<u>Commercial Strategy</u>

1. Introduction

1.1 The County Council's approach to the delivery of successive savings programmes has, in the main, focussed on maximising efficiencies in service delivery and implementing changes to operating models and technology that mean that services can be provided in a cheaper, but more effective way.

1.2 Alongside this, the County Council has also examined areas where it can generate more income in order to reduce the direct impact on services, either through charging for services or through the expansion of traded services to other organisations.

1.3 In addition, as part of the strategy for making 'housekeeping' savings a revised approach was adopted for the investment of surplus cash, that has generated significant returns as part of a balanced portfolio.

1.4 This approach has continued into the Savings Programme 2023 (SP2023) and included an option as part of the *Serving Hampshire – Balancing the Budget* consultation. Feedback suggests that respondents are concerned about the implications of further service charges. However, there was support to lobby central Government to allow additional charging in a number of areas.

1.5 The purpose of this appendix is to outline, as part of the wider Medium Term Financial Strategy (MTFS), the County Council's approach to commercialisation and explain some of the risks and issues associated with certain options, some of which have received recent national press coverage.

1.6 There are four main areas where the County Council can seek to generate additional income to help close the budget deficit:

- Charging users for the direct provision of services.
- Investing money or using assets to generate a return.
- Expanding traded services to other organisations.
- Developing joint ventures that yield additional income or generate a return.

1.7 The following paragraphs explore what the County Council has been doing in each of these areas as part of its longer term financial strategy.

2. Charging Users for the Direct Provision of Services

2.1 Many of the potential areas for charging for services at a county level are governed by statute and by far the biggest area is charging for the provision of adult social care services which generates around £68m of income that is vital in maintaining services in the face of growing demand.

2.2 Income generation through fees and charges in other departments (excluding schools) accounts for a further £55m, much of which sits within Culture, Communities and Business Services (CCBS), for goods and services that people use more as a matter of choice than out of necessity, including Country Parks, Registration Services and Libraries.

2.3 This £123m of fees and charges income is already built into the base budget and it is only any marginal net increases that can be achieved on this figure that would help the County Council close the predicted budget gap. In terms of scale therefore, whilst income generation is of a significant value, against a savings target of £80m it does not represent a significant proportion of the County Council's budget.

2.4 The range of income generating activities that the County Council can enter into is also very different to that of district councils who are able to introduce smaller scale but localised services that may generate a net return. Some examples of areas that have been introduced include:

- Car washing services in council owned car parks.
- Garden waste collection.
- Cleaning services.
- Gardening services.

2.5 In these instances, it is important to remember that the net marginal return against the costs of providing the services tends to be fairly small. Therefore, a significant volume of activity needs to be undertaken to generate a level of income that will have a material impact in budgetary terms, given the size and scale of the County Council and the scope for the sorts of areas highlighted above is limited. On top of this of course, there is also the potential for the venture to be loss making, given that some ventures are not necessarily in areas where the councils have the right expertise.

2.6 The County Council has quite rightly concentrated on areas where it already has experience in providing the services and has built commercial models around these that also improve and enhance the user experience at the same time.

2.7 An excellent example of this is the programme around our country parks, where capital investment is being used to improve facilities and options for users and new income generation strategies are being put in place around catering, activities and car parking with the aim of making the country parks financially self sufficient over the longer term. This approach builds upon our existing service base, is more aligned to the types of services the County Council provides and better reflects the scale at which we work, rather than choosing new or more speculative ventures to launch into.

3. Investing Money or Using Assets to Generate a Return

3.1 The County Council holds reserves for a number of purposes which are explained in more detail in the Reserves Strategy in Appendix 11. The level of the reserves, together with the normal cash flow patterns throughout the year mean that there are significant opportunities for investing surplus cash to make a financial return.

3.2 However, it is important to note that the nature of these investments is very different to those that are undertaken on behalf of the Pension Fund which are very long term investments that focus on return as one of the primary objectives, with a value in excess of £9bn. For shorter term cash balances, the County Council follows the Chartered Institute for Public Finance (CIPFA) and Ministry of Housing, Communities and Local Government's (MHCLG) guidance, which emphasises prudence and specifies the priorities for investment decisions (in order of importance) as security, liquidity and finally yield.

