Agenda Item 10a

Capital Strategy 2019/20
(Including Prudential Indicators)

Office of the Police and Crime Commissioner Report

Public Accountability Conference 20 February 2019

Title: Capital Strategy 2019/20

Report of the Joint Chief Finance Officer

Originating Officers: **Michelle Bellis, Deputy Chief Finance Officer;**
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1. Purpose of the Report

1.1. This capital strategy is a new report for 2019/20, intended to give a high level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services along with an overview of how associated risk is managed and the implications for future financial sustainability.

1.2. The aim of this report is to provide enough detail to allow non-financial decision makers to understand how stewardship, value for money, prudence, sustainability and affordability will be secured without repeating in detail the information that is contained in other documents presented as part of this suite of capital and treasury management reports (agenda items 10b & 10c)

1.3. These reports meet the reporting requirements of the Charted Institute of Public Finance and Accounting (CIPFA) Prudential Code for capital finance in Local Authorities 2017 updated guidance.

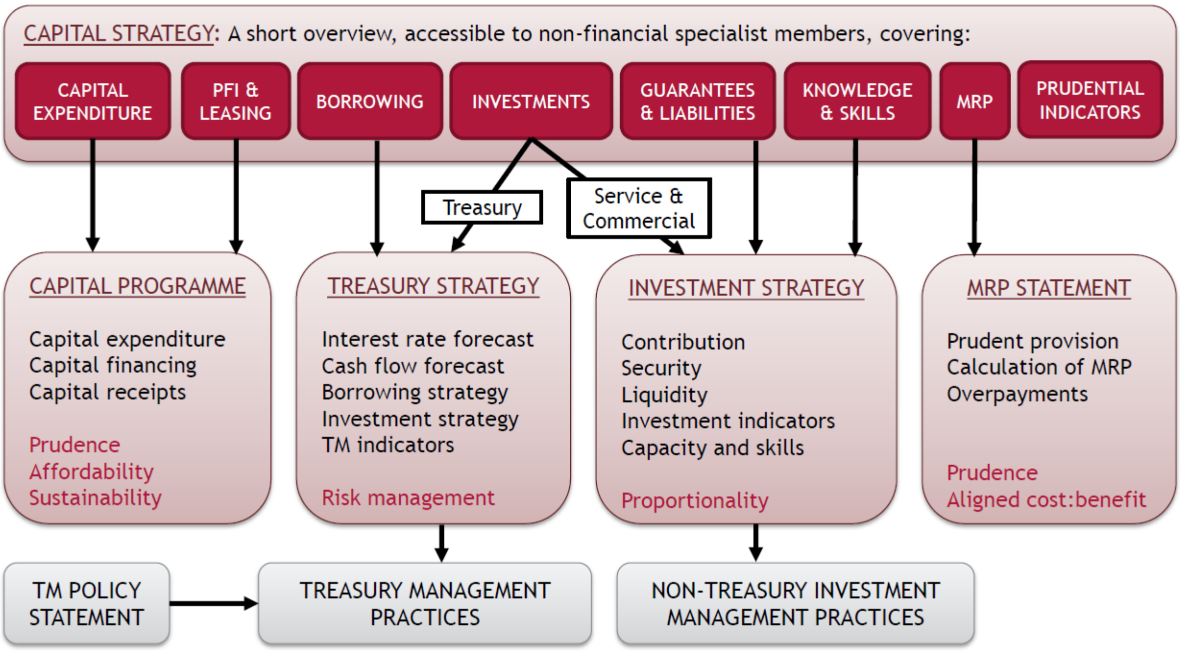
2. Recommendations

2.1. The Commissioner is asked to approve the contents of the report including the Prudential Indicators (as set out in the main body of the report in sections 3 to 7):

3. Introduction

3.1. The CIPFA Prudential Code (the code) and guidance notes were originally issued in 2002 and were later fully revised in 2009, 2011 and again in 2017. This new code requires the Commissioner to look at capital expenditure and investment plans in light of the overall strategy and resources and ensure that the decisions are being made with sufficient regard to the long run implications and potential risks to the Commissioner.

3.2. This capital strategy report provides an overview covering the following report structure:



*The MRP Statement and the Investment Strategy of the Commissioner are encompassed into the Treasury Management Strategy.

3.3. Prudential Indicators, other than those using actual expenditure taken from audited statements of accounts must be set prior to the commencement of the financial year to which they relate. Indicators may be revised at any time, and must, in any case, be revised for the year of account when preparing indicators for the following year. The Joint Chief Finance Officer has a prescribed responsibility under the Code to ensure that relevant procedures exist for monitoring and reporting of performance against the indicators. The Prudential Indicators when initially set and whenever revised, must be approved by the body which approves the budget, i.e. The Commissioner at his Public Accountability Conference.

