

Agenda Item	14a
Report No	HC/24/19

HIGHLAND COUNCIL

Committee: Highland Council

Date: 27th June 2019

Report Title: Capital Programme Refresh- the Corporate Capital Programme and the Current Financial Context

Report By: Head of Corporate Finance and Commercialism

1. Purpose/Executive Summary

- 1.1 Highland Council approved a 5 year capital programme covering the period 2018/19 to 2022/23 on the 7th March 2018. The approved programme encompassed gross project expenditure of over £480m over the initial 5 year period, representing a significant investment across the Council's asset base.
- 1.2 As part of the approved programme was the commitment to certain projects that began in the initial 5 year period but stretched out into years 6-10, 2023/24 to 2027/28. A further £66m of expenditure in these years was approved.
- 1.3 Funding of the approved programme comes from three main sources, the general capital grant received from government, funding from government and other sources for investment in specific projects, and Council borrowing repaid through the Council's revenue budget.
- 1.4 This paper aims to remind Members of the assumptions made around the funding of the programme and looks to review the validity of the assumptions made. In addition it looks at some of the emerging pressure areas in relation to capital expenditure- particularly new and immediate spending requirements that have emerged and requirements for spend beyond the period of the approved 5 year programme.

2. Recommendations

- 2.1 Members are asked to:
 - i. Note the challenges around the funding of capital investment;
 - ii. Approve the proposed timescale for refresh of the capital programme

3. The 2018/19 to 2022/23 capital programme- expenditure

- 3.1 Council approved the current capital programme on the 7th March 2018. The programme approved covered the 5 year period from 2018/19 to 2022/23 with expenditure on some projects stretching into 2023/24 and beyond. A link to the minutes of the Council meeting, and the report and programme agreed by Members can be seen in the background papers section of this report.
- 3.2 The approved programme comprised over £480m of expenditure on projects- but once the 2017-18 capital outturn position had been finalised and project slippage confirmed, the programme now comprises over £490m of capital expenditure from 2018/19 to 2022/23.
- 3.3 Projects starting in years 1-5 of the programme but with expenditure commitments continuing into years 6-10 were also approved. Those projects require total expenditure of over £66m in years 6-10 to reach completion.
- 3.4 The approved programme see significant investment in the schools estate with specific projects planned or underway in Alness, Charleston, Culloden, Ness Castle, Inverness High and Merkinch. In additional to those specific projects a further £55m of investment in schools was budgeted, £25m of which was to match fund an assumed £50m of new Government funding for schools investment. No specific projects commitments were made against that combined £75m of assumed funding but a list of 11 priority schools for investment was agreed.
- 3.5 Other approved projects included an average £7.2m annual investment in existing roads structural improvement as well as stage 2 of the West Link project and the further development of the Inshes roundabout. A number of bridge schemes were also approved including those at Invercoe, Glenmore and the White Bridge.
- 3.6 A total £12.8m investment in the Council's vehicle fleet was approved along with £29m made available for investment in the Council's core properties. Over £10m was budgeted for waste facilities.
- 3.7 Projects approved that are predominately funded by specific government grants include flood schemes in Smithton/Culloden, Caol, Drumnadrochit and Conon Bridge as well as a significant upgrade of the harbour at Uig.
- 3.8 The delivery of many of these projects began in 2018/19 and that financial year saw over £96m of investment made as reported to the Environment, Development and Infrastructure Committee last month. A link to that report is provided in the background papers section of this report.
- 3.9 Subsequent to the approval of the March 2018 programme the Council was successful in its funding bid for £32.6m of capital funding for Early Years investment. Work to deliver those projects is underway and is subject to a separate report on this agenda.

4. Emerging expenditure pressures

- 4.1 Since the programme was approved in March 2018 a number of pressures have

emerged for which budget provision had not been included in the programme. Certain of those pressures required immediate spend to address them whereas other pressures demonstrate a need for capital investment to meet future demand. Where possible the existing programme will be reprioritised to meet the immediate spending pressures whilst formal planning for the extension of the existing programme needs to commence now to ensure plans are in place to meet future demand.

