MIDDLESBROUGH COUNCIL	Middlesbrough moving forward

Report of:	Director of Finance (S151 Officer) Executive Member for Finance & Governance

Submitted to:	Council

Date:	18 January 2023

Title:	Capital Strategy - 2022/23 – Mid Year Update

Report for:	Decision

Status:	Public

Strategic priority:	All

Key decision:	Yes
Why:	Decision(s) will incur expenditure or savings above £150,000

Urgent:	Yes
Why:	Decision needed in the 2022/23 financial year to change the policy on Minimum Revenue Provision.

Executive summary

The Capital Strategy is one of the main elements of the Council's budget approach, alongside the Revenue Budget and the Investment Strategy. Although some high-level metrics on progress have been reported as part of the quarterly budget monitoring process, it is good practice to review this information in more detail at Quarter 2.

This report therefore reviews the position on the Investment Strategy, any changes that have occurred during the year to date, plus any implications for affordability since the original budget was set in February 2022. In addition, the report reviews the position on treasury management, including borrowing, investments, and debt repayment.

The second aspect of the report considers a change to the Council's current policy on Minimum Revenue Provision which may lead to some cost reduction. This will need formal approval by Council as the original policy was part of the budget setting process from February 2022.

Purpose

1. That the Council:

- Consider the current position on the Council's Capital Strategy for 2022/23.
- Approve the change being proposed on Minimum Revenue Provision for 2022/23. This was approved by Executive on 6 December 2022.

Background and relevant information

2. The Capital Strategy report for the Council covers the following areas:

    - How the Investment Strategy is funded.
    - The relevant Prudential Indicators to monitor the performance, affordability and sustainability of the capital expenditure being proposed in line with the requirements of the prudential code.
    - Treasury Management arrangements in place for investing surplus funds and borrowing to fund capital expenditure.
    - The types of investments the Council makes as part of managing its cash balances – the Annual Investment Strategy.
    - Minimum Revenue Provision policy – including outlining how much the Council sets aside to re-pay debt built up to fund prior year's capital expenditure in the Borough.

3. The Capital Strategy report gives a high-level overview of how capital expenditure, capital financing and treasury management activities contribute to the provision of local public services at the Council. In addition, it also gives an overview of how the associated risks involved are managed and the implications for our future financial sustainability.

4. This is a mid-year review of the strategy, which is considered best practice in line with the CIPFA Codes on the Prudential Code of Capital Finance and Treasury Management, to see how the strategy has developed in the first six months of the year. In addition, the Council is considering a change in its policy on Minimum Revenue Provision (MRP). This change in policy needs approval by Full Council as the decision-making body.

5. Capital Expenditure relates to what the Council plans to invest in long-term assets and infrastructure (such as property, equipment, vehicles, roads etc.). The Council must consider how this expenditure is paid for and what the long-term financial implications are of undertaking this investment. The Council is also permitted to borrow funds to finance the investment strategy under the Local Government Act 2003. It needs to consider the impact on the revenue budget of the level of borrowing being proposed, how it funds the repayment of this debt and the period over which this debt is repaid.

6. The Capital Strategy and the key assumptions that influenced the 2022/23 budget are included within the original budget setting report for the financial year, which was approved by Council on 23 February 2022 – Appendix 5.

<u>Prudential Indicators and Capital Investment Plans</u>

7. The Council demonstrates the concepts of affordability, sustainability and prudence on its investment plans by setting a range of Prudential and Treasury Management

indicators. These are set out in the various tables in the Capital Strategy and are key metrics to the Director of Finance when setting the budget plans each year. Any breach of these indicators during a year indicates either a higher level of indebtedness or a lower level of overall prudence on the capital activities of the Council than when the budget was set. The following paragraphs give a brief commentary on these key indicators to assess any changes that have occurred during the financial year to date.

