Portsmouth
CITY COUNCIL

CAPITAL STRATEGY
2024/25- 2033/34

PART II

PART II Borrowing and Investing

CONTENTS

1. Definition

1.1 A key activity is to know when and how much to borrow when the Council requires more cash and investing when the Council has surplus cash. In this way, it manages the Council's cashflows. This activity is known as Treasury Management.

2. Net Debt

2.1 Borrowings increase when capital schemes are financed from borrowing and decrease when debt is repaid.

2.2 The Council's reserves and working capital are invested until the money is required to finance expenditure. The Council's forecast net debt, i.e. its borrowings less its investments are summarised in the table below. This forecast is based on the Council using its reserves to finance capital expenditure in the medium term, rather than undertaking new external borrowing for as long as possible. This is beneficial to the Council's revenue budget as the interest on borrowings normally exceeds the return on the Council's investments. However, this position cannot be maintained in the long term with the Council's net debt increasing year on year. It is expected that the Council will have to undertake further external borrowing in 2025/26 or alternatively sell its Investment Properties.

	2023/24	**2024/25**	**2025/26**	**2026/27**	**2027/28**	**2028/29**
	£m	£m	£m	£m	£m	£m
Borrowings	734	721	751	812	796	780
Less Investments	(244)	(145)	(71)	(86)	(103)	(122)
Net Debt	**490**	**576**	**680**	**726**	**693**	**658**

3. Borrowing

3.1 In the past, the principal source of borrowing has been the Public Works Loan Board, (PWLB) which is operated by HM Treasury. The PWLB can still be used to replace existing debt or to reschedule debt. However, a recent change in the PWLB's lending terms requires Local Authorities to confirm that they do not plan to purchase investment assets primarily for yield or use incidental income from the development of commercial properties for regeneration purposes to fund wider services.

3.2 There are alternative types of borrowing available including:

- Local Authority
- Market Forward Borrowing (for transactions greater than £30m)
- Bond Issue (for transactions greater than £100m)
- UK Municipal Bond Agency (UKMBA)
- UK Infrastructure Bank (UKIB) specially for infrastructure investments such as Transport, waste etc

- Other such as leasing or local bonds

3.3 This Capital Strategy identifies capital aspirations that may be included in future capital programmes. Prudential Borrowing is only available for a Council's "Primary Purpose for Investment", this means that it must be directly and primarily related to the functions of the authority. Also any Prudential Borrowing must meet the "Invest to Save" criteria where those savings accrue directly to the Council on a sustained basis and meet the Prudential Code's tests of affordability, sustainability, and prudence over the lifetime of the borrowing undertaken. Prior to any borrowing, a full business case and financial appraisal is prepared that can satisfactorily demonstrate that borrowing is affordable by the services existing cash limits and must satisfy the S151 Officer.

3.4 Outstanding long-term debt is reviewed regularly with a view to early redemption and rescheduling; although premiums would be payable to the lender and consequently early redemption and rescheduling are rarely financially beneficial to the Council.

Affordability of Borrowing

3.5 To ensure future budgets remain affordable, the Council needs to be aware that capital expenditure financed from Prudential Borrowing incurs both **interest costs** and a **Minimum Revenue Provision (MRP)** for the repayment of debt. The MRP is a revenue charge within the budget which reduces the Capital Financing requirement over time.

3.6 The Council has a policy of calculating MRP on an annuity basis. This means that MRP will start at a relatively low level but require increasing amounts of MRP to be set aside year on year, especially for assets with long useful economic lives. This creates a period of low MRP during the early years as income builds, or savings start to accrue. The distribution of MRP over the life of a capital scheme is determined by the prevailing interest rate. The lower the interest rate, the higher the MRP is in the early years.

3.7 It is estimated that MRP will amount to £9.9m in 2024/25. The inclusion of further schemes in the capital programme financed by Prudential Borrowing will further increase the MRP.

Key Risks

3.8 There are risks with borrowing more than the Council can afford. To mitigate these risks, the Chartered Institute of Public Finance and Accountancy (CIPFA) has produced the Prudential Code for Capital Finance in Local Authorities, which is a statutory code governing local authority borrowing. The Prudential Code requires the Council to establish various indicators over a minimum of 3 years to demonstrate that its capital programme is both affordable and prudent. The Council publishes its Prudential Indicators, over a 5-year period, within its capital programme and the Council then reports its position against the prudential indicators at the end of each financial year.

3.9 To ensure that the borrowing required to finance the capital programme is affordable, the Council:

- Estimates the ratio of its financing costs to its net revenue stream
- Estimates the ratio of net income from commercial and service investments to its net revenue stream.

