Appendix 2

# CAPITAL STRATEGY 2024/25

## 1. Introduction

The capital strategy provides a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the delivery of the Authority's Strategic Economic Plan along with an overview of how associated risk is managed and the implications for future financial sustainability.

## 2. Capital Expenditure and Financing

Capital expenditure is where the Authority spends money on assets, such as land, property or vehicles that will be used for more than one year. In local government this includes spending on assets owned by other bodies, and loans and grants to other bodies enabling them to buy assets, this is predominantly the nature of the Authority's capital expenditure.

In January 2019 a new investment plan was approved by the Combined Authority Cabinet which set out the investment priorities for the next 10 years, the plan was revised in January 2023. This plan included a mixture of both capital and revenue investments which will contribute to successful delivery of the Authority's Strategic Economic Plan.

As part of the devolution deal Government gave a 30-year commitment to the Authority of £15 million devolved grant funding annually. This long-term commitment from Government enables the Authority to borrow funds to unlock growth in the earlier years when it is critical to developing our economy.

The capital programme will be looked at on a holistic approach and required borrowing will be made against the gap on the whole programme not individual projects. The assurance process in place for all capital investments will ensure that each meets the requirements of the prudential code that they are prudent, affordable, and sustainable.

Any commercial opportunities that arise will be appraised and reviewed individually assuring they also meet the requirements of the prudential code and fit in with the Authorities' strategic economic plan.

In 2024/25, the Authority is planning capital expenditure of £412 million as summarised below:

*Table 1: Prudential Indicator: Estimates of Capital Expenditure in £'000*

| | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|---|---|---|---|---|---|
| | Forecast | Budget | Budget | Budget | Budget |
| Capital Expenditure | 259,820 | 392,922 | 247,679 | 213,448 | 62,000 |

*Governance*: Business cases are submitted to the Authority by the lead applicant for all capital projects and they are fully appraised and approved in line with the Combined Authority Assurance Framework approved by the Department for Levelling Up, Housing and Communities (DHLUC). The assurance framework sets out how projects will be monitored through delivery and beyond completion to measure the economic impact of the investment.

All capital expenditure must be financed, either from external sources (government grants and other contributions), the Authority's own resources (revenue, reserves and capital receipts) or debt (borrowing, leasing and Private Finance Initiative). The planned financing of the above expenditure is as follows:

*Table 2: Capital financing in £'000*

| | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|---|---|---|---|---|---|
| | Forecast | Budget | Budget | Budget | Budget |
| Capital Grant Reserve | 0 | 54,353 | 18,197 | 22,012 | 0 |
| Capital Grants | 82,744 | 108,932 | 71,602 | 62,436 | 62,000 |
| Capital Receipts | 775 | 780 | 784 | 0 | 0 |
| Revenue Contributions | 5,108 | 3,944 | 0 | 0 | 0 |
| Borrowing Required | 171,193 | 224,913 | 157,096 | 129,000 | 0 |
| **Total** | **259,820** | **392,922** | **247,679** | **213,448** | **62,000** |

Where possible the Authority will utilise short term internal borrowing to reduce the overall requirement for external borrowing within a given year, this is required to be repaid when it is required for its original purpose. The benefits of internal / short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. The below table sets out the estimated split between internal and external borrowing across the period:

*Table 3: Borrowing estimate in £'000*

| | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|---|---|---|---|---|---|
| | Forecast | Budget | Budget | Budget | Budget |
| Internal Borrowing | 52,103 | -121,869 | -40,339 | -10,000 | -4,000 |
| External Borrowing | 119,090 | 346,782 | 197,435 | 139,000 | 4,000 |
| **Total Borrowing** | **171,193** | **224,913** | **157,096** | **129,000** | **0** |

Debt is only a temporary source of finance, and this is therefore replaced over time by other financing, usually from revenue which is known as minimum revenue provision (MRP). Planned MRP is as follows:

*Table 4: Replacement of debt finance in £'000*

| | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|---|---|---|---|---|---|
| | Forecast | Budget | Budget | Budget | Budget |
| Revenue Streams | 4,214 | 5,699 | 7,537 | 8,548 | 8,868 |

Department for Levelling Up, Housing and Communities (DHLUC) Guidance requires the Authority to approve an Annual MRP Statement each year and recommends a number of options for calculating a prudent amount of MRP. The recommended statement is attached at schedule 1 for approval.

