat into margins is one reason for looking to progress opportunities quickly. The Council is also currently exploring with alternative funders to see if it is possible to borrow some fixed rate funds at below PWLB rates.

3.2 It makes financial sense to borrow money at these rates rather than using the Council's own capital, which in the most recent financial year achieved an average of more than 5% return when re-invested in property funds. Whilst there may be some short term fluctuations associated with the UK Brexit properties acquired are likely to appreciate in capital value over the longer term.

3.3 Councils are able to set whatever borrowing limit they judge to be appropriate. However, it clearly needs to be prudent and affordable. Importantly, we need to consider carefully the impact of increasing levels of debt, our ability to repay, minimise liquidity risk and the risk of increasing interest rates for those repayments.

3.4 Officers liaise with Arlingclose our Treasury Management advisers. They have confirmed they are comfortable with the level of borrowing required to sustain a supplementary capital estimate of £200m to acquire income generating assets., see appendix 2. It has also been recommended that the funds are not borrowed until any acquisitions are completed and the cash is physically needed.

3.5 As part of the annual budget setting process, officers are required to produce a set of prudential indictors which include the operational boundary and authorised limit for external debt. These therefore need to be revised, and an updated set are included as **Appendix 1** for approval.

3.7 If the additional estimate is agreed, the capital programme will increase in 2017-18 from £305.922m to £505.922m. As a result, operational boundary for external debt has increased by £200m to £920m. In order to cover unexpected eventualities outside the remit of this specific report and ‘just in case’ scenarios on cash flow, it is deemed prudent to increase the authorised limit for external debt from £750m to £950m.

3.8 The Council will make appropriate Minimum Revenue Provision (MRP) deductions from the Revenue Budget on an annual basis to ensure sufficient sums are set aside to enable the Council to repay loans incurred on their maturity. The Council’s Treasury Management advisers Arlingclose have provided advice on the most effective way to structure these MRP deductions and are comfortable that our approach is a prudent one. Appendix 2 sets out the MRP policy the Council will be applying

4. Other considerations

4.1 Council should note that should the additional capital estimate be agreed, Cabinet will then have the ability to consider additional investment opportunities above the current limits but that in each case Cabinet will receive a detailed evaluation of the business case and risks in order to decide whether to agree to individual investment proposals.

5. Timetable for implementation

5.1 As appropriate opportunities arise they will be brought to Cabinet for consideration.

Background papers:

None

Appendices: 1) Prudential Indicators 2) Minimum Revenue Provision Policy

Appendix 1: Updated Prudential Indicators Statement 2017/18

The Local Government Act 2003 requires the Council to have regard to the Chartered Institute of Public Finance and Accountancy's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Estimates of Capital Expenditure: The Council's planned capital expenditure and financing, reflecting the requested revisions may be summarised as follows.

Capital Expenditure and Financing	**2017/18 Revised £000's**	**2018/19 Estimate £000's**	**2019/20 Estimate £000's**	**2020/21 Estimate £000's**
Total Expenditure	**505,922**	**216**	**216**	**216**
Capital Grants / Contributions	(980)			
Capital Reserves / Revenue	(7,695)	216	(216)	(216)
Borrowing	(497,247)			
Total Financing	**(505,922)**	**(216)**	**(216)**	**(216)**

Capital Financing Requirement	**31.03.18 Revised £000's**	**31.03.19 Estimate £000's**	**31.03.20 Estimate £000's**	**31.03.21 Estimate £000's**
Total CFR	909,393	901,957	874,334	850,000

The Council had previously been debt free for a number of years, and therefore the CFR had been nil. However, recent acquisitions have led to the CFR increasing significantly and it is forecast to rise again in 2017/18 to reflect the further funding being made available for strategic acquisitions. It will then slowly reduce over time in line with the annuity based funding model used the Council to support each of the strategic acquisitions made.

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years.

Debt	31.03.18 Revised £000's	31.03.19 Estimate £000's	31.03.20 Estimate £000's	31.03.21 Estimate £000's
Total Debt	887,593	878,157	868,534	858,000

Total debt is expected to remain below the CFR requirement during the forecast period.

Operational Boundary for External Debt: The operational boundary is based on the Council's estimate of most likely (i.e. prudent but not worst case) scenario for external debt. It links directly to the Council's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Council's debt.

Operational Boundary

Operational Boundary	2017/18 Estimate £000's	2018/19 Estimate £000's	2019/20 Estimate £000's	2020/21 Estimate £000's
Total Debt	920,000	912,000	904,000	896,000

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements, including the short term VAT related costs incurred with any acquisitions.

Authorised Limit	2017/18 Revised £000's	2018/19 Estimate £000's	2019/20 Estimate £000's	2020/21 Estimate £000's
Borrowing	942,000	934,000	926,000	918,000
Total Debt	**942,000**	**934,000**	**926,000**	**918,000**

Appendix 2: Minimum Revenue Provision Policy

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 Department for Communities and Local Government's Guidance on Minimum Revenue Provision (the CLG Guidance). The DCLG has recently issued consultation (deadline for response 21 December) on revisions to the Minimum Revenue Provision Guidance which the Council will be responding to. Following the consultation period once the MRP guidance is revised the Council will revise its policy in February 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 Council's current policy of fully repaying borrowing and associated liability by using annual MRP set asides to payment annual amortising debt is a fully prudent approach.

The DCLG 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.

Capital expenditure incurred during the financial year on asset acquisitions will not be subject to a MRP charge until the following complete financial year For capital expenditure incurred that is funded from borrowing, MRP will be determined by charging the expenditure over the expected useful life of the relevant asset as the principal repayment on an annuity with an annual interest rate equal to the relevant PWLB rate at the point the expenditure is incurred. 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.

The annuity method makes provision for an annual charge to the General Fund which takes account of the time value of money (whereby paying £100 in 10 years' time is less of a burden than paying £100 now). The schedule of charges produced by the annuity method thus results in a consistent charge over an asset's life, taking into account the real value of the annual charges when they fall due.
The annuity method also matches the repayment profile to how the benefits of the asset financed by borrowing are consumed over its useful life (i.e. the method reflects the fact that asset deterioration is slower in the early years of an asset and accelerates towards the latter years). This re-profiling of MRP therefore conforms to the DCLG "Meaning of Prudent Provision" which

provide that “debt [should be] repaid over a period that is reasonably commensurate with that which the capital expenditure provides benefits”. Capital expenditure incurred during 2017/18 will not be subject to a MRP charge until 2018/19.