3.10 To ensure that the Council's capital programme is prudent, the Council:

- Publishes a capital programme which includes estimates of its underlying need to borrow as measured by its Capital Financing Requirement
- Is required to approve an Authorised Limit for external debt and an Operational Boundary when it approves its capital programme.

3.11 The **Authorised Limit** for external debt, as set by the City Council, is the maximum amount of debt which the authority may legally have outstanding at any time. The authorised limit includes headroom to enable the Council to undertake borrowing to take advantage of unexpected movements in interest rates and to accommodate any short-term debt or unusual cash movements that could arise during the year.

3.12 Whilst the Authorised Limit cannot be breached, the **Operational Boundary** is based on the probable external debt during the year. It is not a limit but acts as a warning mechanism to prevent the authorised limit (above) being breached.

Sensitivity Analysis

3.13 The Council's gross debt on 31 March 2023 was as follows:

	£m	**£m**
Fixed Rate Borrowing	**627**	
Finance Leases	1	
Private Finance Initiative (PFI) Schemes	45	
Sub Total - Fixed Rate Debt		**673**
Lenders Option Borrowers Option (LOBO) Loan	11	
Retail Price Index (RPI) linked loan	63	
Sub Total - Variable Rate Debt		**74**
Total Gross Borrowing		**747**

3.14 90% of the Council's borrowing has a fixed interest rate, but the Council does have two variable rate loans.

- The lender of the LOBO loan has an option to increase the interest rate every two years. The lenders next option is on 19 March 2025. If the lender does increase the interest rate the Council, then has the option to repay the loan.
- The Council has £63m outstanding on a loan which links the instalments payable by the Council to the RPI. The Council has leased the Isle of Wight Ferry Terminal in White Heart Road to Wightlink on an RPI linked rent that mirrors the instalments payable on this loan mitigating the consequences of increases in RPI.

Minimum Revenue Provision (MRP) for Debt Repayment

3.15 Early in 2018 the Government issued revised statutory guidance on MRP requiring the repayment of General Fund Prudential Borrowing to be provided for within 50 years.

3.16 The following MRP policies (applied to calculating the MRP) are set out in the table below and are fully compliant with this policy. It is recommended the City Council approves the Annual Minimum Revenue Provision (MRP) for Debt Repayment Policies set out in the table below (Recommendation 3.2a).

Borrowing	**MRP Methodology**
General Fund Borrowing:	
Supported borrowing other than finance leases and service concessions including private finance initiative schemes #	50-year annuity
Finance leases and service concessions including private finance initiative schemes *	MRP equals the principal repayments made to lessors and PFI operators
Prudential borrowing excluding borrowing to fund long term debtors (including finance leases), investment properties and equity shares purchased in pursuit of policy objectives	Annuity over life of asset
Prudential Borrowing to fund long term debtors	The principal set aside to finance the borrowing used in the original transaction
Prudential Borrowing to fund finance leases	The principal element of the rent receivable be set aside to repay the borrowing that financed these assets
Prudential Borrowing to fund investment properties with an expected holding period of under 50 years	The repayment of Prudential Borrowing will be provided for by setting aside the capital receipt when the property is disposed of including any surplus over the cost of acquisition unless the carrying (market) value of the property falls below that part of the purchase price financed from Prudential Borrowing. If this happens MRP will be made for the shortfall over the residual life of the property. Any uplifts in rental income beyond that in the budget will be used to make MRP.
Prudential Borrowing to fund investment properties with an expected holding period of over 50 years	Annuity over life of asset
Prudential Borrowing to fund equity shares purchased in pursuit of policy objectives	25-year annuity
Housing Revenue Account (HRA)	No MRP is currently provided for. It is currently anticipated that from 2028/29 it will be provided again for the HRA Self Financing Payment in equal instalments over 30 years. MRP is not provided for other HRA debt.

 # The Council applied the last of its supported borrowing 2011/12

** If transactions that take the legal form of finance leases but in substance amount to borrowing, the MRP policy relating to self - financed borrowing will be adopted. An example of when this could happen would be when the Council grants a head lease to an institution in return for an upfront premium and leases the asset back from the same institution in return for a rent.*

3.17 The Council had a review of its MRP policy in 2016/17. Consequently, it highlighted that the previous methods used in the past have resulted in over provisions of MRP from 2008/09 to 2015/16 of £22.6m. The Director of Finance and Resources (Section 151 Officer) will release the over provision of MRP back into General Fund balances over a prudent period by reducing the MRP in future years under delegated authority. This overprovision is forecast to expire in 2026/27.