- 4.2 Cost pressures have come about as a result of a variety of factors, including the requirement for the ongoing stabilisation of the Stromeferry Rock Face (as confirmed by EDI committee in January 2019), the landslip at Kinloch Hourn, the requirement to accommodate investment in affordable housing due to the Council deciding to balance the revenue budget by using the income from second homes Council tax, the potential for pressures emerging around the implementation of the waste strategy and the financial settlement reached on the Wick Community Campus project.
- 4.3 Certain spending demands are emerging as a result of the requirement for infrastructure investment to keep pace with the development of new housing across the region. Particular demands for new primary schools are arising from housing developments at Stratton and Tornagrain and the knock on impact this will have on secondary school capacity in East Inverness.
- 4.4 Further school capacity issues are emerging in Inverness, with demand pressures on the current Gaelic Medium provision needing to be considered as part of a wider view on primary school capacity.
- 4.5 The condition and suitability of the Council's assets continues to be a concern, as it was when the March 2018 capital programme was set. Highland has the largest number of 'C' rated schools in Scotland and is dealing with legacy issues resulting from the quality of schools built in the 1960s and 70s. The requirement to make all our buildings compliant places a requirement for investment to upgrade engineering, energy, fire, security and water safety installations.
- 4.6 The requirement for capital investment extends beyond our buildings with the road and bridge network needing investment far beyond that which is deemed affordable. The backlog of roads investment is estimated to be £178m and the annual expenditure requirement to maintain the condition of roads in a steady state is expected to cost around three times the current annual budget of £7.2m. Underinvestment will see a continued decline in our asset condition- already there are 40 bridges in the Council area that have weight or other restrictions.

5. The 2018/19 to 2022/23 capital programme- funding

- 5.1 The size of the capital programme approved in March 2018 was based on what was deemed affordable. That affordability comprised expected funding from government for both the general capital grant and funding specific projects, and the total amount that could be borrowed within the current loans charges budget. Further information on all those items is included in the sections below.

General capital grant funding

- 5.2 The approved programme was predicated on the level of general capital grant received from government remaining constant over the 5 year period at £31.4m annually. In addition a supplementary £7.5m was assumed to be receivable in 2019/20 to reflect the repayment of funding deducted from the 2016/17 capital settlement.

- 5.3 The Scottish Government continues to give single year settlements for both revenue and capital although a commitment has been made to give a slightly longer term settlement for 2020/21 and beyond. Based on the Scottish Government's recently announced medium term financial strategy, which is at a very high level only, the outlook for local government may see reducing settlements over the medium term.
- 5.4 The actual core capital funding settlement received for 2019/20 was £37.743m, around £1m lower than had been forecast when the capital programme was agreed. Whilst the impact of this reduced funding can be mitigated by borrowing efficiencies any sustained reductions in core funding would need to be built into a revised capital programme.

Project specific funding

- 5.5 Funding of £86.9m for specific projects was assumed in the approved capital plan. This is primarily funding expected to be received from the Scottish Government- specifically for flood projects across the region, harbour improvements at Uig and the new secondary school at AIness.
- 5.6 Around £5m of funding from developer contributions was assumed in the plan. Whilst changes to the rate at which developer contributions are made came into effect after the plan was set those changes are not expected to have a material impact on the plan. In most cases the developer contributions assumed for the first five years of the plan will relate to development approved under the previous contributions guidance.

Scottish Schools for the Future funding

- 5.7 The approved programme contained an assumed £50m successful bid to the successor programme to the next round of Scottish Schools for the Future funding. The assumption was made that that funding would be matched by £25m of Council funding to give a total £75m investment in dealing with school condition issues. 11 priority schools were identified that could potentially benefit from such funding- albeit £75m would not be anywhere near enough to fully rebuild each of those 11 schools.
- 5.8 Since the programme was approved some degree of greater clarity on how the mechanics of the new wave of Scottish Government funding will operate has been emerging. Whilst the exact detail is still to be finalised it is officers' expectation that the Scottish Government will only match fund the same amount as Councils put forward. A consequence of that likely change is that the total £75m (£50m from SG and £25m from Highland Council) that the approved plan had assumed would be available for investment in schools will now only be £50m (£25m each from SG and HC).

Borrowing

- 5.9 The final key source of funding for the approved capital programme is borrowing. In total over £195m of borrowing is needed over the 5 year period to support the approved capital investment. Borrowing must be done in line with CIPFA's Prudential Code for Capital Finance with the key considerations that any borrowing must be affordable, sustainable and prudent.
- 5.10 Any borrowing that the Council undertakes for capital investment must be repaid through the Council's revenue budget. The revenue impact of the borrowing is shown in the Council's loans charges budget. In 2018/19 the total cost of loans charges was £57.1m.
- 5.11 The loans charge budget has two main elements. The first element, 'principal', reflects the repayment of the initial capital sum expended on any particular asset, repaid over the life of that asset. The second element, 'interest', reflects the interest payable on the

Council's external borrowing. In 2018/19 those elements were worth £29.7m and £27.4m respectively.

