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West Mercia

Capital Strategy Review December 2023

2023/24

Report of the Treasurer

Introduction

Each year the Capital Strategy gives a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of local public services, along with an overview of how associated risk is managed and the implications for future financial sustainability. The current Capital Strategy set out the capital plans for the financial year and also considered capital spend over the medium term.

As we enter budget setting for the financial year 2024/25, it is clear that the projections of spend for capital expenditure over the medium term does not reflect the requests for actual spend. A projection of potential spend over the next 5 years could be in the region of £100m-£150m.

The Capital Strategy is also being impacted by the wider uncertainty in the UK economy, particularly in the last 24 months. Brexit, COVID-19 and then the War in Ukraine are all factors which have resulted in high inflation rates and put pressure on public finances of the UK. Part of the response to this has been for the Bank of England to raise interest rates from the historically low rate of 0.25% to the current rate of 5.25%.

The impact of these factors on the West Mercia revenue budget has been significant. Inflation has increased the costs of providing services, which has outstripped additional resources provided from government funding settlements. The focus on officer numbers has also meant less flexibility in how these cost pressures are managed. This comes at a time when the organisation has also been investing in its assets, covering both Digital Service Transformation (DST) and Buildings, to ensure that they are fit for purpose. An element of being able to deliver a balanced budget each year has been using any savings that can be realised from projects such as DST rather than allocating it to offset the revenue impact from the capital programme.

The increasing interest rates has made the cost of borrowing significantly higher. West Mercia was able to borrow £10m at a rate of 0.98% in December 2020, as opposed to the current rate of 5.31% in October 2023. The interest payments on this have increased from £84k to £522k. We are therefore paying an additional £428k a year to service debt. The increase in interest rates had not been in long range forecasts, as the impact of factors such as the recovery from COVID and the war in Ukraine were not seen as risks.

The combined issues of reliance on borrowing to fund the previous programme, at higher interest rates than expected, and the potential large future capital programme is that an increasing amount of revenue will be directed to servicing the interest payments. This has the potential to be financially unsustainable against the need to provide effective policing services.

The scope of this review of the Capital Strategy are:

- To take a long-term perspective on capital investment and to ensure this contributes to the achievement of the Safer West Mercia Plan
- To ensure investment is prudent, affordable, and sustainable over the medium term and adheres to the Prudential Code, Treasury Management Code and other regulatory conditions.
- To make the most effective and appropriate use of the funds available in long term planning and using the most optimal annual financing solutions.

This paper sets out the various factors which are impacting on the capital programme including

- the current challenges from the capital programme to date and its impact on revenue
- A review of how the programme can be managed.
- a description of how capital decisions drive revenue implications
- The potential capital spend in the future and how it can be managed
- Principles for how the capital programme is managed to ensure that it is sustainable.

Section 1 – The West Mercia Capital Programme to date

Capital Expenditure

Capital expenditure is where the Police and Crime Commissioner spends money on assets, such as property or vehicles, which will be used for more than one year. The 2023/24 Capital Strategy made the following assumptions on capital expenditure.

	2019/20 £	2021/22 £	2021/22 £	2022/23 £	2023/24 £	2024/25 £	2025/26 £
Actuals	7,389,296	12,995,000	10,860,000	15,951,000			
Forecasts				16,841,000	28,623,000	19,400,000	9,350,000

The expenditure to the end of 2023/24 is in line with the projections that have been made in the 2023/24 Capital Strategy. There has been a consistent level of expenditure of circa £10m - £15m per year on our capital programme. This has increased in the last 2 years as there reflecting the investments in Digital Services Transformation and a new Police Station in Redditch occurring at the same time.

Whilst we do have some large long term capital projects, the annual programme also made up of a large amount of recurring spend on short term assets such as vehicles, IT equipment including laptops, servers and associated infrastructure and items such as Body Worn protective equipment and cameras.

Capital Financing

All capital expenditure must be financed, either from external sources (government grants and other contributions), West Mercia Police's own resources (revenue, reserves and capital receipts) or it has to be financed from borrowing (debt to be repaid at a future date). The current policy is that any available capital resources, such as capital receipts is used to fund the proportionally high impact that short term assets have on the level of revenue contributions required. This means that the longer life capital investments are financed from borrowing.

The table below shows the capital financing that has been utilised over the last 4 years.