8. Although the Capital Strategy covers the whole of the medium-term financial planning period, this mid-year review focuses solely on the position for 2022/23. Due to the current review of the Investment Strategy and any further changes that may occur before the financial year-end on 2022/23 budgets, it is not appropriate to review the other years at this stage. These will be updated as part of the budget setting report to Council in February 2023.

9. The position at the end of quarter 2 was as follows. This was reported to Executive as part of the regular quarterly budget monitoring arrangements on 8 November 2022:

Prudential Indicators - 2022/23 Quarter 2	Budget (£M)	Actual (£M)
Capital Expenditure	124.825	69.241
Financing		
External Sources	74.344	41.579
Own Resources	6.296	3.257
Debt	44.185	24.405
Capital Financing Requirement	295.865	283.324
External Debt	268.350	205.667
Investments	15.630	21.020
Capital Financing	10.466	10.587
Cost as a % of Revenue Budget	8.8%	8.9%

10. The first point to note is that Investment Strategy for 2022/23 has reduced significantly during the financial year to date. In summary, this relates to slippage on approved capital schemes into later years in the programme, with the funding before re-profiled also. Further analysis of this at individual scheme and directorate levels can be seen within the Quarter 1 & 2 budget monitoring reports.

11. It can also be seen that the amounts of funding needed have reduced below the original budgeted levels. Some of this is for schemes funded by capital grants and contributions by other bodies, but also there is an in-year reduction on the level of borrowing needed of £19.8m (original budget of £44.2m less current budget of £24.4m).

12. There is total outstanding debt of £205.7 million (including debt and lease liabilities) on 30 September 2022, with a further £40 million - £45 million expected to be needed before 31 March 2022. Cash balances are generally higher in the first two quarters of the financial year as grants and contributions tend to be paid in advance of need. This means that the level of external debt above is lower than it should be based on the level of capital expenditure forecast, as borrowing needs have been deferred.

13. The total amount given for additional borrowing in this financial year is higher than the figure quoted in paragraph 11. This is due to additional cash flow demands, because of using earmarked reserves to fund the revenue budget position, plus the early use of grant income in advance which needs to be replaced.

14. The forecast overall total long term external debt at the end of 2022/23 is expected to be around £250million. This should be compared with the estimated *Capital Financing Requirement* (the underlying value which the Council needs to borrow to fund capital activities) of £283m million. The Council therefore has an expected under-borrowed position of circa £33 million or 12%, which has provided some annual savings in interest payments, as other revenue and capital cash has been used in lieu of external borrowing. This is a key strategic decision each year as to whether the under-borrowed position is increased or reduced and does not diverge from that used as part of the budget position.

15. Table 6 in the Capital Strategy for 2022/23 shows the profile of outstanding debt over the whole of the medium-term financial planning period and that this was expected to rise to a maximum of £268 million on 31st March 2023, before starting to reduce in the following financial year. This increase in debt is not expected to rise much further than £250m now given the recent review of the capital programme, which has reduced borrowing requirements from when the original budget position was agreed. This position will be updated again as part of the budget setting report.

16. The Council holds revenue budgets for repaying debt (known as Capital Financing Costs covering MRP and external interest). This costs £10.6m (8.9% of the net revenue budget) for the 2022/23 financial year. The Council has a nominal threshold of 10% of its revenue budget as a cap for capital financing, so there is still some headroom for borrowing on urgent priorities if required, subject to overall council affordability

17. Table 9 in the Capital Strategy for 2022/23 shows that the proportion of capital financing costs is relatively stable at a time when the level of external debt is rising. This is due to the commercial income achieved on recent capital investments in Centre Square, Teesside Advanced Manufacturing Park and Captain Cook Square. It is important that these income levels are maintained otherwise the proportion of the revenue budget attributed to capital financing costs will start to increase.