- 5.12 A key indicator used by councils to assess their borrowing position is to express their annual borrowing costs (loans charges) as a proportion of income from general revenue grants and taxation. For Highland this figure (including borrowing costs associated with PPP schools) stands at over 13%, the fifth highest in Scotland. At a time when the revenue budget is being reduced in real terms, and the Council faces a number of contractual and policy objectives that effectively ring fence a significant proportion of its budget, this situation is not sustainable in the long term.
- 5.13 The regulations surrounding the accounting for loans charges changed in 2016. These regulations govern how the 'principal' element of the loans charges budget must be accounted for. Since the new regulations were put in place discussions on their interpretation has been ongoing between Audit Scotland and local authority Directors of Finance.
- 5.14 A clear view on the interpretation of the regulations has now been reached which would afford this Council some flexibility over the assumed asset life over which the principal element of the loans charge for certain asset types is written off. This would allow the Council to spread the profile of principal repayments over a longer period, thereby reducing the principal payment in the near future. One consequence of doing this would be that the Council is indebted for longer- thereby increasing its total interest cost as debt is paid back over a longer period. **Appendix 1** details the current profile of the Council's loans fund principal repayments.

6. The impact of capital investment on the revenue budget

- 6.1 Capital investment can impact both positively and negatively on the Council's revenue budget. Certain capital projects may be seen as 'spend to save', whereby the capital investment delivers a recurring budget saving that more than outweighs the cost of borrowing and repaying the debt required to finance it.
- 6.2 Other projects may have a less tangible beneficial impact on our revenue budget but may help us avoid revenue costs in the future. An example of such an investment would be the improvement and refurbishment of an ageing property or road which, if the capital work was not done, would continue to degrade and require increasing maintenance spend into the future. Given the demands on our corporate revenue maintenance budget for both roads and properties and the declining condition of our assets it would not appear to be economic to reduce our revenue repairs budgets to allow us to invest more in capital expenditure.
- 6.3 Many of our capital projects, particularly large school or other property construction projects, can impact adversely on our revenue budget in two ways. Firstly the cost of financing the capital investment will impact on our loans charges budget as outlined in the 'borrowing' part of section 5 of this report. Secondly the net running costs of facilities may increase as a result of the investment- principally due to the rateable value of a property increasing significantly after investment.
- 6.4 Our experience from recent school construction projects is that net property costs increase after the capital investment as any savings from having newer, more energy efficient buildings, are outweighed by increased rates costs. In certain circumstances additional staffing costs may be required from staffing a new facility- such as when a

new school is opened to address school capacity issues.

- 6.5 In all cases of capital investment that are funded by borrowing there will be a consequential increase in our loans charges budget. These can be partially mitigated by trying to reduce our overall cost of borrowing (i.e. reducing the 'interest' element of our loans charge) and the benefit from historic capital investment being fully paid off. Over recent years however the Council's total indebtedness has increased markedly as illustrated by the table below:

	General Fund Outstanding debt	Loan charges
	£m	£m
2018/19	695.23	57.12
2017/18	672.95	54.95
2016/17	653.00	55.89
2015/16	608.81	55.30
2014/15	557.64	55.23
2013/14	536.99	53.12
2012/13	513.74	52.16
2011/12	507.41	52.16
2010/11	490.96	50.95

- 6.6 A particular Council focus to invest in our assets over recent years has seen the Council's overall indebtedness increase significantly. Increases to the loans charges budget have been required over the same period in order to finance that expenditure- albeit the rate of increase in those charges has been less pronounced than the rate of increase in indebtedness. In 2018/19 the actual loans charges cost came in almost exactly on budget.
- 6.7 **Appendix 1** shows that based on the current capital plan the 'principal' amount of loans charges that will be met by the revenue budget will remain broadly at the same level over the next 5 years. Total indebtedness is expected to rise until it peaks in 2021-22 meaning the Council will need to continue to reduce its cost of borrowing over the coming years to ensure that the combined value of principal and interest payments does not exceed the available loans charges budget.
- 6.8 Given the huge challenges expected to be faced by the Council's revenue budget over the next few years having the capital programme at its current level should be seen to be at the maximum limit of affordability. Council will need to keenly balance competing demands for revenue and capital spend over the coming years to ensure its long term financial sustainability.
- 6.9 Whilst the Council remains keen to identify new and innovative ways to fund capital investment it is important to state that unless the Council manages to secure external funding for projects the cost burden of capital investment will fall on the Council. How the Council chooses to fund its borrowing will have no impact on the 'principal' element of the loans charges budget- this is solely determined by the cost and lifespan of the assets constructed.
- 6.10 Much of the Council's borrowing is fixed into long term loans which cannot be repaid without substantial penalty. Officers do monitor the potential for the early repayment

and refinancing of those loans but the opportunities to do so remain uneconomic.

