report

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JOINT REPORT OF THE CHIEF FIRE OFFICER AND THE TREASURER OF THE FIRE & RESCUE AUTHORITY

PRUDENTIAL CODE FOR CAPITAL ACCOUNTING

1 PURPOSE OF REPORT

The purpose of this report is to inform Members of the Fire Authority of the Authority's obligations under the CIPFA Prudential Code. It also seeks the approval of the Fire Authority to the proposed capital plans, prudential limits, and monitoring processes set out below.

2 BACKGROUND

2.1 The Local Government Act 2003 set out a framework for the financing of capital investments in local authorities which came into operation from April 2004. Members will be aware that the Act changed the way in which Capital Expenditure is controlled within local government and that the Authority has been operating under the prudential regime since April 2004.

2.2 The principles under which local authorities now operate offer much more freedom in the way that capital expenditure is financed such that local authorities may choose the level of capital expenditure (and thus financing) which best suits their needs and investment priorities.

2.3 In order to assist authorities in determining the most appropriate levels of spending and indebtedness, the Chartered Institute of Public Finance and Accountancy (CIPFA) have developed a "Prudential Code" which requires a number of limits and indicators to be set.

2.4 This report sets out the proposed prudential limits for the Authority for the 2005/6 financial year along with the implications of the proposed Capital Programme which is presented with the main budget papers.

3 CURRENT POSITION WITH REGARD TO CAPITAL

3.1 In order to fully understand the implications of the issues set out below it is important to have a view of the current position of the Service with regard to capital and capital financing.

3.2 Nottinghamshire Fire and Rescue Service has a capital asset base for operational purposes which contains mainly property and some IT and communications assets. This is largely because the restrictions imposed by the old financing regime made the financing of vehicles and most IT related assets impossible, other than by leasing or direct purchase from revenue. Consequently these "assets" do not appear on the Balance Sheet of the Service and are not really therefore, assets of the Service.

3.3 Nevertheless the true working asset base of the Service based on 2003/4 final accounts is :

	£000s
Operational Land & Buildings	23,343
Non-Operational Land & Buildings	245
Vehicles	0
Plant & Equipment	604
Total Fixed Assets	24,192
Leased Vehicles	6,566
Leased IT	897
Leased Other	137
Total Leased "Assets"	7,600
Total All Assets	31,792

3.4 Deferred Charges of £9,000 are also shown as an asset on the Balance Sheet whilst in reality these relate to the set up costs of the Authority of £35,000 which are amortised over seven years.

3.5 The financing of these assets has been carried out in a number of ways including the use of capital receipts, external borrowing and obligations under operating leases. In terms of external obligations the picture is as follows :

	£000s
Total loans outstanding	2,120
Lease obligations to 2007/8	8,364

3.6 The revenue impact of the existing capital base is therefore:

	Leasing £000s	Borrowing £000s
2004/2005	1,431	192
2005/2006	1,717	192
2006/2007	1,955	192
2007/2008	1,765	192
2008/2009	1,496	192

4 PROPOSALS FOR 2005/2006 – 2007/2008 CAPITAL PROGRAMME

4.1 It is usual to consider planning for capital expenditure over a period of three years or more and in the budget report Members will note that a three year programme has indeed been prepared. It is highly likely however, that this programme could change radically in respect of 2006/2007 and beyond due to changes in the fire cover arrangements arising both from the Local Risk Management Plan (LRMP) and the introduction of the Fire Service Emergency Cover (FSEC) model for fire cover planning.

4.2 In the past Government have set Basic Credit Approvals for authorities which limited the amount of capital expenditure. There are now no such limits, however

Government do set a level of Supported Capital Expenditure (SCA) within the Formula Spending Share (FSS) allocated to authorities. This is nothing more than the amount of capital expenditure which Government support via the FSS formula. For the Fire Authority this amount is £930,000 for 2005/6.

4.3 Capital Expenditure for 2005/6 is proposed in the budget paper as £3,362,765 which whilst not governed in any way by the SCA has to be set in context with it.

4.4 The proposed capital programme for 2005/6 includes within it approximately £1.75m of spending on assets which would have been leased under the old regime and therefore would not normally expect to be included within any SCA and also includes expenditure of £700,000 which has slipped from 2004/5 for which provision has already been made within the base budget. The budget cover required for wholly new spending therefore would be broadly the same as the figure of SCA, albeit that this is a somewhat informal guide. Nevertheless this gives some assurance that the capital plans are likely to be affordable.