3.3 The County Council is faced with a historically low interest rate environment. Following the UK's referendum decision in June 2016 to leave the European Union (EU) the Bank of England cut interest rates to 0.25%. Since then rates increased slightly to 0.75% in late 2018, but when the Covid-19 pandemic struck, the rate dropped to 0.1%. The view is that the current low interest rate environment will continue for some time to come. Since a large proportion of the surplus cash balances are invested in short term deposits, low interest rates reduce the income the County Council earns on its investments and may worsen the County Council's overall budget position.

3.4 As part of the 2014/15 strategy the County Council decided to earmark £90m of its cash balances for investments appropriately targeting a higher yield. This was in addition to the £15m of long term investments that had been made for the Street Lighting Private Finance Initiative (PFI) scheme. Subsequently, the County Council increased this amount to £235m and more recently to £250m.

3.5 Higher yields can be accessed through investments in assets other than cash, such as equities, bonds and property. The County Council has made investments in property, equities and government bonds, as well as long term investments with other Local Authorities as shown in the following table which also provides an analysis of the remaining portfolio to highlight the differences in return:

	31/03/20 Balance £m	31/03/21 Balance £m	31/03/21 income return %
Local Authorities Fixed Deposits	20.2	21.7	4.32
Local Authorities Fixed Bonds	10.0	0	0
Pooled Property Funds	75.0	75.0	4.03
Pooled Equity Funds	50.0	50.0	6.45
Pooled Multi-Asset Funds	40.0	48.0	4.53
Long term Investments – High Yielding Strategy	**195.2**	**194.7**	**4.80**
Banks and Building Societies - Secured	15.0	10.7	0.31
Banks and Building Societies - Unsecured	26.3	69.5	0.04
Money Market Funds	175.3	78.0	0.04
Local Authorities	80.5	139.0	0.34
Cash Plus Funds	10.0	10.0	0.93
Short Term Investments	**307.1**	**307.2**	**0.21**
Banks and Building Societies - Secured	33.2	20.0	0.35
Local Authorities	40.0	35.0	1.28
Long Term Investments	**73.2**	**55.0**	**0.94**
Total Investments	**575.5**	**556.9**	**1.89**

3.6 The returns shown are those reported for the Treasury Management activity undertaken in 2020/21 and show the 2019/20 portfolio for comparison. The mid-year results are also included in Appendix 2 of this report and show a similar profile of investment returns.

3.7 The County Council is targeting a return of around 4% from higher yielding investments, which is significantly above any short or long term cash investments as highlighted in the above table. It is important to note that the £195m of higher yielding investments is helping to increase the County Council's overall average investment return, which is providing £9.4m to its income based on average balances in the year. Once the full allocation of £250m is drawn down, this could add a further £2.6m of income to the higher yielding investments.

3.8 However, this type of investment would not be appropriate for the County Council's total balances as there are a number of different risks which must be carefully managed:

- Loss of capital – Unlike cash investments other asset classes have a variable value determined by market conditions, therefore there is a risk that the capital value of the investment may be less than the amount originally invested.
- Illiquidity – Most investment vehicles for non-cash assets offer more limited liquidity, from between one and six months. In addition to mitigate the risk of a loss of capital these investments must not be seen as source of liquidity to avoid crystalizing a loss.
- Entry and exit fees – There may be a bid / offer spread for buying and selling non-cash investments which is a means for the investment vehicles to pass on their transaction costs (in particular stamp duty which is significant for property) to new or exiting investors.
- Volatility in returns – But returns can be expected to be much higher than cash investments over at least the medium term.

3.9 The principle mitigation for all of these risks is ensuring that investments in non-cash assets are held as long-term investments. This will enable the initial costs of any investment and any periods of falling capital values to be overcome. In order to be managed as long-term investments the amounts invested need to be taken from the County Council's most stable cash balances. Therefore, the allocation of £250m has been proposed as half of the Council's forecast future minimum balance.