	Actual Capital Financing				
Sources of Financing	**19/20 £**	**20/21 £**	**21/22 £**	**22/23 £**	**Total £**
Available resources	**1,524,535**	**1,774,396**	**5,033,674**	**2,400,519**	**10,733,124**
Internal Borrowing	**5,864,761**	**-4,779,396**	**5,826,326**	**3,550,481**	**10,462,172**
External Borrowing	**0**	**16,000,000**	**0**	**10,000,000**	**26,000,000**

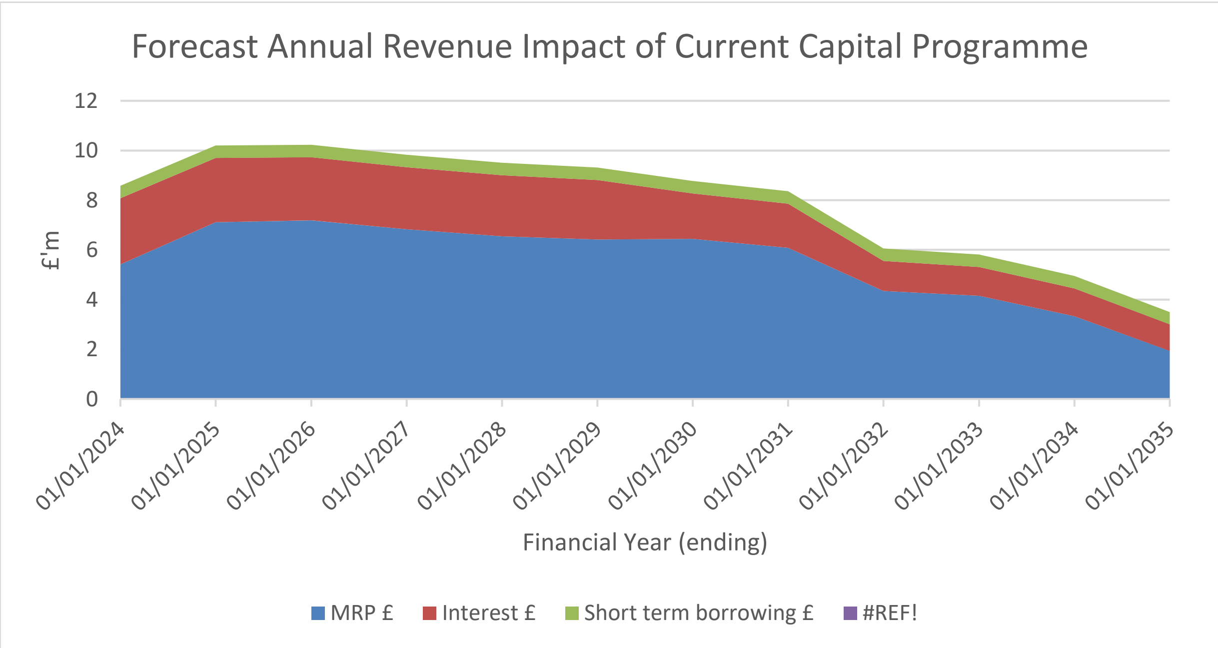
Based on the actual capital programme over the last 4 years we have funded directly £10.7m of the spend (22.7%). This has left £36.4m to be financed from borrowing.

As can be seen we have been utilising up to £6m a year from internal borrowing to fund the programme. West Mercia has held reasonable level of reserves, which has meant that cash resources have been available to fund the expenditure relating to our capital programme. Additional internal borrowing headroom has also been possible where we have seen annual revenue underspends.

At the end of the 2022/23 financial year there was a total of £64.7m relating to West Mercia's capital expenditure that is financed from borrowing. As it stands, we have externally borrowed £26m, which leaves the remaining £38.7m covered from internal resources. Under the capital accounting requirements West Mercia is required to set aside a 'Minimum Revenue Payments' (MRP), which are an annual revenue contribution required to cover the cost of the capital asset spread over its useful life.

Whilst the policy of using internally resources is reasonable, as it avoids having to pay interest, it is reliant on having a health and sustainable level of reserves. The other consequence of using internal borrowing is that it reduces cash balances which could have been used to provide a revenue return from investing it. In the past 10 years we have seen our revenue reserves decrease as it has been allocated to fund specific activity. Therefore we no longer have the cash balances available to meet our revenue expenditure. By the end of March 24, we need to borrow a minimum of £30m to provide the cash resources to continue to meet our payment commitments. It is likely that at least a further £10m will then be required in 2024/25 to maintain sufficient cash balances.