4.5 The profile of Capital Expenditure including actuals for 2003/4 and estimates for 2004/5 to 2007/8 are as follows :

CAPITAL EXPENDITURE					
	2003/4 Actual £000s	**2004/5 Estimate £000s**	**2005/6 Estimate £000s**	**2006/7 Estimate £000s**	**2007/8 Estimate £000s**
Transport	0	50	1,062	1,497	1,250
Property	161	435	1,525	825	827
Comms	0	0	0	0	0
I.T	247	240	0.776	442	67
Total	408	725	3,363	2, 764	2,144

4.6 The Capital Financing Requirement is the sum of money required from external sources to fund Capital Expenditure. It will therefore be the aggregate of all capital expenditure, less any revenue contributions or capital receipts. It is also important to note that the actual requirements for capital financing will depend to some extent upon the timing of the cashflows of the capital expenditure itself. Estimates of the end of year Capital Financing Requirement for the Authority for the current and future years and the actual capital financing requirement at 31 March 2003 are :

CAPITAL FINANCING REQUIREMENT					
	31/3/04 Actual £000s	**31/3/05 Estimate £000s**	**31/3/06 Estimate £000s**	**31/3/07 Estimate £000s**	**31/3/08 Estimate £000s**
Total	19,077	19,802	23,165	25,929	28,073

4.7 It is important to note that the above table provides sufficient "headroom" for a proper balance between leasing and borrowing to be considered.

4.8 Decisions relating to financing methods will be taken as part of an options analysis which will consider the best long term options for the Authority. There are some operational advantages to borrowing, however the prevailing corporation tax regime (in respect of its effect on leasing companies) can often make leasing a preferable option. These options need to be assessed at the time of financing as market conditions can affect these decisions markedly.

4.9 It is also important to note that the figure of £19.802m, showing as the estimated financing requirement for 2004/5, has already been financed within existing revenue budgets.

4.10 Therefore in 2005/6 the Authority will be required to finance £23.165m of capital expenditure (£19.802m already financed as explained above). This financing will be carried out over a number of different periods and different sources may be used. Nevertheless it is possible to estimate the ratio of financing costs to the net revenue stream of the Authority. These estimates assume that the Revenue Budget of the Authority remains fixed, at the 2005/6 proposed level, and that the capital programme remains unaltered.

RATIO OF FINANCING COSTS TO NET REVENUE STREAM					
	2003/4 Actual £000s	**2004/5 Estimate £000s**	**2005/6 Estimate £000s**	**2006/7 Estimate £000s**	**2007/8 Estimate £000s**
Financing Requirement	19,077	19,802	23,165	25,929	28,073
Revenue Cost	192	192	494	779	972
Revenue Budget	39,986	40,285	40,285	40,285	40,285
Ratio	0.41%	0.48%	1.23%	1.93%	2.41%

4.11 It might be considered reasonable to allow the ratio to rise to between 5-6% over time, however, the Fire Authority is a relatively immature Service in terms of debt and the figures presented, whilst correct, do not properly reflect realistic levels of debt for an Authority of similar size. This is because when the Authority was formed in 1998 it inherited a number of fixed assets, primarily land and buildings, which were debt free and therefore there were no associated financing charges. This causes a distortion of the figures in so far as the actual debt figure is "skewed downwards" reflecting the Authority's ability to use these transferred assets effectively free of any charges.

5 EFFECT ON COUNCIL TAXES

5.1 It is a requirement of the Prudential Code that Members are given an estimate of the effect on council taxes of the proposals that are being made for Capital spending. This is not an easy calculation to carry out other than to make the assumption that the Fire Authority will continue to be spending above FSS and therefore all additional spending will fall directly onto the Council Tax. If this were the case then the amount of council tax to be raised to fund capital spending would be :

EFFECT ON COUNCIL TAXES AT BAND D					
	2003/4 Actual £000s	**2004/5 Estimate £000s**	**2005/6 Estimate £000s**	**2006/7 Estimate £000s**	**2007/8 Estimate £000s**
Revenue Cost	192	192	494	779	972
Council Taxbase	320,410	320,410	320,410	320,410	320,410
Council Tax at Band D	0.60	0.60	1.54	2.43	3.03

6 PRUDENTIAL LIMITS

6.1 Under the Prudential Code, the Authority is required to set prudential limits for the amount of indebtedness it can reasonably sustain. These limits are called the **Authorised Limit** and the **Operational Boundary** and whilst similar they are actually subtly different.

- The **Operational Boundary** is the Authority's estimate of its total outstanding debt, gross of investments and other long-term liabilities. This is to reflect the most likely scenario and not the worst case. It is possible for the operational limit to be temporarily breached to take account of unusual movements in cash flow, but this should not be a regular occurrence.

- The **Authorised Limit** is essentially the same, but allows headroom over and above the operational boundary to take account of such unusual movements in cash flow and therefore should be the maximum amount of external debt that the Authority is exposed to at any given time.

6.2 A variation from the operational boundary is permissible, but reportable, whereas any proposed variation from the authorised limit must be authorised by the Fire Authority.

6.3 These limits need to be set including both long term external borrowing and also short term borrowing in respect of overdrafts.