3.10 The selection of investments to target higher yields is carefully managed with the assistance of Arlingclose, the County Council's treasury management advisor, who recommend that the County Council diversifies its investments targeting a higher return between asset classes. This is in order to mitigate the loss of capital value, so that there is no over exposure to an event that impacts the value of investments in a particular asset class, such as a fall in property prices.

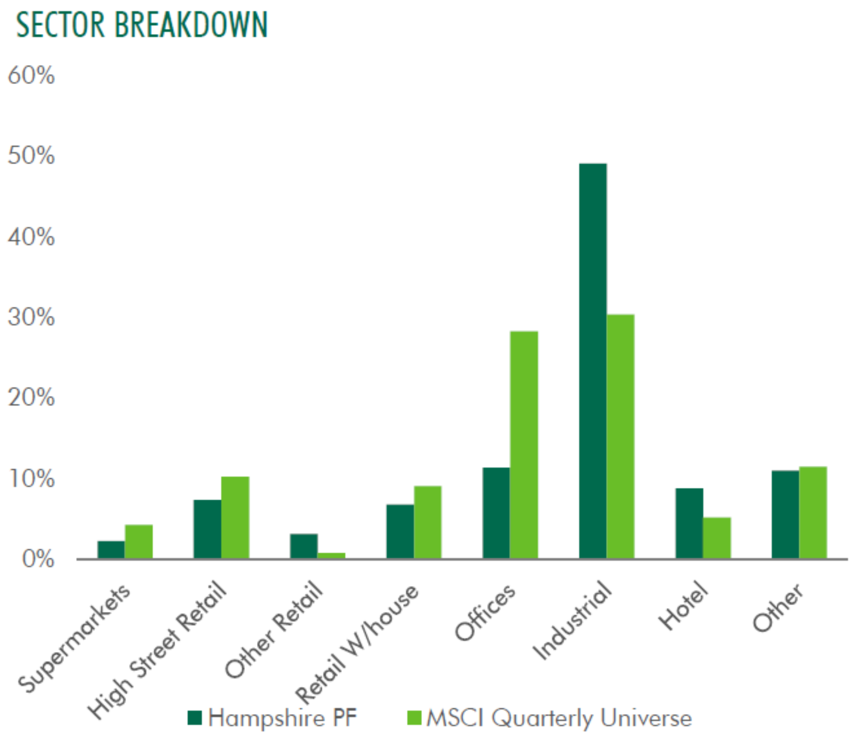
Direct or pooled investments

3.11 The County Council utilises pooled investment vehicles as the most appropriate means to access asset classes such as property or equities. Pooled funds are managed by external specialist investment managers who are best placed to select the particular investments and then manage them, for example for property investments managing the relationship with tenants and maintenance of the building.

3.12 The County Council could build its own direct portfolios of these investments, such as property, as the Pension Fund has, however its total allocation of £250m for a diversified portfolio would not enable this to be done efficiently and effectively with the appropriate risk mitigation. The Pension Fund's property investment manager, CBRE, advises that the appropriate size of a direct property portfolio would be at least £400m to £500m and the Pension Fund's current allocation tor property investment is £721m. This is to ensure that there is a sufficient number of properties to minimise the relative size of any one in the portfolio and achieve a spread across both geographical regions and industry sectors. As an example, the following charts compares the Pension Fund's property portfolio with one of the pooled funds that the County Council has invested in.

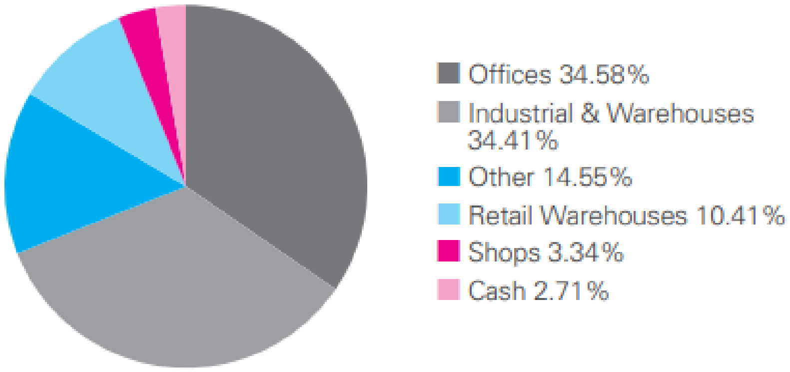
Comparison of Property Funds

Pension Fund Direct Portfolio – Portfolio size: £585m and number of properties: 52 (at 30 June 2021)



The dark green bars are Hampshire's portfolio compared to the benchmark.

