Commercial Strategy

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 Transformation to 2021 (Tt2021) Programme and as part of the *Serving Hampshire – Balancing the Budget* consultation feedback, generating additional income was again the most preferred option for helping to close the budget deficit.

1.5 The purpose of this section 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 £64m 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 £39m, much of which sits within Culture, Communities and Business Services (CCBS), for goods and services that people use more of a matter of choice than out of necessity.

2.3 This £103m 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 anything 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.

2.8 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 £7bn. For shorter term cash balances, the County Council follows 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 have increased slightly to 0.75%. Whilst the current uncertainty around the EU exit could change the position longer term, 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. The County Council has now agreed to increase this amount to £235m.

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:

	31/03/18 Balance £m	**31/03/19 Balance £m**	**31/03/19 Balance %**
Local Authorities Fixed Deposits	20.0	20.0	3.96
Local Authorities Fixed Bonds	10.0	10.0	4.20
Registered Providers	5.0	0.0	
Pooled Property Funds	55.0	67.0	4.35
Pooled Equity Funds	40.0	52.0	5.78
Pooled Multi-Asset Funds	20.0	42.0	5.38
Long term Investments – High Yielding Strategy	**150.0**	**191.0**	**4.92**
Banks and Building Societies - Secured	11.7	30.4	0.93
Banks and Building Societies - Unsecured	55.0	15.0	1.34
Money Market Funds	25.7	55.3	0.79
Local Authorities	160.5	124.5	1.12
Registered Provider	20.0	5.0	3.40
Cash Plus Funds		10.0	1.50
Short Term Investments	**272.9**	**240.2**	**1.10**
Banks and Building Societies - Secured	78.3	73.3	1.31
Local Authorities	61.0	78.0	1.36
Long Term Investments	**139.3**	**151.3**	**1.33**
Total Investments	**562.2**	**582.5**	**2.41**

3.6 The returns shown are those reported for the Treasury Management activity undertaken in 2018/19 and show the 2017/18 portfolio for comparison. Half 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 £191m 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 £235m is drawn down, this could add a further £2.1m 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 £235m 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.