3.18 Currently there is an open MRP Consultation relating to updating regulations and statutory guidance and the outcome is expected for implementation in 2024/25.

4. Investments

Treasury Management

4.1 Arising from the organisation's cash flows or treasury risk management activity, this type of investment represents balances which are only held until the cash is required for use. Treasury investments may also arise from other treasury risk management activity which seeks to prudently manage the risks, costs or income relating to existing or forecast debt or treasury investments.

Service Delivery

4.2 Investments held primarily and directly for the delivery of public services including housing, regeneration, and local infrastructure. Dunsbury Park, Portsmouth Retail Park, Portico and Ravelin are included in this category as income received would be used for regeneration purposes. Returns on this category of investment which are funded by borrowing are either related to the financial viability of the project in question or otherwise incidental to the primary purpose.

Commercial Return

4.3 Investments held primarily for financial return with no treasury management or direct service provision purpose. Risks on such investments should be proportionate to a council's financial capacity – i.e., that 'plausible losses' could be absorbed in budgets or reserves without unmanageable detriment to local services. An authority must no longer borrow to invest primarily for financial return.

Due Diligence

4.4 The Council initially identifies suitable Treasury Management investments using credit ratings from Fitch, Moody's, and Standard and Poor. Where possible, credit ratings are compared to insurance premiums against a counter party defaulting. Insurance premiums against a counter party defaulting can be compared to a widely used index of the market (ITRAAX). If the market has concerns about a borrower, it should be reflected in a higher insurance premium. Although credit ratings are supported by an in-depth analysis of the borrower, insurance premiums provide a more up to date indicator of a borrower's credit worthiness. Prior to making investments, any news relating to the borrower is also considered.

4.5 All property acquisitions require a business case which includes a full financial appraisal. The detailed business case and financial appraisal includes building surveys, environmental surveys and valuations in accordance with the Red Book. In addition, properties continue to be revalued on an annual basis.

4.6 Other sources of information that are relevant to particular sectors are also considered either as a substitute for credit ratings and insurance premiums in sectors where these are not available or to supplement credit ratings and insurance premiums. Examples of this are the governance and viability ratings assigned to larger registered social landlords (RSLs) by the Homes and Communities Agency (HCA), and data sets published by the Building Societies Association

4.7 For further detail on the Council's investment criteria, see the Treasury Management Policy.

Service and Commercial Investments Acquired Through the Capital Programme

4.8 According to the CIPFA Treasury Management Code, investment properties acquired through the capital programme are regarded as investments in addition to investments of surplus cash.

4.9 CIPFA has revised the Prudential Code relating to service and commercial investments so that:

1) The risks associated with service and commercial investments should be proportionate to a local authority's financial capacity – i.e. that plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services
2) An authority must not borrow to invest for the primary purpose of commercial return
3) It is not prudent for local authorities to make any investment or spending decision that will increase the Capital Financing Requirement (CFR), and so may lead to new borrowing, unless directly and primarily related to the functions of the authority, and where any commercial returns are either related to the financial viability of the project in question or otherwise incidental to the primary purpose
4) An annual review should be conducted to evaluate whether commercial investments should be sold to release funds to finance new capital expenditure or refinance maturing debt
5) A prudential indicator is required for the net income from commercial and service investments as a proportion of the net revenue stream
6) Local authorities should create new Investment Management Practices to manage risks associated with non-treasury investments, (similar to the current Treasury Management Practices).

Statutory Guidance

4.10 The Government issued revised statutory guidance on local government investments early in 2018 coming into effect from 01 April 2018. The guidance requires Councils not to borrow purely for financial gain.

4.11 The Government's revised statutory guidance also requires local authorities to present a range of indicators to allow members and other interested parties to understand the total exposure from borrowing and investment decisions. It is recommended that the indicators contained in the Appendix be approved. The Government's statutory guidance requires the Council to consider the long-term sustainability risk implicit in becoming too dependent on commercial income or in taking out too much debt relative to net service expenditure. In particular, the Government's statutory guidance requires the City Council to set limits that cannot be exceeded for gross debt compared to net service expenditure, and for commercial income as a percentage of net service expenditure. It is recommended that if these limits are exceeded, the Director of Finance and Resources (Section 151 Officer) bring a report to the Cabinet and City Council.