18. One way to reduce capital financing costs is to reschedule the debt. This means to repay the debt earlier than expected and then to reborrow at a rate lower than the existing interest rate on the loan. This has been very difficult to do since 2008 due to low borrowing rates and high premiums on any early repayment options. Given the increase in interest rates in recent months, these premiums are starting to reduce and there may be some options for the Council to pursue. These are monitored on a regular basis by our treasury management advisers and if any of these are felt to be financially beneficial, they will be highlighted to Members by the Director of Finance.

19. It is also a statutory requirement for the Council to set an authorised limit for external debt at the start of each financial year. This is an amount beyond which it would be ultra-vires (or outside of the Council's legal powers) to exceed in a particular financial year. The authorised limit for 2022/23 is £356 million.

20. It should be noted that the authorised limit for the Council is currently much higher than either the level of external debt or the capital financing requirement. This is not uncommon within local authorities, to build in extra headroom for unexpected capital investment, possible debt re-financing opportunities and the remote possibility of needing to borrow for exceptional revenue purposes. At present, the Council's authorised limit is set at £73m above its capital financing requirement and allows a degree of flexibility within the Council's planning processes and this legal limit. It should be noted that any unexpected debt financing in a year could breach some of the other prudential indicators so this would need to be identified as part of the quarterly performance monitoring reports to Executive.

Treasury Management

21. Treasury Management is defined as the management of the Council's cash flows, borrowing and investments, and the associated risks. The main risks that affect a local authority include credit risk, interest rate risk, liquidity risk and refinancing risk.

22. The Council is generally cash rich in the short term, as many grants and contributions are paid in advance of need. Because of this, any excess cash is invested with an appropriate counterparty until the funds are required. When making an investment, the Council follows the advice set out in the Local Government Act 2003 and within the Treasury Management Code, with paramount consideration given to the security of the sum invested, followed by the liquidity position of the Council, and finally the interest rate achievable on the investment.

23. Given that credit criteria is the most important factor when making an investment decision, the Council receives regular updates from its external adviser, Arlingclose, on changes in credit ratings for individual financial institutions. They also advise on maximum amounts to be invested with each counterparty and maximum durations for any fixed term deposits made. This framework helps to protect against the loss of any sums invested (credit risk), ensures liquidity is not compromised and earns interest to support the revenue budget (not a major factor at present.

24. In relation to external borrowing, the Council seeks to achieve a low but certain cost of finance, whilst retaining the flexibility to borrow for short-term periods, and to respond to demands of the Investment Strategy as needed. The Council therefore has a balance between taking advantage of currently low rates of interest for short term borrowing (predominantly from other local authorities), versus the need to achieve certainty over rates of borrowing in the longer term from either government or financial institutions (mainly from the PWLB or other banks).

25. Out of the £205.667m worth of external debt on 30 September 2022, 65% is long term from the Public Works Loan Board – the government agency for local authority borrowing and 30% is long term with financial institutions (generally banks). There is around 5% of short-term borrowing in place at present from other local authorities. The

average interest rate on this debt is around 2.5% with an average life to maturity of just under 25 years. All longer-term debt held by the Council is at fixed rates of interest.

26. Current long term interest rates for borrowing from the PWLB are between 4% and 5% depending on the length of the loan (local authorities can borrow up to 50 years from central government), with short term rates being between 2.8% and 3.9% for up to one year in duration. These are significantly higher than in recent financial years and reflect the Bank of England’s attempt to control the levels of inflation in the UK economy at present. Although it is expected that interest rates for both borrowing and investments will level off over the next 1-2 years and then start to reduce, any borrowing implemented over the remainder of this year is likely to be short-term in nature. Higher than expected interest rates will put pressure on the capital financing budget as the year progresses.

27. On local authority borrowing, there has been much interest from both regulators and the media in recent months around individual councils taking significant amounts of long-term debt from the PWLB for the sole purposes of commercial activity – generally property investment. Under the Prudential Code, local authorities have lots of freedom to conduct and self-regulate their own borrowing and investment activities.