4. Capital Expenditure and Financing

Prudential indicator of affordability – Estimates of capital expenditure

4.1. Capital expenditure is the term used to describe expenditure on assets, such as property, vehicles and ICT equipment, that will be used (or have a life) of more than 1 year. There is some limited discretion on what is to be treated as capital expenditure and assets costing less than £25k will be charged to the revenue account in accordance with the Financial Rules and Regulations (this is known as the deminimis level).

4.2. The capital expenditure estimates for the current year and four year medium term are shown below:

Capital Expenditure	2017/18 Actual £m	2018/19 Forecast £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
Capital Expenditure	5.25	6.05	8.71	9.47	5.35	8.34

4.3. The profile of capital expenditure fluctuates annually. Across the current four year programme, annual average expenditure typically comprises £1.4m to replace fleet vehicles, £2.5m on estate schemes and around £3.3m for replacement of ICT systems and equipment. ICT Expenditure reflects the Constabulary Strategy to invest in technology to support the delivery of operational policing and provide efficient business processes; schemes include the replacement of a number of control room systems with a single integrated solution and the national programme to replace the Police Radio System (Airwave) with an Emergency Services Network (ESN). Expenditure on Estates schemes over the 4 years includes the construction of the Eden Deployment Centre and the commencement of a scheme to provide a territorial headquarters in the west of the county (subject to option appraisal and formal approval). Smaller rolling replacement schemes are also included in all sections.

4.4. Budget holders are consulted in early October each year to review the previously approved 10 year capital investment plan, make changes based on latest information and project it forward one more year. These submissions are amalgamated and the resources available are applied. Shortfalls identified will need to be funded by increased revenue contributions or borrowing. Capital over the medium term is fully financed. Currently the Commissioner holds no external borrowing, however there is an underlying borrowing requirement, which is currently funded through internal borrowing.

Internal Borrowing – the practice of using reserves and provisions that have been set aside for future use to fund capital expenditure plans now. External borrowing comes with interest payments of currently 3%+ where investments are barely making 1% return in terms of interest, therefore there is an incremental cost to borrow in advance of need (known as cost of carry). This is therefore discouraged if there are cash reserves available that can be drawn down as an alternative to borrowing.

4.5. Over the 10 year capital plan there is currently a £1.8m shortfall in funding. Capital expenditure plans of this length depend greatly on estimated figures regarding future business requirements. Budget holders have been tasked with looking at their capital plans to refine their estimates and attempt eliminate this funding shortfall.

4.6. Before the commencement of each financial year the schemes for that year are revisited to be assigned an approval category. Large schemes which have previously been approved by the Commissioner following submission of a business case and the smaller rolling replacement schemes are approved on a firm basis or delegated to the Joint Chief Finance Office for future approval. Schemes requiring business cases, option appraisals and financial appraisals are given the status of indicative until they have been thoroughly scrutinised by all relevant business leads before being passed to the Police and Crime Commissioner for final approval.

4.7. All capital expenditure must be financed from one of three places:

- External sources, such as government grants or contributions
- Internal resources - revenue budgets, capital reserves or capital receipts.
- Debt – borrowing, Private Finance Initiative, leasing

The planned financing of the above expenditure is as follows:

Capital Financing	2017/18 Actual £m	2018/19 Forecast £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
Capital Receipts	0.00	0.00	0.00	1.96	0.16	0.00
Government Grants	0.00	0.58	2.77	4.11	0.37	0.00
Revenue Contributions	5.25	5.47	5.94	3.40	4.82	4.94
Total Financing	**5.25**	**6.05**	**8.71**	**9.47**	**5.35**	**4.94**
Borrowing *	0.00	0.00	0.00	0.00	0.00	3.40
Total Funding	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**3.40**
Total Financing and Funding	**5.25**	**6.05**	**8.71**	**9.47**	**5.35**	**8.34**

* All borrowing in the table is internal although towards the end of the medium term it will be necessary to externalise our borrowing.

4.8. Debt is only a temporary source of finance, since loans and leases must be repaid, and this is therefore replaced over time by other financing. The Commissioner is required to set aside a sum each year from the revenue budget to repay borrowing, which is linked to the life of the asset being financed. This is known as the minimum revenue payment (MRP) and can be likened to the minimum repayment on a credit card debt. The estimates for the repayment of internal borrowing from the revenue budget is shown below:

Minimum revenue provision	2017/18 Actual £m	2018/19 Forecast £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
Minimum revenue provision for the financial year	0.42	0.43	0.49	0.50	0.53	0.55

4.9. The capital financing requirement (CFR) is a measure of the amount of capital spending that has not yet been financed by capital receipts, grants or contributions, it is in essence the amount of internal debt finance of the Police and Crime Commissioner. The CFR increases each time there is new capital expenditure financed by debt and decreases with MRP repayments, capital receipts assigned to repay debt or by making additional voluntary contributions. The current and estimated CFR levels are shown below but it should be noted that these include an amount for the PFI financing of on average £4.5m.

