Cabinet **18 July 2018**	SPELTHORNE MEANS BUSINESS

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	**Council is asked:** **To approve supplementary capital estimate for property acquisitions within the Borough of £594.859m for 2018/19 to facilitate generating sufficient income to enable the Council to progress its housing and regeneration projects across the Borough.** **To agree the revised set of prudential indicators which include increasing the operational boundary by £588m and authorised limit for external debt by £586m (Appendix 1) to £1,500m for Operational Boundary and £1,520m for Authorised Limit for 2018/19** **To agree the interim policy on Borrowing in Advance of Need described in paragraphs 4.7 to 4.12 of this report for all investments undertaken from 19 July 2018 until Council agrees its new Investment Strategy** **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 for the Council to deliver its ambitious housing and regeneration programme across the Borough and to help meet the needs of its residents identified in the Corporate Plan, the Council needs to generate additional income to offset the adverse revenue impacts which arise on these development projects before they reach income producing stage.		

1. Key issues

1.1 Housing and Economic Development are two of the Council's four key priorities in the Corporate Plan 2016 – 19. They will continue to grow in importance, forming the backbone of the Council's strategy to 'stand on its own two feet' financially. Delivering on these priorities will not just simply shape the future of the borough, and provide much needed housing, jobs and inward investment. At the same time, the rental income streams will help ensure the Council can be financially secure in the future, and enable us to continue to provide services to our residents.

1.2 The Council keeps under regular review its ability to prudently and sustainably deliver its housing, economic regeneration and strategic place shaping Capital projects. Taking into account the potential future pipeline of Capital projects coming through, it is timely and appropriate to revise the Council's relevant approvals. The Council needs to both authorise sufficient Capital Programme provision to enable expenditure to be undertaken once specific projects are identified and approved by Cabinet and secondly that there is a sustainable way of financing that expenditure. The first requirement will be addressed by increasing the Capital Programme Provision for acquisitions and housing delivery projects by £594.859m. The second requirement will be addressed by increasing the Council's borrowing limits to enable the Council to borrow fixed rate funds from the Public Works Loans Board. There are two borrowing approvals which the Regulations require Councils to approve

a) **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. It is proposed to increase this by £588m to a total of £1,500m

b) **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. As a worse case assumption this is always higher than the authorised limit. It is proposed to increase by £586m to a total of £1,520m.

The above levels will be underpinned by maintaining a prudent Minimum Revenue Provision policy which ensures maintains a sensible approach to paying off debt on an annual basis.

1.3 The Council currently has a small scale housing delivery programme (Bugle Returns and Churchill Hall), and is beginning to make good headway on a journey to deliver a programme with significantly greater ambition. The aim is to deliver a wide ranging housing and regeneration programme across the whole Borough, and a number of larger scale projects are or will be coming on stream shortly. These include the redevelopment Ceaser Court in Sunbury (formerly Benwell House), the redevelopment of Thameside House in Staines-upon-Thames (known as the BUPA building), new affordable housing at the White House site in Ashford and the conversion of the West Wing of the Council Offices here at Knowle Green to residential.

1.4 There are a number of further projects in the pipeline, which are designed to deliver a range of different housing tenures. The aim is to use these to help address housing pressures by enabling the Housing Team to place people from the housing register in these units. This has a two-fold benefit. Firstly, it will help ease pressures on the Council's revenue housing budget (potentially less required for B&B). Secondly, the rental income from these units will recycled back to the Council (whether directly or via the Councils wholly owned housing delivery company, Knowle Green Estates Ltd). A firm decision has yet to be made on the management of these units which will either fall to the Council or Knowle Green Estates Ltd.

1.5 Undertaking housing development creates a short to medium term financial pressure for the Council as the development expenditure has to be financed through borrowing with interest and Minimum Revenue Provision charged to the Revenue Budget. This would result in the Revenue Budget increasing significantly over the Outline Budget period. Consequently, unless additional income is generated from other sources it may not be possible to undertake and complete these schemes (with all the knock on ramifications that this entails). Each scheme will eventually produce rental income, but each will also have a significant period in the planning and construction phases where cash flow is negative before the incoming generating stage is reached.