The Authority's cumulative outstanding amount of debt finance is measured by the capital financing requirement (CFR). This increases with new debt-financed capital expenditure and reduces with MRP, loan fund repayments and capital receipts used to replace debt. Based on the above figures for expenditure and financing, the Authority's estimated CFR is as follows:

*Table 5: Prudential Indicator: Estimates of Capital Financing Requirement in £'000*

| | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|---|---|---|---|---|---|
| CFR | 558,500 | 807,713 | 955,898 | 1,074,936 | 1,064,614 |

## 3. Treasury Management

Treasury management is concerned with keeping sufficient but not excessive cash available to meet the Authority's spending needs, while managing the risks involved. Surplus cash is invested until required, while a shortage of cash will be met by borrowing, to avoid excessive credit balances or overdrafts in the bank current account. The Authority is typically cash rich in the short-term as revenue income is received before it is spent, but cash poor in the long-term as capital expenditure is incurred before being financed. Using internal borrowing the revenue cash surpluses are offset against capital cash shortfalls to reduce overall borrowing.

*Borrowing strategy*: The Authority's main objectives when borrowing is to achieve a low but certain cost of finance while retaining flexibility should plans change in future. These objectives are often conflicting, and therefore when borrowing the Authority will seek to strike a balance between cheap short-term loans and long-term fixed rate loans where the future cost is known but higher.

The Authority does not borrow to invest for the primary purpose of financial return and therefore retains full access to the Public Works Loans Board.

Projected levels of the Authority's total outstanding external debt are shown below, compared with the capital financing requirement (see above).

*Table 6: Prudential Indicator: Gross Debt and the Capital Financing Requirement in £'000*

| | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|---|---|---|---|---|---|
| | Forecast | Budget | Budget | Budget | Budget |
| Debt | 417,965 | 757,558 | 939,569 | 1,057,825 | 1,037,176 |
| CFR | 558,500 | 807,713 | 955,898 | 1,074,936 | 1,064,614 |

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

*Affordable borrowing limit*: The Authority is legally obliged to set an affordable borrowing limit (also termed the authorised limit for external debt) each year. In line with statutory guidance, a lower "operational boundary" is also set as a warning level should debt approach the limit. As a Mayoral Combined Authority a borrowing cap was agreed with Treasury which cannot be exceeded, this cap is set out below alongside the limits.

*Table 7: Prudential Indicators: Authorised limit and operational boundary for external debt in £'000*

| | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|---|---|---|---|---|---|
| HMT Borrowing Cap | 1,000,000 | 1,237,000 | 1,237,000 | 1,237,000 | 1,237,000 |
| Authorised Limit – Borrowing | 426,130 | 1,017,000 | 1,017,000 | 1,017,000 | 1,017,000 |
| Authorised Limit – Leases | 207,180 | 220,000 | 220,000 | 220,000 | 220,000 |
| Authorised Limit - Total | 633,310 | 1,237,000 | 1,237,000 | 1,237,000 | 1,237,000 |
| Operational Boundary – Borrowing | 355,110 | 943,000 | 943,000 | 943,000 | 943,000 |
| Operational Boundary – Leases | 172,650 | 190,000 | 190,000 | 190,000 | 190,000 |
| Operational Boundary – Total | 527,760 | 1,133,000 | 1,133,000 | 1,133,000 | 1,133,000 |

Further details on borrowing are included in the Treasury Management Strategy included at Appendix 1.

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

The Authority's policy on treasury investments is to prioritise security and liquidity over yield, which is to focus on minimising risk rather than maximising returns. Cash that is likely to be spent in the near term is invested securely, for example with the government, other local authorities or selected high-quality banks, to minimise the risk of loss.

Further details on treasury investments are included in the Treasury Management Strategy included at Appendix 1.

*Risk Management.* The effective management and control of risk are prime objectives of the Authority's treasury management activities. The treasury management strategy therefore sets out various indicators and limits to constrain the risk of unexpected losses and details the extent to which financial derivatives may be used to manage treasury risks.

*Governance:* Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Section 73 officer and finance staff, who must act in line with the treasury management strategy and treasury management practices approved by Cabinet. Mid-term and annual reports on treasury management activity are presented to the audit committee and cabinet.