Prudential indicator of affordability – Capital Financing Requirement

Capital Financing Requirement	2017/18 Actual £m	2018/19 Forecast £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
Capital Financing Requirement as at 31 March.	17.98	20.85	22.30	21.69	21.05	23.80

4.10. When a capital asset is no longer needed, it may be sold so that the proceeds, known as capital receipts, can be spent on new assets or to repay debts. The capital financing has been forecast assuming that all capital receipts will be used to finance new assets rather than reduce existing debt. Estimated capital receipts for the medium term are as follows:

Capital Receipts	2017/18 Actual £m	2018/19 Forecast £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
Asset sales	0.52	0.66	0.55	0.00	0.24	1.00

4.11. To ensure that capital assets continue to be of long term use and facilitate delivery of strategic objectives, there are Estates, Fleet and ICT strategies produced which are reviewed and approved annually.

4.12. Full details of the 10 year programme can be found in the separate report 'Capital Programme 2019/20 to 2028/29' (item 10b on this agenda).

5. Treasury Management

5.1. Treasury management is concerned with keeping sufficient but not excessive cash available to meet spending needs while managing the risks involved. Surplus cash is invested until required while a shortage of cash will be met by borrowing, to avoid excessive credit balances or overdrafts in the bank current account. The Police and Crime Commissioner is generally cash rich in the short term due to the level of reserves currently held and revenue grants being received in advance of spend, but cash poor in the long term due to capital expenditure being incurred in advance of being financed.

5.2. **Borrowing Strategy** - The main objectives when borrowing are to achieve a low but certain cost of finance, while retaining flexibility should plans change in future. These objectives are often conflicting, and the Commissioner therefore seeks to strike a balance between low cost short-term loans (currently available at around 0.75%) and long-term fixed rate loans where the future cost is known but higher (currently 3.0%+). Current forecasts show that short term borrowing, probably from other local authorities, may be required at the start of 2020/21 to bridge a shortfall in cash in advance of receipt of the new financial year's revenue grants.

The Commissioner's actual external debt as at 31 March 2019 will be £4.75m, comprising other long term liabilities of £4.75m in relation to the PFI. It is unlikely that the Commissioner will actually exercise external borrowing until there is a change in the present structure of investments rates compared to the costs of borrowing. It should be noted that all external borrowing with the PWLB (Public Works Loans Board) was repaid during 2012/13.

Projected levels of the total outstanding debt are shown below compared with the capital financing requirement (CFR).

Prudential indicator of prudence – Gross debt and the Capital Financing Requirement

Gross Debt and Capital financing requirement	2018/19 Forecast £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m
Closing CFR 31 March	17.55	17.06	16.56	16.03
Gross Debt 31 March	4.75	4.58	4.40	4.20

Statutory guidance is that external debt should remain below the CFR in the previous year plus the estimates of any increase in the CFR at the end of the current year and the next two financial years this is to ensure that borrowing is only for capital purposes. The Commissioner remains well within this limit.

Liability Benchmark - The 2017 code encourages Authorities to define their own 'Liability Benchmark' which will provide a basis for developing a strategy for managing interest rate risk. On the basis that Arlingclose are not forecasting significant interest rate movements in the short term and that the Commissioner has no plans to make any long term external borrowing decisions over the next financial year, because of the 'cost of carry', development of a liability benchmark at this point would not provide added value. However, the Commissioner will actively develop indicators to manage interest rate risk in due course once there is more clarity over borrowing intentions.

Prudential indicator of affordability – Authorised limit and operational boundary for external debt

As an assurance that borrowing is only undertaken for capital purposes and is sustainable, the Commissioner is required to set an affordable borrowing limit (also termed the authorised limit for external debt) each year. In line with the statutory guidance a lower 'operational boundary' is also set as a warning level should debt approach the limit.

Authorised Limit for External Debt	2019/20 £m	2020/21 £m	2021/22 £m	2022/23 £m
External Borrowing	18.977	18.654	18.334	21.417
Other Long Term Liabilities	4.585	4.403	4.197	3.965
Total Authorised Limit	23.562	23.057	22.531	25.382

Operational Boundary for External Debt	2019/20 £m	2020/21 £m	2021/22 £m	2022/23 £m
External Borrowing	17.477	17.154	16.834	19.917
Other Long Term Liabilities	4.585	4.403	4.197	3.965
Total Operational Boundary	22.062	21.557	21.031	23.882

Further details on the borrowing strategy are on pages 7 to 9 of the treasury management strategy (agenda item 10c).