- 6.11 The Council continues to undertake a mixture of short and long term borrowing to capture an optimal mix of low interest rates, refinancing risk and maturity profile. All long term borrowing currently undertaken is taken from the Public Works Loans Board which provides a more accessible and responsive source of finance and with interest rates available that offer the best value for the Council.

7. Next steps

Schools programme

- 7.1 The timescale for the formal launch of the next phase of Scottish Government Schools for the Future funding is unclear, but it is assumed that it will be in this calendar year. As Members will be aware, it will be important that the Council is ready when the opportunity arises. In that regard various actions have been progressed in relation to assessment and development of the priorities.
- 7.2 At this stage, there is no requirement to achieve “Shovel Ready” status for these priorities. In fact the timescale and costs of achieving this for all would be excessive and potentially abortive given the uncertainty around funding. To reach that status would involve considerable further work, ultimately taking proposals to fully developed design and tender stages, which is likely to cost several million pounds for all of the potential projects.
- 7.3 The intention therefore is to move forward on a “**Bid Ready**” basis, which involves having clarity around the priorities, potential scope of solutions and, where considered appropriate, some further investigations and development of concept or outline proposals. This approach would require £250,000 of funding, Member approval for this is requested in the subsequent item on this agenda. Consideration may also have to be given to carrying out new condition surveys of all schools which also has a cost implication.
- 7.4 The following report on this agenda outlines the approach to prioritising school investment projects and the work that has been undertaken on validating the condition and suitability survey process. However, affordability is likely to be the key consideration when assessing which of the 11 prioritised locations would be included in a funding bid to the Scottish Government, particularly if this bid is to be limited to a total value of £50M as explained in 5.8. Scottish Government criteria, and funding timescales, which are not known at this time, will also have a bearing on prioritisation.

Capital programme refresh

- 7.5 As part of the Council governance review that is currently ongoing it is also proposed that the governance arrangements for the capital programme, at both an officer and Member level, are reviewed to ensure they are fit for purpose. A key part of that review will include a clear understanding of where decisions on capital spend may be taken as well as ensuring clarity of reporting on capital spend. Given the strategic importance of the capital programme to the whole Council the review will consider whether capital programme reporting should be provided to meetings of the full Council instead of to the EDI committee as currently happens.
- 7.6 Given the recent clarification on the interpretation of the new loans fund regulations (as outlined in section 5.14) a review of the Council’s current arrangements will be concluded. The likely outcome of that review will be to bring a proposal to Members that could suggest lengthening the asset lives for certain types of asset to deliver an immediate saving to the loans fund budget. Such a change would however increase

indebtedness for future years. Council will be asked if they consider such a change to be prudent and whether they would like to use any immediate revenue saving to mitigate against revenue budget pressures, use for future years' revenue budget savings or use to finance increased capital investment.

- 7.7 As a capital plan should be a long term strategic document work will commence to refresh the current programme with a view to extending it to become a firm five year programme with indicative allocations for the five, or even ten years beyond that. This work will endeavour to link the capital programme with the Council's development plans, asset management and rationalisation plans, strategic and service plans, and of course revenue budget planning.
- 7.8 Given the most important element of the capital plan will be around affordability it is intended that any decision on the capital plan is done in recognition of the revenue budget to be set in February 2020. Any capital plan agreed will need to be kept under review to ensure assumptions around capital grant or borrowing costs remain accurate and no new spending demands or other cost pressures emerge.
- 7.9 At the same time as the work detailed in sections 7.1 to 7.8 is ongoing, Members are also reminded that year 2 of the 5 year capital programme approved in March 2018 will continue unaffected. Over £100m of capital projects are planned for delivery in 2019/20 and will continue to be reported through the EDI committee.

