9. CAPITAL STRATEGY (A/13321 / PN)

Purpose of the report

The purpose of this report is to update the Capital Strategy approved by the Authority in August 2011; to agree a revised set of principles to guide the Authority's approach to budgeting for capital expenditure, and also to approve a Capital Programme for the next medium term period, aligned to the current Asset Management Strategy, and the new Corporate Strategy for 2016-2019.

Recommendations

1. **1. That the key principles and working assumptions outlined in paragraphs 7 and 8 be approved**

2. That the potential projects identified in the Capital Programme in Appendices 2 and 3, and the means of financing them, form part of an approved Programme for the duration of the Corporate Strategy period up to March 2019.

3. That individual projects within Appendix 2, if the project cost is under £150,000, be delegated to Resource Management Team supported by either borrowing or the Capital Fund, subject to the Authority's Prudential Framework Authorised Limit and subject to the Chief Finance Officer's assessment that future estimated Capital Fund receipts will be achieved and are available for allocation.

4. That individual projects within Appendix 2 above £150,000 be brought to committee for approval, subject to the Authorised Limit and subject to the Chief Finance Officer's assessment that future estimated Capital Fund receipts will be achieved and are available for allocation.

5. That, in accordance with working assumption (4) in this report, £50,000 from the Capital Fund is earmarked to support capital expenditure which would otherwise be funded from the Revenue Budget, to allow the Authority to allocate £50,000 of Revenue resources to ensure that the disposal programme approved in the Asset Management Plan continues up to March 2019.

6. That any other proposals for use of the Capital Fund not identified in Appendix 2 are the subject of a further report to committee for consideration.

How does this contribute to our policies and legal obligations?

2. The Prudential Code for Capital Finance in Local Authorities was updated in 2012, and its objective is to ensure, within a clear framework, that the capital investment plans of Local Authorities are affordable, prudent and sustainable. Authorities are required by law to have regard to the Code and are advised on this matter by the Chief Finance Officer.

Background

3. Members approve the Revenue Budget and Capital Budget annually in February.

Members have also approved the approach to Asset Management, in the Authority reports of February and May 2014. A useful summary of the current position was taken to the Authority meeting in December 2014 by the Assistant Director of Policy and Partnerships, and in March 2015 the Audit Resources and Performance committee approved a report concerning the financial performance of the property portfolio. In September 2015 the Chief Executive's report on the new Strategic Framework was approved which will inform the 2016-2019 Corporate Strategy, which is reported to this meeting.

Capital investment decisions need to be made in the context of an approved asset management plan, show appropriate value for money appraisal, and align fully with corporate objectives. All capital projects over £150,000 are the subject of a committee report and Member approval, in line with Standing Orders. The Authority approves the Prudential code indicators in March of each year – the Prudential code indicators concern the Authority's borrowing, where borrowing is required to support capital investments which cannot be financed by other means (explained in the table below).

4. Capital investment broadly covers any expenditure over £10,000 which yields economic benefits, controlled by the organisation, for a period longer than 1 year. Capital projects are either:

- Acquisitions (i.e. new assets)
- Enhancements (improvements to existing assets)
- Replacements (replacing obsolete assets)

The categories of project in this Authority cover typically:-

- Property – land & buildings
- Information Technology hardware and software
- Vehicles
- Fixtures and Fittings
- Equipment

Expenditure on capital is subject to public sector controls designed to ensure that the expenditure is affordable and that resources are available to support capital expenditure requirements, hence the rules require that borrowing, and capital receipts where assets are sold, are only used to support <u>capital</u> and not <u>revenue</u> expenditure.

Local Authorities are able to finance capital investment from a number of sources:

Source	**Advantages**	**Disadvantages**
Directly from revenue budgets	Simple; no restrictions other than budget limitations	Distorts and disrupts routine expenditure; difficult to budget for larger projects
External Grant aid	Free support from other organisations for capital assets	Few, other than compliance with grant conditions or repayment clauses linked to asset life; possible distortion of strategic priorities
From the Capital Fund	Using receipts from past sales; "free" capital	Availability depends on past and future sales receipts; not sustainable as only a one-off source

From borrowing	Spreads the cost over the asset life; relatively low cost finance available; budgeting for loan repayments is easier; debt repayment period matched to asset life will allow replacement asset to be financed from revenue budget (i.e. a new loan for the new asset replaced)	Affordability into the future to cover debt repayments; income risk (if trading related); interest payments
From cashflow	Allows temporary surplus funds to be used instead of making immediate borrowing arrangements; facilitates management and timing of borrowing; may be cost effective in the short term	Optimum market borrowing rates may not be available when borrowing is taken out; annual minimum revenue provision payments are still required to ensure debt is repaid and not deferred.