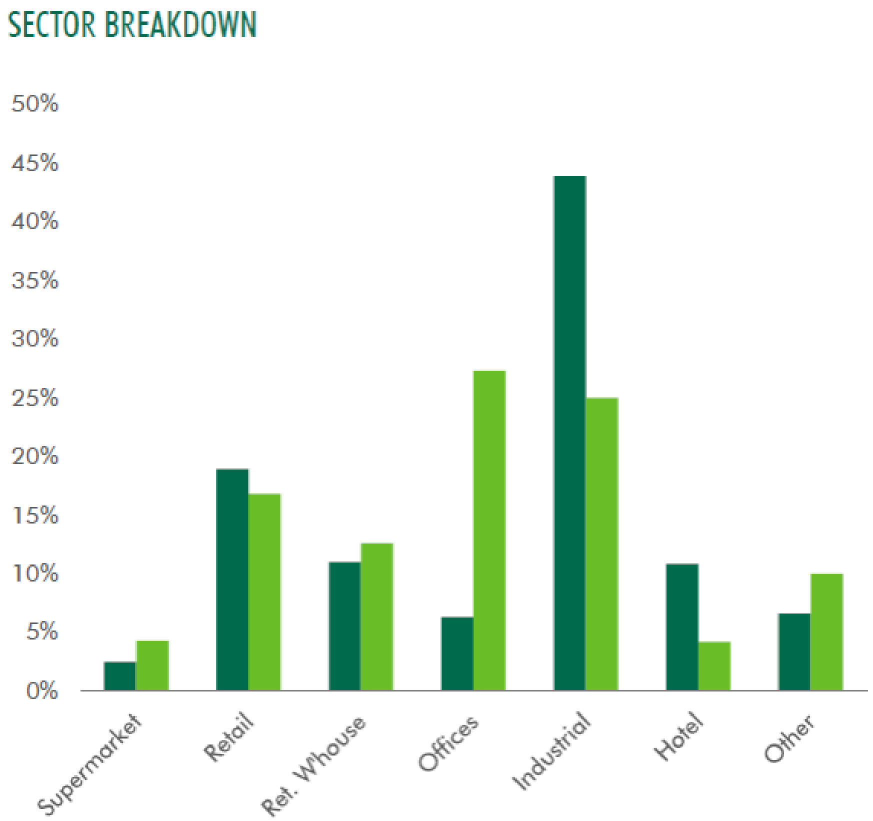
Direct or pooled investments

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 £235m 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 current pension fund allocation for property investment is £760m. This is to ensure that there 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.

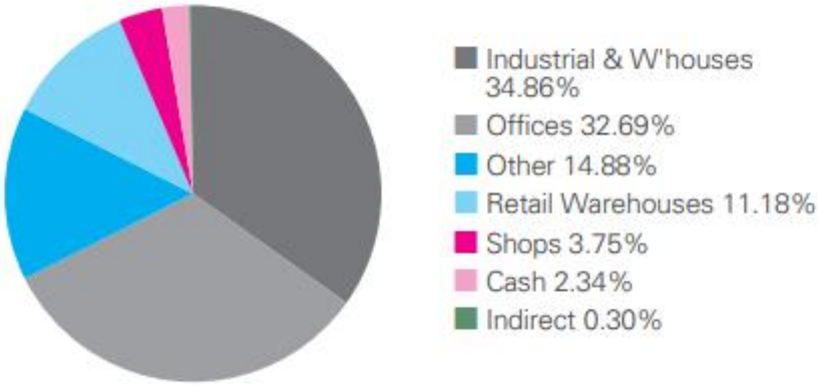
Comparison of Property Funds

Pension Fund Direct Portfolio – Portfolio size: £531m and number of properties: 56 (at 30 June 2019)



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

Pooled Property Fund – Portfolio size: £1.178bn and number of properties: 75 (at 30 June 2019)



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 Recent local examples would also suggest that as a pure investment opportunity the returns are limited. Southampton City Council have recently invested £65m to earn a £1m or 1.54% net return. Whilst this might be part of a wider programme either for economic development or future major development opportunities, the reality is that had they invested £65m into a pooled property fund, they could have earned over £2.5m per annum based on the 3.85% earned last year.

3.15 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 (4.35% 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 Property Assets

3.16 The County Council is utilising its own property to make a return. In areas where we already own buildings we are working with partners to utilise this space more effectively from a joint service provision point of view and at the same time making a return on the space we have provided.

3.17 CCG Partners were already sharing space with the Adults' Health and Care Department and this is due to be expanded with the cross Hampshire joint CCG working arrangements moving into Castle Avenue and taking up to 73 desks plus dedicated meeting room space.

3.18 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 buying up property using prudential borrowing purely to try to make a financial return.

3.19 In addition to property rationalisation, the County Council is also making more efficient use of its existing office space as part of the expansion of its shared service arrangements. Changes to technology introduced through the Enabling Productivity Programme together with more flexible working arrangements have enabled an additional 130 staff to be employed and accommodated within EII South and East as part of the onboarding of the three London Boroughs and Hampshire Pension Services taking over the pension administration for West Sussex County Council.

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 such as Oxfordshire County Council. 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. Analysis of traded services assessed that the 42 trading areas with the highest income were generating combined revenue of around £135m.

4.3 In net terms, this level of trading activity makes a contribution of over 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 2018/19 total departmental trading reserves stood at £9.2m, representing 2.1% 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 the Isle of Wight Council and the Education Skills and Funding Agency.
- 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 Borough.
- Developed its Pension Services model to provide administrative services across a number of partners operating very different pension schemes and has recently taken on the administration for West Sussex County Council LGPS and Firefighter schemes.
- Provided high quality support and interventions to the Isle of Wight, Torbay, Buckinghamshire and now 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 and trading standards.
- 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 Tt2021 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 that 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 2021/22, which is nearly six times the level of trading activity that we currently undertake.