Pooled Property Fund – Portfolio size: £1.254bn and number of properties: 75 (at 30 June 2021)



3.13 The County Council could attempt to build a sub-scale direct portfolio, but this would add significant risk to the Council which would not align with its investment objectives. Without sufficient diversification the County Council would be exposed to too great an impact from a single property it had invested in. Through its experience with the Pension Fund the County Council has seen a property fall vacant at an inopportune time and remain vacant for a significant period of time. This risk can be mitigated in a large diversified portfolio, such as the Pension Fund's, but this is beyond the reach of the County Council, the majority of whose balances are not available for this sort of investment.

3.14 At a national level there is much press coverage about the property investment 'bubble' being created by local government on the back of cheap borrowing from the Government and the financial risks that this poses. The Government stopped short of limiting this type of activity but have issued guidance around the need for appropriate analysis, assessment and scrutiny before investment decisions are made. The County Council's approach of investing in pooled property funds is already providing significantly higher returns (4.03% last year) without the need to prudentially borrow, without the risk of owning individual properties itself and with the security of a much larger and diverse portfolio than could be achieved on its own, even with our scale of investments.

Utilising Land and Property Assets

3.15 The Hampshire County Council estate is primarily held for operational purposes. Property Services works closely with all departments to make best use of the County Council's property and land assets to deliver public value through arrangements with third parties that both enhance the County Council's service offer to the residents of Hampshire and deliver a revenue income stream to the County Council to support its own service provision.

3.16 Commercial arrangements in place across the estate are primarily with partner organisations whose services align with the primary operational use of the site or building. Examples include:

- lease arrangements within the corporate office portfolio with the NHS, Connect 2 Hampshire, Property Services' and ETE's private sector partners and Trade Unions

- development of our libraries as Community Hubs through co-location of services provided by charities and community groups such as the Citizen's Advice Bureau, Enham Trust, Age Concern and Parish Councils, as well as hiring of space to community groups;
- arrangements with third parties at the Country Parks and Outdoor Centres, for example the miniature train at Royal Victoria Country park, sailing clubs at Calshot and a scout group at Runways End;
- grazing licences across the Countryside and County Farms portfolios
- lease and hiring arrangements for Early Years settings, sports clubs and other third parties at school sites.

3.17 We also generate income through granting wayleaves and easements across the County Council's land and continue to be proactive in taking opportunities for short term lease arrangements and have been particularly successful in recent years letting land for contractors' site compounds, for example linked to the Smart Motorway works on the M3 and M27.

3.18 The County Council has a small number of legacy arrangements that generate income from commercial tenants including:

- Holiday Inn at Fareham
- Hillier garden centre at Sir Harold Hillier Gardens, Romsey
- Lease of ETE land to Maritime Transport at Nursling
- Starter business units and warehouse accommodation at Segensworth

3.19 One positive outcome of the Pandemic has been the rapid transfer to new ways of working which maximises the use of technology and flexible working locations. The Corporate Office Accommodation Board is working to capitalise on this opportunity and further work is being undertaken to maximise the usage of space in existing buildings with a view to potentially offering whole buildings, such as Athelstan House on the commercial market for lease. Once again this is the County Council using its existing assets to generate income with minimal risk, compared to borrowing to buy commercial property purely to try to make a financial return.

4. Expanding Traded Services to Other Organisations

4.1 The County Council has an established record of traded services, predominantly with schools and other public sector partners. These include local partners such as Hampshire Constabulary and the Fire and Rescue Service, and out of county organisations including many other local authorities, police forces, health and voluntary sector organisations. These are depicted in our extending organisation diagram. External trading is conducted through a range of different arrangements, from direct trading with business units to subscription models, Service Level Agreements and joint working partnerships.