5. The Authority has a cautious approach to capital investment, but significant capital investment still takes place. Appendix 1 is a breakdown of capital expenditure and capital receipts in the last 10 years, and shows how this expenditure has been financed in each year.

Proposals

6. It is necessary to set out, for Members approval, the <u>key principles</u> and the <u>working assumptions</u> which can be used as the basis to guide future capital expenditure decisions. It is unlikely that the key principles will change as they form part of the statutory requirement, as well as representing a sensible approach to capital investment. The working assumptions however may need to be changed periodically depending on the situation or further review, subject to future committee approval.

7. The <u>key principles</u> are:

   1. Assets created or replaced will be subject to a process of consideration of the extent to which they have a high “strategic fit” with the Authority’s purposes over the longer term, with an approved Asset Management Plan and Corporate Strategy the reference point for that consideration.

   2. Capital investment proposals will take into account whole life costs, covering the initial capital investment as well as any revenue income or expenditure implications. The possible “exit” value of the asset created should be assessed as a relevant consideration in reducing the risk in respect of cost and / or strategic fit.

   3. The principle of sustainability requires that the ability to replace existing assets when they have reached the end of their useful life should be given priority, subject to 1 above; these replacement costs ideally need to be available within existing budgetary provision and not be dependant on uncertain additional funds.

   4. Priority will be given to capital projects which deliver revenue savings or additional income streams.

8. The working assumptions help to guide investment decisions over the medium term and are:-

1 That the capital investment needs of services with trading or other financial objectives (car parks/toilets; cycle hire centres; visitor centres; estates) should be met from trading or business plan income or existing revenue budgets, including environmental improvement initiatives.

Advantages

Capital proposals for the above can be brought forward at any time, and need not be subject to a prioritisation process measured against other proposals, as the constraint applied by the service's business plan will generally confine capital proposals within boundaries affordable from income / rental / trading sources, and hence planning for these investments and replacements is consistent with the private sector, because the scale of the investment is tailored to the likely economic return. The majority of these capital proposals will need to be financed from borrowing, with an annual charge to the service for the asset being purchased. Budget holders will feel they have greater control over replacement of assets and necessary improvements. Our experience of the carbon management projects (to which Members allocated £250,000 from the Capital Fund in 2011) is that the improvements in environmental performance are generally cost neutral, taking into account tariff payments, so there is no financial impediment in approving these projects.

Constraints

There is a risk that the capital investments cannot be afforded. The existing specific reserves for these areas of operation will need to be retained as a supplementary source of finance. The appetite for risk in a proposal should be consistent with its fit to core objectives, and should not lead to unreasonable trading/income risk to achieve minor objectives. Proposals not capable of being supported within the business plan targets could bid for further capital funds, but would then need to be subject to a prioritisation process against other projects (see 2 below).

2 That the Capital Fund be used for investments which are strategically important but do not have the prospect of an economic return, or where the return is not sufficient to cover the cost of borrowing, subject to consideration of the extent to which external funding or donations can reduce the net investment cost.

Advantages

The projects could not otherwise be considered for approval. The estimates of potential capital receipts over the Corporate Strategy period will inform the potential for investment.

Constraints

The respective priority of projects which require investment within the Corporate Strategy horizon will need to be determined before decisions can be made to use the Capital Fund. Once the decisions on priorities are made, the resources are effectively ring-fenced for the duration of that period. There is a risk that the Capital Fund is not used strategically to support projects which will be required over a longer timescale, for which Capital receipts may not be forthcoming in the future. The appraisal process should take account of the likelihood of external funding or donations prior to commitment of funds.

3 That the capital investment needs of the Authority for Information Technology, vehicle replacements and a degree of headquarters refurbishment are met from the existing sums set aside within the revenue budget for repayment of debt (currently totalling £72,000, £63,000 and £54,000 p.a. respectively within the baseline budgets)

Advantages

There is a need within these three principal asset categories to replace obsolete assets and the financial capability to replace needs to be safeguarded to ensure stability of operations, predominantly financed by National Park Grant. The assets are replaced only if the need is there in line with Key Principle number 1 above. The asset life cycle is approximately 3-5 years for IT, 7 years for vehicles, and 25 years for headquarters' refurbishment. The cost of vehicle replacements is partially offset by the residual value of the vehicles achieved on disposal; vehicles used by the Warslow, Trails and North lees estates are financed by the estate budget, and the pool cars represent a significant saving compared to staff using their own cars for official travel and being reimbursed at 40p per mile.