A projection of the revenue impact of the £64.7m of the capital programme which is being funded from borrowing over the next 10 years is shown below;-



As can be seen the annual financial implication remains above £8m for the next 8 years, peaking at over £10m in 2025/26, before it starts to fall and then reduce significantly by 2035. This is due to the financing implications of the investment in short term assets, principally the large investment in improving our digital infrastructure which has been assessed as having a 10 year life span.

The main elements are

- long term borrowing relating to new build properties which is considered to be financially sustainable.
    - eg the current Redditch new build, which has a useful economic life of 40 years, and is calculated to have a total MRP of £650k per year + interest cost (which are to be offset by a contribution from our joint partner in this project, HWFRS)
    - Financing the cost of Bromsgrove joint Police and Fire station / The OCC / Hereford custody / Defford central storage facility
    - these long term projects are costing the organisation approximately £2m a year in MRP
- The digital services transformation programme which has a 10 year
    - The £8m spent in 22/23 financial year costs £800k a year in MRP with the associated interest cost of the borrowing on top of this.
    - Three years of this level of spend would add £2.4m to the revenue budget.
- We are funding the upgrade in our ICT equipment over 7 years each year that has been adding approximately 500k extra each year to the MRP (over 7 years that would amount to £3.5m).
- Investment in Fleet vehicles is not having a significant impact on revenue as this element of the programme is funded through available resources, such as capital receipts in year. Available capital resources are being used to fund the vehicles first as these are the most expensive short life assets to fund from MRP and borrowing.

Based on current prediction of funding available for the budget of £278.5m, the impact of the capital programme would account for 3.66% of the 24/25 revenue budget. That would put us 4th in the list of all Police forces based on their 23/24 reported position. This is the principal reason for the demand pressures identified on the revenue budget. By reducing this demand pressure would reduce the MRP contributions, providing additional resources to be invested back into policing.

There are some potential options to reduce the ongoing revenue impact through taking steps to fund the programme from allocating further revenue, capital receipts or obtaining grants and funding from external sources to offset the level of borrowing required. This would mean that the resources are not available to fund any future capital requirements.

There is no scope to change the MRP methodology used as it is clear from the Prudential code that retrospective changes are not acceptable and would not expect to make significant difference to the revenue implications.

Section 2 - Future Year Capital Programme

How does capital decisions drive revenue implications in relation to short term assets

This is a worked example in relation to spending £3.5m annually on police vehicles, which given limited reserves and other sources of capital financing has to be funded from external borrowing.

- The policy is to write the vehicles off over 5 years.
    - This would create an annual MRP charge of circa £650k.
    - Every year that we fund capital this way would add an additional £650k to revenue.
- To afford the scheme we would have to borrow £3.5m each year.
    - This would cost £183,750 in interest payments each year.
    - calculation based on 5-year maturity loan to match the MRP, at current rates of 5.25%
- To fund the programme, we would have to continue to borrow £3.5m annually, which after 5 years would make a total borrowing of £17.5m
    - This would then result in in interest payments of £918,750 annually.
- At the 5 years point the annual MRP cost on the revenue budget is £3.5m and will continue in perpetuity as we continue to invest in vehicles. However, there is also a revenue charge of £918k in interest to service the borrowing requirement.

The point of this example is to demonstrate that using external borrowing to fund short life assets is not value for money, particularly as interest rates increase. As we do not have the level of reserves to sustain internal borrowing, it is more effective to utilise revenue funding for these assets, and to fund more expensive one-off capital investments from borrowing, spreading the cost over the longer useful life of the asset.

The impact of future the capital programme and how this could be managed.

The initial proposals for the 2024/25 budget was a spend of £55m compared to the Capital Strategy projection of £19.4m (see page 3). An estimate of the most basic requirements for an ongoing annual capital programme would be in the region of £10m - £15m. This does not include spend on continuing investment in ICT infrastructure and in investment in improving the estate, which is identified as a key risk for the organisation. This would therefore be significantly above the projection of a spend of £9.350m in 25/26 included in the Capital Strategy.

Based on a revised capital programme of over £100m in the next 5 years and assuming that we continue with the current approach to funding the programme, would result in an increasing annual revenue cost to the MTFS, reaching £17.57m by 2027/28. Assuming a total revenue budget at this time in the region of £320m, the capital financing element would account for 5.47% of the total revenue budget.