4.2 Trading already makes a significant contribution to the County Council's finances. Income from external trading supports service budgets as well as enabling them to make departmental contributions. Previous analysis of traded services assessed that the 44 trading areas with the highest income were generating combined revenue of around £114m.

4.3 In net terms, this level of trading activity makes a contribution of around 10% each year to the cost of direct and indirect overheads, many of which would still be incurred even if the trading activity did not take place. At the end of 2020/21 total departmental trading reserves stood at £8.8m, representing 1.2% of the Council's total earmarked revenue reserves.

4.4 It is important, however, that we distinguish between the income generated through trading activity, which is noteworthy, and the surplus that activity generates, which is considerably smaller. Indeed, the benefits the County Council obtains from external trading are largely non-financial. Trading enables us to maintain capacity and capability within the workforce; helping us to attract and retain high calibre staff. This shores up the quality of our service provision to Hampshire residents and at the same time, enables us to make a contribution towards our organisational overheads.

4.5 Trading also delivers a number of wider benefits within Hampshire. Providing local employment through trading is an economic benefit to the County. The role our services play in moderating the external market and in ensuring that public value is a core principle in service delivery (as opposed to purely profit driven private sector provision) brings quality to the areas in which we trade, providing positive reputational benefits through the value we add.

4.6 The County Council's scale and its ability to maintain capacity across a wide range of services during this period of austerity has also opened up new opportunities as other organisations have divested themselves of their technical, professional or back office expertise. Over the last ten years the County Council has:

- Expanded its Property Services function, entering into a partnership with Reading Borough Council and undertaking work on behalf of Hampshire and Isle of Wight Fire and Rescue Service, Hampshire Constabulary and a range of local authorities across the south east and London.
- Created a shared services partnership with Hampshire Constabulary and Hampshire Fire and Rescue Authority which now provides services to Oxfordshire County Council and 3 London Boroughs. Further expressions of interest are currently being considered.
- Developed its Pension Services model to provide administrative services across a number of partners operating very different pension schemes including LGPS, Police and Firefighter schemes. This arrangement currently includes three other local authorities.
- Provided high quality support and interventions to the Isle of Wight, Torbay, Buckinghamshire and West Sussex Councils in the area of children's safeguarding.
- Successfully run 'pure' trading ventures in the areas of County Supplies, Catering Services and Transport Management that have a combined turnover of nearly £60m.
- Increased income and services offered in specialist areas such as scientific services, ecology services and environmental impact advice.

- Maintained significant levels of services to our schools across a wide range of functions such as HR, Finance, IT, school improvement, governor and music services.
- Utilised its capacity, expertise and skills in professional and technical areas to offer services such engineering consultancy, strategic transport and travel planning.

4.7 The SP2023 Programme builds on the trading activities that we already undertake and with which we are familiar, with a view to reducing the net cost of these services, albeit there is a loss of capacity available to support the activities of the County Council. However, what is clear is that trading does not in itself represent a solution to the budget gap that we face. Even at a return rate of around 10% (which by any commercial standard would be an exceptionally ambitious and therefore unreliable projected profit margin) it would require additional turnover of £800m to meet the £80m target required to balance the budget by 2023/24, which is about seven times the level of trading activity that we currently undertake.

4.8 The Chief Executive has recently commissioned a Council wide piece of work to examine our traded services in order to have much greater visibility at a strategic level of the commercial strategy, opportunities and barriers in all traded service areas provided to other organisations.

4.9 The output from this work will help to identify priority areas for focus in the coming years, together with any actions or investment required to remove barriers to growth and to continue to grow traded services in a sensible and sustainable way such that they can make contributions to future savings plans beyond SP2023.

5. Developing Joint Ventures That Yield Additional Income or Generate a Return.

5.1 There are a number of opportunities that the County Council can pursue either through its land holdings or through the relationship it has with partners or contractors for looking at new and innovative ways of generating a financial return.

5.2 To date the County Council has been helpful in responding to Borough Council Local Planning Authority requests for the potential use of its public land holdings for potential residential development. Up to 2030 around 10% of all new dwellings across Hampshire will be built on County Council owned land and 8% will be on sites within the County Council’s strategic land programme (SLP) In addition, this will continue the stream of substantial capital receipts the County Council has benefitted from over recent decades to enable it to reinvest in existing services and ongoing transformation initiatives.