Constraints

The resource requirements need to be flexible if service delivery requirements change. The proposal to move to an IT infrastructure as a service model achieves this; similarly fleet vehicles can be disposed of flexibly at any stage of their asset life if circumstances change, as the earlier higher residual values are able to pay off the remaining loan amounts.

4 That the use of capital to support the revenue budget on an emergency basis, or to achieve financing flexibility, is considered annually, by substituting revenue financed capital expenditure with Capital Fund financing.

Advantages

Should the National Park Grant Spending Review result in unanticipated difficulties in balancing a revenue budget on an emergency basis some capital fund monies could be used to support underlying capital expenditure financed from the revenue budget, freeing the revenue budget to underwrite the deficit temporarily, so that this adds a small degree of temporary flexibility in how the Authority is able to respond to difficult budget settlements. This approach may also be useful, in a more limited way, to achieve flexibility in financing of some expenditure which could not otherwise be capitalised. Appendix 2 suggests that a figure of £200,000 is set aside from the Capital Fund for such emergency purposes. The remaining £50,000 is proposed to be used (as per Recommendation 5) for supporting the disposal programme on which this Capital Strategy largely depends.

Constraints

Financing of this nature will need to be agreed at the outturn stage to Audit Resources and Performance (ARP) Committee as an emergency measure, and will depend on the availability of capital expenditure already financed from the revenue budget in order to achieve the substitution. Appendix 1 shows that there is a degree of capital expenditure financed on this basis annually (averaging approximately £150,000 p.a.).

The Capital Programme 2016/17 to 2018/19

9. The Capital Programme represents anticipated major proposals over the next Corporate Strategy period, informed by the key principles and working assumptions

above. Members considered in workshops earlier in 2015 a number of proposed capital investments, and Resource Management Team (RMT) then approved for further appraisal a number of possible projects which, although not exhaustive, would be given higher priority in the next Capital Programme. Members are asked today to approve in principle these allocations subject to a subsequent business case decision, which would be either RMT or the ARP committee, depending on the cost of the project; if Members approve the principle of these projects within the capital programme they will understand the context when the individual projects are ready to come forward for approval (for those projects over £150,000 which require committee authority). Where the delegated decision for a project lies with RMT, Members are being asked to approve use of the Capital Fund for these projects, providing they are within the scope of this Capital Programme, within Appendix 2 and 3. Currently RMT has delegation to approve borrowing for projects under £150,000 (within the Prudential limit) but has no authority to commit Capital Fund resources. Recommendation 3 requests this, if Members accept the proposal. In effect, under the proposed Capital Programme, this delegation is restricted to any structural repairs to core infrastructure (within the £500,000 figure in Appendix 2) and emergency revenue budget funding (the £250,000 figure), providing projects are within the £150,000 delegation.

10. In line with key principle number 1 above, other capital projects may come forward, but their incorporation into the Capital Programme will depend on successful approval of a business case, and capability of financing it within the Prudential Authorised Limit. Proposals for financing from the Capital Fund are not expected to come forward unless they have been identified in this report, but Members will always have the option to consider further capital projects, but there will clearly be a knock-on impact on other projects identified in this Programme, if financing from the Fund is required.

11. Appendix 2 therefore is a list of the proposals anticipated to form the Capital Programme for the next Corporate Strategy period up to 2018/19. Appendix 3 gives a little more detail on the nature of each proposal.

Financing the Capital Programme

12. Appendix 2 also shows the proposed method of financing the projects identified, within the options identified in the table in paragraph 4 above. With the exception of the items identified in working assumption 3 above, the main discretion in financing of the capital programme is whether the funds are allocated from the Capital Fund (i.e past and future capital receipts from asset disposals) or borrowing, in line with the key principles.