8. Implications

- 8.1 Resource- As outlined in section 6 of this report any capital investment will impact on the Council's revenue budget. Given the pressures on the Council's revenue budget Council will need to ensure that any amendments or extensions to the existing capital programme are affordable in the wider revenue budget context.
- 8.2 Risk- As outlined when the capital programme was agreed in March 2018 there are a number of risks associated with the programme. Inflation in project costs or other reasons for project cost increases would need to be managed within the wider programme. On the funding side increases in our borrowing costs or reduced capital settlements from Government would further curtail our ability to invest in capital. As the affordability of the capital programme is intrinsically linked to the Council's revenue budget any matters impacting on that budget could have a consequential impact on the capital programme.
- 8.3 The capital programme entails a significant amount of construction activity which may have Climate Change or Carbon Clever implications. Specific projects will also have their own implications with new buildings anticipated to be more environmentally friendly than those being replaced. All such implications will be assessed as part of the project management process for individual projects.
- 8.4 There are no specific Legal, Gaelic or Community implications as a result of this report.

Designation: Head of Corporate Finance

Date: 12th June 2019

Author: Edward Foster, Head of Corporate Finance

Background Papers:

https://www.highland.gov.uk/meetings/meeting/3943/highland_council/attachment/73527

https://www.highland.gov.uk/download/meetings/id/73257/item_3_capital_programme_201819_to_202223

[https://www.highland.gov.uk/download/meetings/id/75261/item_6 -_capital_expenditure_monitoring](https://www.highland.gov.uk/download/meetings/id/75261/item_6_-_capital_expenditure_monitoring)

Detail of outstanding principal, new capital expenditure and annual principal repayment profile

Appendix 1

Financial year	Opening balance- Debt outstanding	New capital expenditure to be financed by borrowing	Loans charge 'principal' instalment paid through revenue budget	Closing balance- Debt outstanding
2018-19	672,947	50,355	29,778	696,958
2019-20	696,958	66,627	30,582	729,569
2020-21	729,569	33,267	31,212	731,624
2021-22	731,624	19,007	30,934	719,697
2022-23	719,697	14,121	30,929	702,889
2023-24	702,889	2,493	30,770	674,612
2024-25	674,612		30,521	644,091
2025-26	644,091		30,128	613,963
2026-27	613,963		29,497	584,466
2027-28	584,466		29,009	555,457
2028-29	555,457		27,549	527,908
2029-30	527,908		26,460	501,448
2030-31	501,448		26,064	475,384
2031-32	475,384		25,414	449,970
2032-33	449,970		24,348	425,622
2033-34	425,622		23,705	401,917
2034-35	401,917		22,307	379,610
2035-36	379,610		20,093	359,517
2036-37	359,517		17,177	342,340
2037-38	342,340		15,489	326,851
2038-39	326,851		12,366	314,485
2039-40	314,485		11,690	302,795
2040-41	302,795		11,198	291,597
2041-42	291,597		10,849	280,748
2042-43	280,748		10,637	270,111
2043-44	270,111		10,529	259,582
2044-45	259,582		10,286	249,296
2045-46	249,296		10,000	239,296
2046-47	239,296		9,577	229,719
2047-48	229,719		8,904	220,815
2048-49	220,815		7,387	213,428
2049-50	213,428		7,026	206,402
2050-51	206,402		6,985	199,417
2051-52	199,417		7,061	192,356
2052-53	192,356		7,211	185,145
2053-54	185,145		7,376	177,769
2054-55	177,769		7,122	170,647
2055-56	170,647		7,386	163,261
2056-57	163,261		7,293	155,968
2057-58	155,968		7,265	148,703
2058-59	148,703		7,238	141,465
2059-60	141,465		7,270	134,195
2060-61	134,195		7,356	126,839
2061-62	126,839		7,500	119,339
2062-63	119,339		7,574	111,765
2063-64	111,765		7,662	104,103
2064-65	104,103		7,860	96,243
2065-66	96,243		8,089	88,154
2066-67	88,154		8,074	80,080
2067-68	80,080		7,303	72,777
2068-69	72,777		7,305	65,472
2069-70	65,472		7,430	58,042
2070-71	58,042		7,556	50,486
2071-72	50,486		7,201	43,285
2072-73	43,285		6,763	36,522
2073-74	36,522		6,581	29,941
2074-75	29,941		6,286	23,655
2075-76	23,655		6,264	17,391
2076-77	17,391		5,543	11,848
2077-78	11,848		5,101	6,747
2078-79	6,747		3,611	3,136
2079-80	3,136		1,900	1,236
2080-81	1,236		524	712
2081-82	712		524	188
2082-83	188		188	0
			858,817	