28. Both the Government and the Chartered Institute of Public Finance & Accountancy have said that borrowing for the sole purposes of commercial investment is against the spirit of the Code. The PWLB no longer provides loans for this type of activity from 1st April 2021 with Section 151 Officers having to confirm each year that their investment plans do not contain any of these types of activity. CIPFA is also updating the Prudential Code during 2022/23 to stop any borrowing for yield purposes and to also highlight and non-prudential practices.

29. Although the Council has undertaken some capital projects in recent years that have generated a revenue income stream as set out in paragraph 16 above, the primary aim has always been to regenerate the areas involved and to grow the wider economy within the Town. As a result, these activities would be able to continue under the Code and with funding from the PWLB if required.

Minimum Revenue Provision

30. The Council is required to maintain an annual policy for the repayment of debt incurred over previous financial years. The current policy is split into different elements which are based on: when the borrowing was originally incurred, the type of assets, and the useful economic life of the assets which the borrowing is funding. The Council in 2016/17, amended this policy to more accurately reflect the useful economic life of these assets. No changes have been made since then. The current policy is set out in the Capital Strategy for 2022/23 – appendix to the February 2022 Budget Report for information.

31. Given the current economic environment the Council has held discussions with our treasury management adviser, Arlingclose, on whether any further changes can be made to the policy whilst still remaining within the statutory guidance issued by government. The rest of the report will set out an option for change on MRP that will better accommodate the revenue costs of the capital programme and provide greater consistency between supported and unsupported borrowing.

What is MRP?

32. Local authorities are required each year to set aside some of their revenue income as a provision for debt repayment. This is termed the Minimum Revenue Provision. There is a simple duty for a Council each year to make an amount of available, which it considers "prudent". The MRP Guidance makes recommendations to authorities on the interpretation of that term.

33. Local authorities are asked to prepare an annual statement of their policy on making MRP and to have this approved by their decision-making body before the start of each financial year. This is an important element of the budget setting process each year.

What is a prudent provision?

34. The main part to the guidance is concerned with the interpretation of the term "prudent provision". The guidance proposes several options. It explains that provision for repayment of the borrowing, which financed the acquisition of an asset, should be made over a period bearing some relation to that over which the asset continues to provide a service or has economic benefit. It should also cover the gap between the Capital Financing Requirement (the underlying need to borrow) and the various sources of capital income available to the Council to finance its capital programme, such as capital receipts, capital grants, contributions and direct revenue financing.

35. The current options that government recommend for being prudent are set out towards the end of the current Capital Strategy (Options 1-5). These differ between supported borrowing (pre-2008 debt) and unsupported borrowing (post 2008 debt). The difference between the two relates to the fact that government provided direct funding for supported borrowing, whereas for unsupported borrowing, these resources need to be provided based on the overall resources allocated to the Council via the local government finance settlement.

Council Policy

36. The current Council policy on MRP is as follows:

- For supported capital expenditure, Middlesbrough Council intends to use option 5 - a 2% annuity basis for the coming financial year. This part of the CFR is currently £80.5m.

- For unsupported capital expenditure, Middlesbrough Council intends to use option 3 - the asset life method for the coming financial year. This part of the CFR is currently £202.8m.

37. The total MRP budget for the 2022/23 financial year is £5.9m or 2.05% of the capital financing requirement.

38. The MRP policy for the Council was last reviewed and changed for the 2016/17 year where a 4% allowance for supported debt was changed to a 2% annuity basis. This policy was backdated to 2008 when unsupported borrowing came into being. This resulted in a total backdated saving of £15m plus a lower on-going cost in earlier years.

Increased payments in later years have been factored into the Council's budget projections.

39. On unsupported borrowing, the Council maintained the asset life policy which spreads the revenue charges equally over the life of the assets funded by prudential borrowing.

Annuity Basis of MRP

40. An annuity is a type of financial repayment model which repays a loan amount plus interest over the term of the financial instrument. To ensure certainty, it uses a fixed annual payment. Each year of the loan, a combination of principal and interest are repaid.