13. The extent of borrowing is governed by the Prudential Framework and the “Authorised limit” - the maximum allowable borrowing level - is set by the Authority in March of each year, based on the advice of the Chief Finance Officer. Within the constraints of the Prudential Framework, the limit is self-determined by the Authority, and can be adjusted annually. With the exception of the capital replacements identified in working assumption 3, the majority of borrowing approvals are expected to be financed from income, and projects will only be approved if there is sufficient confidence that net income assumptions will more than cover debt repayment / interest (i.e they have good debt repayment / interest cover ratios). Risk is further reduced if there is a strong “exit” value to the investment in line with key principle number 2. On the basis that a reasonable working assumption for the Authorised Limit is that it should not be in excess of 50% of annual net expenditure, this suggests an absolute borrowing limit, for projects in the Capital Programme, of £1.87m.

This is derived as follows:-

50% of net expenditure (defined as National Park Grant plus investment interest)	£2.70m
Less current Capital Financing Requirement (i.e. existing borrowing need outstanding)	(£0.83m)
Further borrowing "headroom"	**£1.87m**

The Capital Fund available for allocation within the Capital Programme period is expected to be in the region of £1.72m as shown below:-

	£,000
Capital Fund as at 31/03/2015	**335**
Less farm extension (Authority Minute 07/06)	(45)
Less Minor Works allocation – outstanding commitments (Minute 58/11)	(63)
Less Carbon Management allocation – outstanding commitments (Minute 58/11)	(152)
Less Aldern House reconfiguration – outstanding commitments (Minute 52/14 Sept 2014)	(78)
Net Disposals achieved in 2015/16	830
Estimated Disposals 2016-2019	1,940
Capital Fund as at 31/03/2019	**2,767**
Retention – substitution to balance revenue budget	(250)
Retention – estimates not yet sufficient to allow confident allocation	(800)
Capital Fund available for allocation 2016-2019/20	**1,717**

The above analysis supports the assertion that capital investment proposals of up to £3.59m during the next Corporate Strategy period can be considered for approval within the Programme outlined in Appendix 2. A summary of Appendix 2 is shown below:-

Potential borrowing proposals	£2.49m
Potential Capital Fund allocations	£1,10m
Total	**£3.59m**

The Capital Programme contains indicative net costs which may change as business cases are developed, and the availability and percentage contribution of grant funds is better understood. One of the major costs and concerns of the Authority is represented by structural works on the Trails; Appendix 2 allows for an immediate allocation of £600,000 towards structural work financed by the Capital Fund, with a further requirement for funds potentially financed from borrowing and repaid over time from greater commercial activities on the network. The £340,000 figure is the extent to which this next phase of works can be supported from the current Capital Programme, whilst remaining within the suggested borrowing ceiling; if greater funds are identified as being required, then Resource Management Team will consider how this greater sum can be accommodated, by reducing the cost of other proposals in Appendix 2, or deferring the expenditure until the subsequent Capital Programme period when other financing may become available.

The Capital Programme proposed in Appendix 2 is therefore capable of being financed overall within the £3.59m proposed above, The only difficulty is that the suggested borrowing ceiling will be breached by £620,000 (£2.49m rather than £1.87m); whereas the Capital Fund may be under-used by the same amount (£1.10m rather than £1.72m). The figures are estimates, and will be refined further as business cases develop; either costings will be refined to fall within the suggested borrowing ceiling, as mentioned above, or a case can be made for this slightly higher borrowing limit "under-written" by the availability of Capital Funds, which would remain unspent to reduce risk.

To re-balance the financing, it would be possible to allocate some of the Capital Funds instead of relying on borrowing for some projects, but this might compromise the key principles and working assumptions set out above; to avoid this a decision could be made to use Capital Funds to reduce the Capital Financing Requirement below the suggested borrowing ceiling, but still retain an internal "debt repayment" charge to the project.

The Chief Finance Officer will advise on this, based on actual circumstances, at the time the Authority is asked to set the Prudential borrowing limits.

14. **Risk Management:**

Because of the usually high cost and long term nature of capital expenditure, there is a risk that capital projects are entered into with a poor strategic fit for the future, and are neither sustainable or affordable. The principles and assumptions set out in the report are designed to ensure that resources are capable of being allocated to essential capital replacements, whilst other proposals are subject to competition based on their respective priority, or are able to be self-financing based on prudential assumptions within business plans. Consideration of the "exit" value of a capital investment also reduces the risk of an investment being a drain on future resources.

15. **Sustainability:**

Key principles number 2 and 3 seek to achieve a sustainable approach to capital requirements.

16. **Background papers**

None

Report Author, Job Title and Publication Date

Appendix 1: Summary of capital expenditure 2005-2015
Appendix 2: Capital Programme project proposals
Appendix3 : Brief rationale for each proposal

P Naylor, Head of Finance, 26 November 2015