5.3. **Investment strategy** - Treasury investments arise from receiving cash before it is paid out again. The Commissioner makes investments because he has a cash surplus as a result of his day-to-day activities, for example when income is received in advance of expenditure (known as treasury management investments). The Commissioner does not make investments to support local public services by lending to or buying shares in other organisations (service investments), or to earn investment income (known as commercial investments where investment income is the main purpose).

The Commissioner's policy on treasury investments is to prioritise **security** and **liquidity** over **yield**; that is to focus on minimising risk rather than maximising returns. Cash that is likely to be spent in the near term is invested securely, for example with the government, other local authorities or selected high-quality banks, to minimise the risk of loss. Money that will be held for longer terms is invested more widely to balance the risk of loss against the risk of receiving returns below inflation. Both near-term and longer-term investments may be held in pooled funds, where an external fund manager makes decisions on which particular investments to buy (subject to strict criteria) and the Commissioner may request his money back at short notice.

Estimates of investment levels and investment income are shown below:

Estimated Treasury Position	Estimate 2019/20 £m	Estimate 2020/21 £m	Estimate 2021/22 £m	Estimate 2022/23 £m
Investments (average)	15.185	9.816	7.376	4.563
Interest Receipts	0.120	0.165	0.140	0.115

Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Joint Chief Finance Officer and Financial Services staff, who must act in line with the treasury management strategy approved by the Commissioner. Quarterly reports on treasury management activity are presented to the Joint Audit Committee. The Joint Audit Committee is responsible for scrutinising treasury management decisions.

Prudential indicators relating to treasury management activities are set out in the treasury management strategy.

Further details on treasury investment strategy are on pages 9 to 13 of the treasury management strategy (agenda item 10c).

6. Liabilities

6.1. In addition to debt of £4.75m detailed above, the Commissioner's balance sheet also shows long term liabilities totalling £1.229bn in respect of the Local Government and Police Officer Pension Scheme deficits. These will be met through a combination of payments from the revenue budget over a long period and support from central Government. A sum of £1.4m has been set aside to cover risks from legal claims and insurance liabilities. The Commissioner is also at risk of having to pay for an unlawful discrimination claim arising from the transitional provisions in the Police pension Regulations 2015 but has not put aside any money because there has been no firm outcome to the case, no clarity of the scale of the claim and no certainty over who will bear the costs at this time.

6.2. The risk of liabilities crystallising and requiring payment is monitored by the Finance Services team. Further details on liabilities and guarantees are on page 93 of the 2017/18 statement of accounts.

7. Revenue Budget Implications

7.1. Although capital expenditure is not charged directly to the revenue budget, interest payable on loans and MRP are charged to revenue, offset by any investment income receivable. The net annual charge is known as financing costs; this is compared to the net revenue stream i.e. the amount funded from Council Tax, business rates and general government grants.

Prudential indicator of affordability – Proportion of financing costs to net revenue stream

Ratio of Financing Costs to Net Revenue Stream	2017/18 Actual £m	2018/19 Forecast £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
Investment income	0.090	0.140	0.170	0.140	0.120	0.050
MRP	0.420	0.430	0.490	0.500	0.530	0.550
Financing Costs	**0.330**	**0.290**	**0.320**	**0.360**	**0.410**	**0.500**
Net Revenue Stream	101.820	104.530	106.510	107.640	108.800	110.000
Ratio	0.32%	0.28%	0.30%	0.33%	0.38%	0.45%

The ratios of financing costs to the revenue budget above are considered sustainable.

Due to the very long-term nature of capital expenditure and financing, the revenue budget implications of expenditure incurred over the MTFF period may extend for up to 50 years into the future. The Joint Chief Finance Officer is satisfied that the proposed capital programme is **prudent, affordable and sustainable.**

8. Knowledge and Skills

8.1. The Commissioner employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. The Joint Chief Finance Officer is committed to the Governments apprenticeship levy scheme and currently has a number of key employees studying at Level 3/4 (AAT) and Level 7 (CIPFA).

8.2. Where employees do not have the knowledge and skills required, use is made of suitably qualified external advisers. The Commissioner currently employs Arlingclose Limited as treasury management advisers. The contract expires on the 31 March 2019 and a process to re-tender the contract is currently underway. This approach is more cost effective than employing such staff directly, and ensures that the Commissioner has access to knowledge and skills commensurate with his risk appetite.