41. As there is a fixed repayment period, plus a nominal interest rate on the loan, the annuity calculation splits the individual payments between principal and interest. In earlier years, the repayments are predominantly interest based but as the loan period advances, principal is gradually repaid, and the interest charges become lower. In the latter years of the loan the repayments are predominantly principal. This method of debt repayment is very much akin to a mortgage when the sum borrowed is cleared in the later years of the agreement, at the expense of the first half of the term.

42. Increasingly local authorities are moving to an annuity basis of MRP provision which caters for lower debt repayments in earlier years, with the consequence of greater amounts in later years, recognising that interest paid is higher in the earlier years.

Suggested Future Approach for MRP

43. It is proposed that the Council move to an annuity basis of MRP provision on unsupported debt from 2008. This is the significant part of the Council's capital financing requirement.

44. The 2% annuity basis uses a 50-year financial model to allocate principal and interest payments over the life of the asset but as highlighted above, this results in lower charges for the first half of the asset's life and then higher charges over the remaining period. Conversely, interest payments are higher in the early years. This is advantageous to the Council in the light of rising interest rates where new borrowing is required.

45. The impact of the MRP change will be to improve the management of the revenue budget for capital financing and to smooth the total cost of capital financing over many years.

46. Under regulation we are unable to backdate the policy for prior financial years and the Council will continue to hold MRP already provided on our balance sheet. It will only be future charges that are influenced by the new policy.

Is this change prudent?

47. This policy change is fully compliant with the MRP statutory guidance under Section 21(1A) of the Local Government Act 2003. Many local authorities are using this basis for their current MRP policies on both supported and unsupported borrowing, and it is a method that is recommended by treasury management advisers and accepted by government and regulators. The amendments made to the current policy are highlighted in red on **Appendix 1** to this report.

What decision(s) are being recommended?

That the Council:

- Consider the current position on the capital strategy for 2022/23.
- Approve the change being proposed on Minimum Revenue Provision for 2022/23.

Rationale for the recommended decision(s)

48. Members should note the progress to date against the key elements of the capital strategy and challenge any areas that vary from when the budget was set in February.

49. The proposed policy change harmonises the Council's policies in respect of debt repayment and ensures a smoothed profile which is more affordable from the current revenue budget.

Other potential decision(s) and why these have not been recommended

50. The other decision that could be made is to reject the above change being proposed and remain with the existing MRP policy, charging £5.8m to the revenue budget for debt repayment in 2022/23. This would mean that the revenue budget overspend would continue at a higher level than if the change in policy was approved, but more indebtedness would be redeemed this financial year.

Impact(s) of the recommended decision(s)

Legal

51. All activity on capital financing, investments and borrowing under current local authority powers is within the local government act or the capital finance & accounting regs.

Strategic priorities and risks

52. There are no implications for the policy framework of the Council. The main point to note in relation to risk is that all capital investment, borrowing, and investment decisions are of significant value and thereby of necessity involve a significant degree of financial, credit and interest rate risk. The relevant details are always set out for Members to note in either the capital strategy each year or in the financial instrument elements of the Statement of Accounts.

Human Rights, Equality and Data Protection

53. There are no issues to note on these areas as part of this report.

Financial

54. The financial implications of the various issues covered are highlighted within the main body of the report. The MRP already set aside on the balance sheet will be retained, however, we anticipate that the smoothing impact brought about by the change will lower financing costs on the revenue budget. Any in year savings will be set aside to manage future cost pressures possibly through higher interest rates.

Actions to be taken to implement the recommended decision(s)

Action	Responsible Officer	Deadline
To effect the changes to the MRP Policy, being proposed by Council, in the 2022/23 year-end accounts.	Head of Finance & Investments	By end of April 2023.