## 4. Investments for Service Purposes

The Authority makes investments to assist in delivering the Strategic Economic Plan, including making loans to the special purpose vehicles, Local Authorities and local businesses.

*Governance:* Decisions on such investments have to adhere to the assurance framework and as such will follow the same assessment and decision-making process as all Combined Authority investments into projects or programmes. The Section 73 officer is responsible for ensuring that adequate due diligence is carried out before investment is made.

Table 8: Prudential Indicator: Proportion of income from investments to net revenue stream £'000

| | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|---|---|---|---|---|---|
| | Forecast | Budget | Budget | Budget | Budget |
| Total Income from Investments | 5,663 | 8,794 | 19,441 | 27,879 | 34,379 |
| Proportion of net revenue stream | 5% | 8% | 18% | 24% | 30% |

Further details on service investments are included within the Investment Strategy included at Appendix 3.

## 5. Liabilities

As set out in table 6 above, the Authority forecasts to hold £418 million of long-term debt at 31st March 2024.

*Governance:* The risk of liabilities crystallising and requiring payment is monitored by the Finance team and reported appropriately.

## 6. Revenue Budget Implications

Within the 10-year investment plan it was agreed that in order to ensure successful delivery of the Strategic Economic Plan the Authority would borrow funds to unlock growth in the earlier years when it is critical to developing our economy. The increasing ratio of net financing costs to net revenue is driven by this nature of Investment Programme delivery whereby borrowing in the early part of the programme is supported by longer term revenues (namely devolved funding and enterprise zone income).

Although capital expenditure is not charged directly to the revenue budget, interest payable on loans and MRP are charged to revenue, offset by any investment income receivable. The net annual charge is known as financing costs; this is compared to the net revenue stream i.e. the amount of revenue funding available for investment excluding specific grant schemes.

This ratio may appear to be large in comparison to a Local Authority, but a Combined Authority does not require revenue streams to provide statutory services and as such all funding is available for investments into projects. The Section 73 officer is satisfied that the proposed capital programme is prudent, affordable and sustainable.

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

| | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|---|---|---|---|---|---|
| Financing costs (£'000) | 8,342 | 11,232 | 19,498 | 20,083 | 18,778 |
| Proportion of revenue | 38% | 41% | 77% | 82% | 70% |

## 7. Knowledge and Skills

The Authority has professionally qualified staff across a range of disciplines that follow continuous professional development (CPD) and attend courses on an ongoing basis to keep abreast of new developments and skills. The skills available from internal resources allow the Authority to assess business cases for capital investment and external professional advice is taken where required.

Through a service level agreement Stockton Borough Council (SBC) provides the Combined Authority with the treasury management service. The CIPFA code requires that staff with responsibility for treasury management receive adequate training to carry out this role. SBC assess the requirements for training as part of the staff appraisal process and they regularly attend courses and seminars provided by Arlingclose and CIPFA.

## Schedule 1 – Annual Minimum Revenue Provision Statement 2024/25

Where the Authority finances capital expenditure by debt, the Capital Financing Requirement (CFR), 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 Authority to have regard to the Department for Communities and Local Government's Guidance on Minimum Revenue Provision (the MHCLG Guidance) most recently issued in 2018.

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 Grants, reasonably commensurate with the period implicit in the determination of that grant.

The MHCLG Guidance requires the Authority 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 as well as locally determined prudent methods.

- The nature of the majority of Authority's capital expenditure is in the form of loans and grants towards capital expenditure by third parties as part of the investment plan. As the Authority's borrowing cannot be indirectly linked to an individual asset the number of years used for MRP calculations will be 25. The MRP will be determined by charging the expenditure over this period on an annuity method.
- Where borrowing occurs to directly support projects outside of the Investment Plan, MRP will be determined by charging the expenditure over the expected useful life of the relevant asset determined on an annuity method. MRP will commence from the 1st April of the year following the asset becoming operational.
- Where Capital Expenditure is incurred on capital loans, which are not an investment for commercial purposes, MRP will be charged to the equivalent of the expected credit loss which has been recognised in the year. Capital loan repayments received will be used to reduce the CFR on that loan.
- Finance Lease principal repayments are used to reduce the CFR on the leased asset on an annual basis.

Capital expenditure incurred during 2024/25 will not be subject to a MRP charge until the following year.