



Office of the Police and Crime Commissioner Report

Public Accountability Conference 19 February 2020

Title: Capital Strategy 2020/21

Report of the Joint Chief Finance Officer

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1. Purpose of the Report

- 1.1. This capital strategy was 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 Chartered Institute of Public Finance and Accounting (CIPFA) Prudential Code for capital finance in Local Authorities 2017 updated guidance.

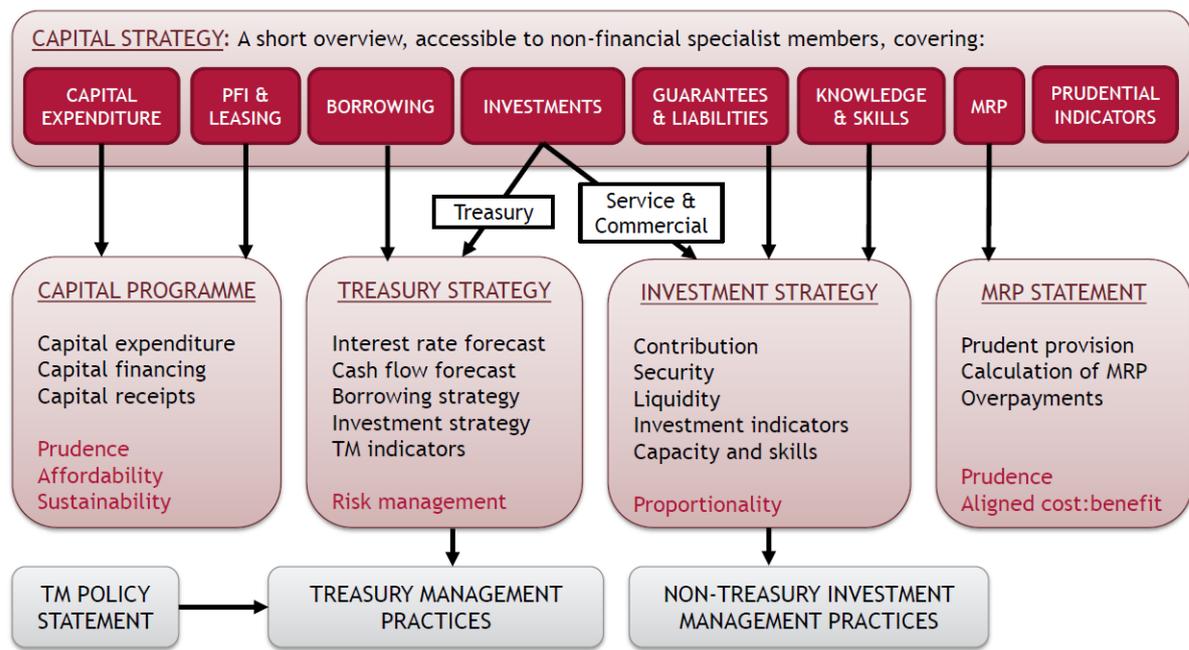
2. Recommendations

2.1. The Commissioner is asked to approve the contents of the report.

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 summarises the purpose and governance over a range of activities associated with capital investment and financing, which are reported on in detail elsewhere on this agenda item. The diagram below provides an overview of the scope of these activities, their inter-dependencies and reporting structures:



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

4. Capital Expenditure and Financing

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 de minimis level).

4.2. Capital expenditure plans are under-pinned by asset strategies, which are developed by respective service leads linked to delivery of the Commissioner's Police and Crime Plan and the Constabulary's overall Vision 2025. The principal asset strategies and their objectives are

- The ICT Strategy, which has six key themes
 - On-going provision of trusted and reliable ICT services. Business as Usual
 - A cost effective and affordable ICT service
 - Actively supporting the delivery of Cumbria Vision 25
 - To implement national ICT systems
 - To meet local demand to renew and replace Core Systems and Applications
 - Collaboration
- The Estates Strategy, which aims to maintain an Estate which is fit for purpose whilst reducing overhead expenditure and maximising and exploiting existing assets.
- The Vehicle Strategy, which aims to satisfy the Constabulary's vehicle needs within a sustainable financial model.