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. In the current round of Hampshire Local Plans through to around 2029, approximately 6,000 new homes have been or are expected to be allocated and delivered on County Council land. Currently, this equates to around 7% of all new private and affordable housing in Hampshire for this period. 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. The largest site is Manydown in Basingstoke, which is outlined in more detail in the paragraphs below.

Manydown, Western Basingstoke.

5.4 In the case of Manydown, in May 2016 the County Council, along with joint landowner Basingstoke and Deane, secured the allocation of the initial Manydown Phase 1 development for 3,200 homes to be provided in the period up to 2029. Following public consultation that has enabled the finalisation of a development masterplan, planning approval is now being sought to take the site forward.

5.5 In addition, following the consideration of alternative methods of delivery, control, risk and finance via the Manydown Business Plan, the Executive Member for Policy and Resources (EMPR) has approved a Private Sector Master Developer Joint Venture approach. This enables the procurement of a major Private Sector Partner (PSP) who will work with both landowners as co-developers of Manydown. Following an extensive procurement process, final contract terms are about to be signed with Urban and Civic (U&C) and their funding partner the Wellcome Trust that will see the final pieces of the joint venture put in place.

5.6 A joint company has already been set up by the two councils, the Manydown Garden Communities LLP (MGC), which will in turn enter into a 50/50% Limited

Liability Partnership Development Company ('Dev Co.') with U&C. 'Dev Co.' will bring together the land, staff expertise and capital investment of the two authorities with the Master Developer expertise and finance of the PSP to enable the commencement of homes and infrastructure on site in 2020/21. In addition, this arrangement will also look to attract appropriate government and Enterprise M3 (EM3) LEP infrastructure grant funding and planning obligation funding into the development.

5.7 As part of the above, the County Council will actively participate in the provision of private housing for sale or rent and also affordable house building for sale and rent within its 'Dev Co.' role. As a result of this, it will be in a position to decide if it wishes to receive either capital or revenue benefits from its involvement. In addition, this model, without the involvement of Basingstoke and Deane, might be further considered for its wider Strategic Land Programme across the county.

5.8 In addition to 'Dev Co.', a further arrangement would be put in place by the two landowning authorities to hold any retained private or affordable homes for rent which at this stage is termed 'Invest Co.'. This could also be used to retain and hold potential commercial assets that also were being held for the purposes of revenue income. In turn, 'Invest Co.' would be supported by another creation of the two authorities, 'Manage Co.' This would provide the day to day running, management and maintenance etc of any retained assets. Both 'Invest Co.' and 'Manage Co.' would be able to utilise the existing officer and consultant partner skills and expertise that the two authorities already make use of in their day to day business as usual.

Relationships with Contractors and Partners

5.9 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.

5.10 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

5.11 At the beginning of this financial year, 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 will supply agency staff to the County Council (in the same that CSK already provide agency staff to Kent County Council). Not only will this arrangement save money compared to other private agencies, it will also have a focus on quality, ensuring that agency workers who are rejected by the County Council in one service area cannot end up being employed elsewhere through another route.

5.12 The company (Connect 2 Hampshire) will take some time to bed in, but by utilising the existing expertise, knowledge and legal arrangements for Commercial Services Kent, the new company was formed and operating in a much shorter timescale than would otherwise have been the case.

6. Commercialisation in Local Government – Conclusions

6.1 This section 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 £105m by 2021/22.
- Will increase gross trading services as part of Tt2021 to around £155m.
- Have increased investment returns on cash balances from £3.5m per annum in 2011/12 to £12.6m 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 contribute approaching £140m net 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 over exposing 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 Tt2021 on the back of over ambitious or unsustainable income targets that would build significant risk into future financial plans.