Activity in the Investment Property Market

4.12 The Council has an investment property portfolio that it acquired over several years for £173m.

4.13 The Council's overall long-term strategy is to dispose of its investment property portfolio and to mitigate the risks attached to the investment property portfolio in the meantime. The Councils exit strategy is as follows:

1) To sell property when it becomes clear from a property and financial perspective that a sale will be preferable to a hold and rent (based on frequent review of forward cash flow forecasts)
2) Use all proceeds to make MRP (including any surpluses)
3) If the carrying (market) value of a property falls below that part of the purchase price financed from unsupported borrowing, MRP will be made for the shortfall over the residual life of the property
4) Any uplifts in rental income beyond that in the budget to be used to make additional MRP
5) The savings in debt costs to contribute towards the loss of rental income to the General Fund. Over time the significance of the rental income will reduce as it is eroded by inflation.

4.14 The Commercial Property Portfolio is managed by an in-house team who are qualified members of the Royal Institute of Chartered Surveyors.

Investment Indicators

Gross General Fund (GF) Debt to GF Net Service Expenditure

4.15 The Councils GF borrowing is forecast to be two times its GF net service expenditure in 2024/25. It is recommended that GF borrowing be limited to four times GF net service expenditure. This will allow further borrowing to be undertaken if it is financially advantageous.

Income from Investments for commercial and service purposes to General Fund (GF) Net Service Expenditure

4.16 The Council will depend on income from investments for commercial and service purposes to fund 9.3% of its estimated GF net service expenditure in 2024/25. To ensure that the Council does not become over dependent on income it is recommended that no more than 14% of GF net service expenditure will be funded from investment income.

Interest Cover

4.17 The Council's investment property portfolio has been financed from borrowing. There is therefore a risk that income from investment properties may be insufficient to pay the interest incurred on the associated debt. However, the net income from the investment property portfolio exceeds the cost of the associated interest 2.3 times.

Loan to Value Ratio

4.18 The Council's investment property portfolio has only recently been acquired, but the market value of the properties is thought to be sufficient to repay the borrowing that financed their acquisition.

Forecast Income Returns

4.19 The investment property portfolio is expected to make a net return of 2.6% against the original cost of the properties in 2024/25.

Gross and Net Income from Investment Properties

4.20 The investment property portfolio is expected to generate a retained income of £3.8m in 2024/25.

External Operating Costs

4.21 External operating costs are driven by lease events such as rent reviews and lease renewals. Some years have more lease events than others.

5. Skills and Knowledge

5.1 The issues covered by this report are in their nature complex, so all the Council's senior finance staff are chartered accountants. The Treasury Manager is a qualified Chartered Certified Accountant. Where the Council does not have the necessary in-house skills and services, it employs Link Asset Services to provide interest rate and economic forecasts, and counter party information.

5.2 On 31 March 2023, £41.16m of the Council's investments of surplus cash were being managed externally consisting of £28.66m invested in instant access money market funds, £4.8m in a multi-asset fund and £7.7m invested in corporate bonds that were being externally managed.

5.3 The City Council is also a member of Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management Network which provides training events throughout the year. Some training is also provided by Link Asset Services. Additional training for investment staff is provided as required.

5.4 Councillors are offered training by an external consultant to provide them with an overview of treasury management after the local government elections.

6. Treasury Management Reporting

6.1 An integrated approach to Treasury Management gives rise to consideration in relation to:

- Borrowing
- Repaying
- Refinancing
- Investing.

6.2 Treasury management has been defined by the Chartered Institute of Public Finance and Accountancy (CIPFA) as "the management of an organisations borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks". Put simply, the Council's approach to cash flow includes:

- Borrowing when the Council requires more cash
- Investing when the Council has surplus cash.

6.3 In addition to the Capital strategy, the Council also has a Treasury Management Strategy. The Treasury Management Strategy contains:

- The Treasury Management Indicators that set the boundaries within which treasury management activities will be undertaken and
- An Annual Investment Strategy that specifies how surplus cash will be invested.

6.4 To demonstrate good governance, all treasury management reports taken to the Governance and Audit and Standards Committee and all treasury management reports requiring policy decisions are taken to the Cabinet and the City Council.

Report	Reporting of Compliance & Performance in Previous Period	Policy Changes	Audience
Treasury Management Policy	N/A	Yes	G&A&S Committee Cabinet City Council
Treasury Management Quarter 1 Monitoring	Yes		G&A&S Committee
Treasury Management Mid-Year Review	Yes	Yes	G&A&S Committee Cabinet City Council
Treasury Management Quarter 3 Monitoring	Yes		G&A&S Committee
Treasury Management Outturn	Yes		G&A&S Committee