4.3. Each strategy is refreshed annually. The updated financial implications are distilled early in the financial planning process and subsequently consolidated to produce a ten year capital programme. The overall capital programme is then subject to a process of financial scrutiny in the context of both available capital funding resources and the overall revenue budget position. The financial approval process includes specific challenge at a Capital Star Chamber chaired by the Deputy Chief Constable. The final capital programme and associated asset strategies are subject to approval by both the Constabulary Chief Officer Group and the Commissioner at his Public Accountability Conference.

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

Capital Expenditure	2018/19 Actual £m	2019/20 Forecast £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m	2023/24 Estimate £m
Capital Expenditure	5.21	7.10	7.55	8.00	10.88	8.36

- 4.5. The profile of capital expenditure fluctuates annually. Across the current four year programme, annual average expenditure typically comprises £1.5m to replace fleet vehicles, £1.5m on estate schemes (although by their nature these investments tends to be more lumpy) and around £3.0m for replacement of ICT systems and equipment.
- 4.6. The 2020/21 capital programme includes ICT expenditure, completion of the replacement of a number of control room systems with a single integrated solution, the national programme to replace the Police Radio System (Airwave) with an Emergency Services Network (ESN), continued development of mobile working solutions, consideration of options for ICT infrastructure and storage and the replacement of business systems. Expenditure on Estates schemes over the 4 years is dominated by the need to evaluate options and provide a territorial headquarters in the west of the county. Smaller rolling replacement schemes including CCTV are also included in all sections.
- 4.7. 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.
- 4.8. The capital programme must be financed from a combination of capital grants, capital receipts, reserves, direct support from the revenue budget and, unlike, the revenue budget borrowing is permitted. Whilst it is a statutory requirement that the Commissioner agrees a balanced revenue budget, the Prudential Code requires the capital programme to be demonstrated as ‘Affordable, Prudent and Sustainable’, it is up to each authority how it determines these criteria. Cumbria defines an ‘Affordable, Prudent and Sustainable’ programme as being fully funded (from the sources outlined above) for the medium term financial forecast period of 4 years. The revenue budget and MTFF must also fully reflect any revenue implications of the capital programme including servicing costs of borrowing.

- 4.9. The difficulty facing Cumbria is that capital grants have been reduced to a negligible level, the potential to generate future capital receipts is low and capital reserves are likely to be extinguished in the next four years. Whilst some additional capital borrowing is planned to finance long lived estates projects, this is not a viable option for shorter life assets such as vehicles and ICT. Collectively this means that the Capital Programme is increasingly reliant on contributions from the revenue budget to fund it. This is reflected in the revenue budget and MTFP where revenue support for capital have increased from an annual figure of £1.8m to £3.5m by the end of the forecast period.
- 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.
- 4.11. Full details of the 10 year programme and associated financing can be found in the separate report 'Capital Programme 2020/21 to 2029/30' (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. Treasury Management involves the management of large sums of money and is therefore inherently risky. Accordingly, treasury activities are strictly controlled and managed in accordance with CIPFA's Prudential Code. The Treasury Management Strategy is approved annually by the Commissioner at his Public Accountability Conference, with activities being reported upon a periodic basis through the same meeting. The Joint Audit Committee also provides scrutiny of treasury management activities. Responsibility for treasury activities is delegated to the Joint Chief Finance Officer, who delegates responsibility for day to day management to the Head of Financial Services. The Treasury Management Strategy incorporates subsidiary investment and borrowing strategies, which are summarised below.
- 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. The risk that an investment counter-party defaults is very real as illustrated by the BCCI and, more recently, Icelandic Banks scandals, which impacted on public sector bodies. The investment strategy seeks to mitigate this risk by only investing in high quality, trusted counter-parties and spreading the investment portfolio across organisations. 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.