1.6 The reductions in Revenue Support Grant have been on-going for a number of years, and this means it is imperative that the Council focuses on the most effective ways of increasing on-going income streams in order to be able to maintain existing services and deliver much needed additional housing within the Borough. 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 £7.5m 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.

1.7 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.

1.8 In order to deliver the full range of housing projects, place shaping projects within our main towns in the Borough and be able to finance the net cost of a new Leisure Centre, we estimate that we need to generate approximately a further £6m per annum of net revenue income, which requires approximately £800m worth of income generating assets to be acquired, taking our net borrowing up to roughly £1,500m which is approximately £600m more than our current borrowing approval limits allow.

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 £594.859m supplementary capital estimate to enable the Council to pursue further significant opportunities to generate income streams to offset the revenue impacts of financing its housing and regeneration programme.

(b) Agree a revised set of prudential indicators which include increasing both the operational boundary and authorised limit for external debt by £588m and £586m respectively

(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 borrowing 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 are able to generate sufficient sinking funds to cover risk of future refurbishments and rent free/void periods to ensure that we minimise financing costs and risk of future forced sale of assets.

2.3 When the Council approved the Capital Programme in February 2018 it approved an Operational Boundary limit of £912m and an Authorised Limit of £934 for 2018-19. It is proposed to increase the Operational Boundary limit by £588m to £1,500m and increase the Authorised Limit by £586m to £1,520m for 2018/19

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 £595m 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.

3.6 If the additional estimate is agreed, the Capital Programme will increase in 2018-19 for acquisitions from £203m to £819m. As a result, operational boundary for external debt has increased by £888m to £1,500m. 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 £934m to £1,520m.

3.7 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. Legal considerations

4.1 Council should be aware that the statutory regime for investments by local authorities changed on 2 February 2018 with effect for investments from 1 April 2018.

4.2 The specific power of investment is contained in section 12 of the Local Government Act 2003. Under section 15 of the same Act, a local authority must have regard to such guidance as the Secretary of State may issue and to such other guidance as the Secretary of State may by regulations specify.

4.3 The Secretary of State has made the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (the regulations). By virtue of these regulations the Council must have regard to guidance published by the Secretary of State (the New Guidance) and also have regard to additional guidance published by CIPFA (the Codes of Practice).

4.4 Not only does the Council have to have the power to invest legally, it must consider the regulations and the Codes of Practice in doing so. In addition to that there is also the Council's general duty at public law to exercise its powers reasonably, properly and in accordance with best value, fiduciary duty and the general administrative law principles with regard to mitigation of risk and all due diligence.

4.5 The New Guidance contains a number of provisions with regards to the preparation of an Investment Strategy and how that should be presented to

Council before the start of the financial year. Officers are working on this strategy and it will provide further details for Council on the type of investments which the Council will consider, how they are linked to the Council's corporate plan and service delivery, the links to the Council's medium term financial strategy, the Council's approach to risk & reward, repayment of borrowing, performance management and governance of its investments etc. This will be a significant document for the Council and there will be engagement with councillors during the autumn as regards the detail of the strategy and the implications for the Council overall.

4.6 One significant change in the New Guidance, which differed from the consultation document (circulated in November 2017) was that there is an additional section headed, "Borrowing in advance of need". This concept has been taken from explanatory comments in previous versions of the Codes of Practice. Unfortunately neither the New Guidance nor the Codes of Practice define what is meant by Borrowing in advance of Need. There was a definition in the draft Guidance for consultation which stated, "Borrowing to invest in a yield bearing opportunity is borrowing in advance of need". This is not stated in the New Guidance, instead the context now included is as follows (at paragraphs 46 and 47):

Authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed.

Where a local authority chooses to disregard the Prudential Code and this Guidance and borrows or has borrowed purely to profit from the investment of the extra sums borrowed the Strategy should explain:

- *Why the local authority has decided not to have regard to this Guidance or to the Prudential Code in this instance; and*
- *The local authority's policies in investing the money borrowed, including management of the risks, for example, of not achieving the desired profit or borrowing costs increasing*

4.7 The Council will fully articulate its policy on Borrowing in advance of need in its Investment Strategy (referred to earlier which is in the course of preparation). However as an issue arises no about investments which will be made after effective date of 1 April 2018, then the Council needs to be mindful of this New Guidance and to show it has actively considered it and taken it into account. In the interim it is suggested that the policy of the Council (which will be developed further in the Investment Strategy to be presented later) is as follows:

4.8 The Council does not borrow in advance of need purely to in order to profit from the investment of the extra sums borrowed. The Council does however borrow to invest in order to fulfil its statutory functions. In doing so the Council will always take into account the New Guidance and the Codes of Practice.