Whilst 5.47% may be sustainable in terms of the overall budget any way to reduce this amount, to release revenue to fund policing, would be seen as value for money. A key element of making the capital programme sustainable would be to fund recurring spend on short life assets from the base revenue budget. This would cover assets such as vehicles / ICT equipment / annual assets works.

Of the initial proposed capital programme for 2024/25 there is the following proposals

Asset life	**Description of types of spend**	**Amount**
Less than 10 years	Vehicles Body Armour Tasers Telephony Annual Estates Maintenance programme	£6.080m
10 years	DST investment programme Includes SAAB, sharepoint	£8.052m
10 years	Change Programme Includes EV infrastructure. Athena, DFT, Custody, Cosford and data driven policing	£4.168m
10 years	Estates investment relating to condition survey work and refurbishment	£6.440m
Greater than 10 years	Estates investment in assets including £11.6m on Redditch new build	£15.904m
	Total	**£41.172m**

Based on the table above, there would be a minimum requirement of £6m from revenue resources to cover the cost of our short-life assets. This does not consider the fluctuations in demand for these types of assets on an annual basis. Therefore, It would require in the region of £7 – £10m of revenue allocation each year to ensure that there is sufficient resources over the medium term.

Currently the annual revenue budget includes an allocation of £1.5m to support the financing of the capital programme.

Section 3 - Principles for how the capital programme is managed to ensure that it is financially sustainable.

Principle 1 - That short life assets (under 10 years) are financed through revenue resources.

Principle 2 – That request for funding for assets with a useful life of 10 – 15 years are clear on the return on investment (RoI), to offset the associated revenue costs of any borrowing, ensuring there is no overall increase in the revenue budget.

Principle 3 – For assets with a useful life of 10 – 15 years which do not have a clear RoI, then it should be funded from revenue resources. Where a project has a partial RoI identified, a mix of Revenue and Capital Funding may be required. A clear business case should be made that sets out the appropriate financing for the project with clear assessment of life cycle costs.

Principle 4 – That capital receipts from the sale of buildings held by the PCC, will be used to fund future investment in buildings.

Principle 5 – That the revenue impact of the full capital programme over the medium term is capped at 4.5% of the Net Revenue Budget as an indicator of being financially sustainable.

Principle 6 – That the required level of revenue resources is reviewed as part of the Medium-Term Financial strategy, Business planning and the annual revenue budget to ensure that it remains at an appropriate level to be fund short life assets.

Conclusion

There are competing priorities in respect of setting a balanced revenue budget. Whilst the priorities of the Safer West Mercia Plan are the focus of setting the budget, it must also ensure that it is sustainable. A significant element of this is an understanding the revenue consequences of the capital programme.

The recommendation is that the principles set out in section 3 are adopted and that business and financial planning is focused on meeting these principles, particularly over the medium term.

As discussed in Section 1 we already have a significant revenue commitment from the historical capital programme. Given the pressure on policing resources it will require choices as to how the revenue demand is managed to ensure that we have a sustainable capital programme. It is not considered viable to resolve the historical and future capital programme at the same time. The recommendation is that we apply the principles set to ongoing capital programme as the financial impact of the historic programme is understood and included in our financial planning.

Ensuring that the annual capital programme is kept to a minimum in the short term would provide opportunity to keep spend within available financing. However, it is recognised that there is a need to continue to deliver on the investments that we have been making. It does not appear possible to identify the required level of revenue resource immediately given the expenditure identified in the draft 2024/25 budget proposals. It will require further consideration as to how the organisation will transfer revenue resources to fund the purchase of short life assets.

The recommendation is that the transition is completed for the 2026/27 budget. This gives 3 years to transition to supplement the £1.5m that is already in Revenue Contributions to Capital (RCCO). Given the pressure on the 24/25 budget there is a risk that it would require additional savings to be delivered above that already identified in the draft budget, which is why the following is recommended.

- between £0.5m - £1.0m in 2024/25 would be recommended given the issues raised in this report.
- that a minimum of 1% of the NRE budget included in 2025/26 budget setting as additional RCCO / revenue spend on short term assets, with aim of finding further resources.
- This would leave the 2026/27 budget to include an additional revenue resource allocation to ensure that the principles set out in this paper are being met

Through the transition period there is the recommendation that revenue underspends and capital receipts are allocated to offset the MRP costs of short life assets which are not being funded from revenue. Careful management of the capital programme would be needed to ensure that the 4.5% MRP limit on revenue is not breached.