Whilst the Commissioner has historically held significant investments, these balances are being reduced as the Commissioner has undertaken internal borrowing to support the capital programme (see below) and reserves are drawn down to support the revenue budget.

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

- 5.4. **The Borrowing Strategy** – As indicated the Commissioner currently holds no external debts, other than a PFI arrangement described in section 6 of this report, with all external borrowing with the PWLB (Public Works Loans Board) having been repaid during 2012/13. However, there is an underlying need to borrow, known as the Capital Financing Requirement (CFR), arising from historical decisions to finance capital expenditure from borrowing within prudent limits. To date this has been met from internal borrowing.
- 5.5. 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 CFR for the 31 March 2020 is forecast to be £22.15m.

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.

- 5.6. 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 would therefore have 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 a small amount of short term borrowing, probably from other local authorities, may be required at the start of 2021/22 to bridge a shortfall in cash in advance of receipt of the new financial year's revenue grants.

It is unlikely that the Commissioner will actually exercise long term external borrowing until there is a change in the present structure of investments rates compared to the costs of borrowing, as this would result in a significant net interest cost to the revenue account in the short term. Nevertheless, such financing decisions have long term consequences and should be taken in this context. Long term interest rates will therefore be carefully monitored with the aim of deciding the most advantageous time to take on long term liabilities.

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 Link Asset Services (the Commissioner's treasury advisors) 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.

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.

Further details on the borrowing strategy are on pages 8 to 9 of the treasury management strategy (agenda item 10c).

6. Other Liabilities

- 6.1. In relation to other external liabilities the Commissioner's balance sheet currently shows debt of £4.75m in relation to a private finance initiative (PFI) scheme for the provision of the Territorial Police HQ in West Cumbria. This debt is scheduled to reduce gradually through annual unitary charge payments met from the revenue account, until 2026 when the primary arrangement comes to an end. At this point a decision on the provision of future policing facilities in West Cumbria will need to be made. Options are currently being evaluated.
- 6.2. 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.
- 6.3. The risk of liabilities crystallising and requiring payment is monitored by the Finance Services team. Further details on liabilities and guarantees are on page 96 of the 2018/19 statement of accounts.

7. Prudential Indicators

- 7.1. Both capital expenditure plans and treasury management are supported by a range of Prudential Indicators, whose purpose is to act as an early warning system that these activities are falling outside prescribed limits and may no longer be affordable, prudent or sustainable. 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. Details of Prudential indicators are set out on pages 15-21 of the treasury management strategy (agenda item 10c).

8. Revenue Budget Implications

- 8.1. 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.
- 8.2. The Commissioner is also 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	2018/19 Actual £m	2019/20 Forecast £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m	2023/24 Estimate £m
Minimum revenue provision for the financial year	0.43	0.49	0.61	0.63	0.65	0.68

- 8.3. The net annual charges to the revenue account are collectively known as financing costs; which are compared to the net revenue stream i.e. the amount funded from Council Tax, business rates and general government grants as a key prudential indicator of the affordability, prudence and sustainability of capital expenditure plans see below.

Ratio of Financing Costs to Net Revenue Stream	2018/19 Actual £m	2019/20 Forecast £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m	2023/24 Estimate £m
Investment income	0.15	0.14	0.10	0.07	0.05	0.01
MRP	0.43	0.49	0.61	0.63	0.65	0.68
Financing Costs	0.29	0.35	0.51	0.55	0.60	0.67
Net Revenue Stream	104.02	111.14	118.76	120.04	124.44	126.84
Ratio	0.27%	0.32%	0.43%	0.46%	0.48%	0.53%

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**.

9. Knowledge and Skills

- 9.1. 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).
- 9.2. Where employees do not have the knowledge and skills required, use is made of suitably qualified external advisers. The Commissioner currently employs Link Asset Services Limited as treasury management advisers. 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.

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