5.3 However, in addition, an alternative avenue that the County Council is currently actively pursuing is to become even more active and influential in the market of delivering homes across the county on some of its key sites. This will have the benefit of not only giving greater influence and certainty in the types and rates of homes, neighbourhoods and infrastructure and facilities being developed on its land but also the potential for greater certainty in the programming of development and receipts through economic cycles. Furthermore, it will also offer the County Council the advantage of considering whether it wishes to benefit from capital or revenue receipts from development and residential assets or combinations of the two depending on individual sites and its own circumstances.

5.4 The largest site is Manydown in Basingstoke and a joint venture arrangement between Hampshire, Basingstoke and Deane Borough Council and a private sector partner (Urban and Civic) is now in place and is working towards securing the necessary finances to complete infrastructure works and the development of 4,200 houses on the Manydown site.

5.5 Whilst this approach increases the costs and risks associated with the development of our land interest, it also provides the opportunity for the greatest dividends, which are expected to be received from 2026/27 onwards and will be in the 10s of millions of pounds.

Relationships with Contractors and Partners

5.6 Another area that the County Council can look to exploit is the relationships it has with its partners and contractors. There is already a long standing relationship with our waste disposal contractors Veolia that includes innovative ways of generating income for both parties. The long term contract allows the use of surplus capacity at our waste facilities for commercial purposes for which the County Council receives an income share.

5.7 Similarly, provisions are in place for working with our new highways maintenance contractor Skanska to develop joint ventures linked to the existing contract that will yield additional income for both parties.

Joint Ventures with other Councils

5.8 At the beginning of 2019, the County Council entered into a joint venture with Commercial Services Kent (CSK - owned by Kent County Council) to set up an arms length trading company that supplies agency staff to the County Council (in the same way that CSK already provide agency staff to Kent County Council). Not only does this arrangement save money compared to other private agencies, it also improves quality by ensuring that agency workers who are rejected by the County Council in one service area cannot end up being employed elsewhere through another route.

5.9 The company (Connect 2 Hampshire) was set up utilising the existing expertise, knowledge and legal arrangements for Commercial Services Kent and the new company was formed and operating in a much shorter timescale than would otherwise have been the case.

5.10 Early results have been positive despite some pressures in the system (particularly within the social care sector during the pandemic and during the ‘pingdemic’ experienced over the summer) but the relationship with the company is strong and we have worked together to resolve issues where they have arisen.

5.11 Financial results are positive with an estimated £176,000 expected to be returned to the County Council as a dividend from the 2020/21 financial year.

6. Commercialisation in Local Government – Conclusions

6.1 This appendix has demonstrated that by building on its existing strengths, at the same time as looking for innovative (but low risk and sustainable) options for investment and utilisation of assets, the County Council has radically shifted its approach to income generation and the pursuit of commercial opportunities during the period of austerity.

6.2 The success of the County Council’s approach now means that we:

- Will be generating fees and charges income of more than £123m by 2022/23.
- Will increase net income from sales, fees and charges as part of SP2023 by around £1.9m.
- Have increased investment returns on cash balances from £3.5m per annum in 2011/12 to £10.5m last year.
- Will start to generate longer term savings through property development and joint ventures with partners that will contribute to future savings programmes.

6.3 Total commercial based activity will make a substantial contribution to supporting the County Council’s bottom line and to helping maintain high quality services, staff capacity and the retention of skills and technical expertise.

6.4 This has all been achieved through the pursuit of a range of initiatives targeting increased income generation but without overexposing the Council to excessive risk or considering radical changes that take the County Council into areas that are not its core business or indeed pursuing more niche opportunities that simply do not offer with any confidence anything like the scale of income to merit the effort and upfront investment.

6.5 While the organisation should and will continue to explore all further opportunities to extend these net incomes and identify new ones, it would be a grave error to reduce our planned savings for SP2023 on the back of over ambitious or unsustainable income targets that would build significant risk into future financial plans.