Appendices

1	Revised Policy Statement for 2022/23 on Minimum Revenue Provision.

Background papers

Body	Report title	Date
Corporate Affairs & Audit Committee	Capital Strategy 2022/23	9th December 2021
Executive	Capital Strategy 2022/23 – Mid-Year Update	6th December 2022

Contact: Justin Weston, Head of Finance & Investments
Email: justin_weston@middlesbrough.gov.uk

APPENDIX 1

MINIMUM REVENUE PROVISION POLICY 2022/23

INTRODUCTION

1. Local authorities are required each year to set aside some of their revenue income as provision for debt repayment. There is a simple duty for an authority each year to make an amount of revenue provision, which it considers "prudent". (Minimum Revenue Provision) MRP Guidance makes recommendations to authorities on the interpretation of that term.

2. Authorities are legally obliged to "have regard" to any such guidance – which is exactly the same duty as applies to other statutory guidance including, for example, the CIPFA Prudential Code, the CIPFA Treasury Management Code and the CLG Guidance on Investments.

3. Authorities are asked to prepare an annual statement of their policy on making MRP and to have this approved by the body before the start of each financial year.

MEANING OF "PRUDENT PROVISION"

4. The main part to the guidance is concerned with the interpretation of the term "prudent provision". The guidance proposes a number of options. It explains that provision for repayment of the borrowing, which financed the acquisition of an asset, should be made over a period bearing some relation to that over which the asset continues to provide a service or has economic benefit. It should also cover the gap between the Capital Financing Requirement and the various sources of capital income available to the Council to finance its capital programme, such as capital receipts, capital grants, contributions and direct revenue financing.

OPTIONS FOR PRUDENT PROVISION

Option 1: Regulatory Method

5. For debt supported by (Revenue Support Grant) RSG in previous years, authorities will be able to continue to use the formulae in regulations, since the RSG was provided on that basis.

Option 2: CFR Method

6. This is a technically simpler alternative to Option 1 and may also be used in relation to supported debt. While still based on the concept of the Capital Financing Requirement (CFR), which can be derived from the balance sheet, it avoids the complexities of the formulae in the regulations.

Option 3: Asset Life Method

7. For new borrowing under the Prudential system (from 2008) for which no government support is given, there are two main options. Option 3 is to make provision for debt repayment in **equal annual instalments** over the estimated life of the asset for which the borrowing is undertaken. This is a possibly simpler alternative to the use of depreciation accounting (Option 4), though it has some similarities to that approach.

8. The formula allows an authority to make **voluntary extra provision** in any financial year that this is affordable.

9. In the case of the construction of a new building or infrastructure, MRP would not need to be charged until the new asset comes into service. This "**MRP holiday**" would be perhaps 2 or 3 years in the case of major projects and could make them more affordable. There would be a similar effect in the case of Option 4 under normal depreciation rules.

Option 4: Depreciation Method

10. Alternatively, for new borrowing under the prudential framework for which no Government support is being given, Option 4 may be used. This means making MRP in accordance with the standard rules for depreciation accounting.

11. Councils will normally need to follow the standard procedures for calculating depreciation when making this revenue provision.

Option 5: 2% Annuity Method

12. This method recognises the time value of money and the useful life of the assets funded from borrowing and is seen as a fairer way of charging MRP. It is supported by the Council's treasury management advisers (Arlingclose) and is being adopted by many local authorities nationally as the way of accounting for pre 2008 debt.

2022/2023 MINIMUM REVENUE PROVISION -

REVISED STATEMENT FOR MIDDLESBROUGH COUNCIL

13. The Secretary of State recommends that before the start of each financial year a local authority prepares a statement of its policy on making MRP in respect of that financial year and submits it to the full council as part of its budget setting process. The statement should indicate which of the options listed above are to be followed in the financial year.

14. For supported capital expenditure Middlesbrough Council intends to use option 5, a 2% annuity basis for the coming financial year.

15. For unsupported capital expenditure Middlesbrough Council intends to use option 5, 2% annuity basis for the coming financial year.