4.9 The policy of the Council is to borrow only where there is an identified need which relates to its core purposes as a local authority. At this present time, the need arises from development activities centred on the provision of housing and town centre regeneration in the Borough. The Council has a number of schemes which will not be developed without the identification of suitable revenue generating opportunities to cover the planning, development and construction of works. Whilst these schemes will eventually be income producing investments in their own right (as an incidental benefit to the primary objectives of housing and regeneration) there is a funding gap during the early stages of the projects which needs to be met.

4.10 The Council's clear policy in investment is to avoid risks of investing money in assets which will not (a) cover their own costs, including the most prudent approach to MRP and foreseeable risks of voids, repairs, maintenance and refurbishment and (b) provide a surplus which will provide for the identified needs on other projects. The Council will seek rent guarantees and carry out due diligence to ensure that the risks of not achieving the desired returns are, as far as possible, eliminated or mitigated.

4.11 The Council will invest inside and outside its Borough boundary. Its preference is to invest inside the Borough where possible and where suitable opportunities exist. The Council's strategic parameters for investment have already been agreed and will be confirmed again as the Investment Strategy develops.

4.12 The Council will fully articulate its Investment Strategy (this is a new document as required by the revised Guidance to be put in place by councils by end of 2018-19 and builds upon the existing strategies and policies we already have in place), in order to allow all stakeholders, residents, council taxpayers, business rates payers, partners and external auditors to understand how and why the Council invests and how it meets the requirements of the New Guidance and the Codes of Practice. This will enable all such stakeholders to hold the Council to account if they do not agree with the approach which is taken.

5. Other considerations

5.1 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.

6. Timetable for implementation

6.1 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 2018/19

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**	**2018/19 Estimate £'000**	**2019/20 Estimate £'000**	**2020/21 Estimate £'000**
Opening CFR	416,250	681,984	1,487,736	1,486,009
Capital Investment	273,360	814,083	6,016	5,166
Capital Grants / Receipts	(2,271)	(770)	0	0
Revenue Contributions	(838)	(216)	(216)	(216)
Repayment of debt	(4,517)	(7,345)	(7,527)	(7,714)
Capital Financing Requirement financial year end 31 March	**681,984**	**1,487,736**	**1,486,009**	**1,483,245**

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 2018/19 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	**31Mar18 Revised £'000**	**31Mar19 Estimate £'000**	**31Mar20 Estimate £'000**	**31Mar21 Estimate £'000**
Total Debt	664,566	1,470,318	1,468,591	1,465,827

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	**31Mar18 Revised £'000**	**31Mar19 Estimate £'000**	**31Mar20 Estimate £'000**	**31Mar21 Estimate £'000**
Total Debt	920,000	1,500,000	1,500,000	1,500,000

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	**31Mar18 Revised £'000**	**31Mar19 Estimate £'000**	**31Mar20 Estimate £'000**	**31Mar21 Estimate £'000**
Borrowing	942,000	1,520,000	1,520,000	1,520,000
Total Debt	**942,000**	**1,520,000**	**1,520,000**	**1,520,000**

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 Ministry for Housing, Communities and Local Government's Guidance on Minimum Revenue Provision (the MHCLG Guidance). The MHCLG has recently reissued guidance on this topic which has been considered in reviewing this policy.

The broad aim of the MHCLG 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 MHCLG Guidance requires the Council to approve an Annual MRP Statement each year, and recommends a number of options for calculating a prudent amount of MRP. The following statement incorporates options recommended in the Guidance.

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 MHCLG "Meaning of Prudent Provision" which provides that "debt [should be] repaid over a period that is reasonably commensurate with that which the capital expenditure provides benefits".

Capital expenditure incurred during 2018/19 will not be subject to a MRP charge until 2019/20.