6.4 Cash flow forecasts have been prepared for 2005/6 to 2007/8 and indicate that there will be no difficulty in maintaining a positive current account balance on a month by month basis and therefore there is no proposal to seek an increase in the Authority's approved overdraft limit of £200,000. Previous experience shows however, that these estimates can sometimes be wrong temporarily due to delays in income receipts and it has proved necessary in the past to negotiate temporary increases in this figure of up to £500,000. It is therefore proposed that this figure of £500,000 should be included within both the operational boundary and the authorised limit. This is the same figure that was used for 2004/5.

6.5 Whilst not in the Capital Programme as an additional item, it is likely that the Authority will be involved in a contract for the acquisition of land and carrying out building works in connection with the proposed Beeston/Dunkirk merger and relocation. Whilst it is anticipated that this will be a largely self funding scheme, substantial delays in cashflows will require some additional short term borrowing until the Dunkirk site can be marketed. Additional borrowing ceiling is therefore sought for £2m to enable this to take place.

6.6 It is therefore proposed that the Authority should set the following authorised limits and operational boundaries for the year 2005/6, 2006/7 and 2007/8 :

PRUDENTIAL LIMITS			
Year	**2005/6**	**2006/7**	**2007/8**
Authorised Limit	8,781	9,622	11,980
Operational Limit	7,983	8,747	10,891

7 TREASURY MANAGEMENT

7.1 In Nottinghamshire the Fire Authority has always carried out its own treasury management in accordance with CIPFA guidelines. Whilst the sums involved are small, it is nevertheless important to ensure that the Authority's best interests are protected.

7.2 The Authority has already approved a lending list of institutions that it is prepared to lend to, and these constitute those with only the highest credit ratings. This policy is to continue although the use of other investment vehicles is being considered currently.

7.3 In terms of borrowing, it has always been considered prudent to use Public Works Loans Board (PWLB) Fixed Interest Loans. This is because the PWLB offers rates which cannot be obtained anywhere else in the marketplace. The Head of Finance and Resources is currently taking advice on Treasury Management matters and will bring a report to the Fire Authority in due course to explain how current policies might be varied to maximise funds in this area.

8 INTEREST RATE RISK EXPOSURE

8.1 Whilst the PWLB has fairly strict rules for borrowing, the Authority meets all of their requirements and therefore it is proposed to continue with this strategy. As to the issue of fixed -v- variable rate decisions it would not be prudent to rule out variable rates absolutely, and therefore it is considered that up to 30% of borrowing might come from variable rate sources if these are considered financially advantageous at the time of financing. For policy changes beyond this, however, it is suggested that Fire Authority approval should be sought. The assumptions used throughout this report assume that fixed interest rates are likely to rise by up to 1% during 2005/6 and that investment rates may rise by up to 0.5%.

8.2 The total value of lending is expected not to exceed £4,500,000 at its peak during 2005/6 however it is difficult to assess, given scant previous experience, what the likely investment profile might be. At this stage it is unlikely that the Authority will engage in investment for any period longer than 12 months. Current investments are all short term and at rates fixed for short periods.

8.3 It is proposed therefore that the Authority sets the following limits for interest rate exposures for 2004/5, 2005/6 and 2006/7 :

INTEREST RATE EXPOSURES			
	2004/5	**2005/6**	**2006/7**
Upper limit for fixed rate exposures	100%	100%	100%
Upper limit for variable rate exposures	30%	30%	30%

8.4 This means that the Head of Finance and Resources will manage fixed rate exposures from a minimum of 70% to a maximum of 100% and variable exposures from a minimum of 0% to an upper limit of 30%.

9 MATURITY OF LOANS

The majority of existing external loans are for periods of 40 years as they relate to land and buildings. Whilst the code of practice and various CIPFA guidelines state that there should be no direct linkage between the assets financed and the loans taken out it is considered that the life span of the assets purchased must inform this process. It is proposed therefore that as a wider range of assets are to be purchased that upper and lower limits for loan financing should be set as follows:

LOAN MATURITY		
	Upper Limit	**Lower Limit**
Under 12 months	20%	0%
12 months to 5 years	20%	0%
5 years to 10 years	75%	0%
Over 10 years	90%	25%

10 MONITORING OF INDICATORS

It is proposed that prudential indicators should be monitored on a monthly basis by the Head of Resources and Finance and that a report is made to the Fire Authority on a quarterly basis to confirm that these limits are being adhered to.

11 FINANCIAL IMPLICATIONS

The financial implications of this report are set out in full within the body of the report.

12 PERSONNEL IMPLICATIONS

There are no specific personnel implications which arise directly from this report.

13 EQUAL OPPORTUNITIES IMPLICATIONS

There are no equal opportunities implications arising from this report.

14 RISK MANAGEMENT IMPLICATIONS

The risk exposures in this report relate primarily to two areas :

i) The risk of over exposure of the Authority to interest rate fluctuations ;
ii) The risk that the Authority has an unmanageable or unaffordable level of borrowing.

This paper serves to set out those risks and ensure that they are managed.

15 RECOMMENDATIONS

That Members note the contents of this report and approve the prudential limits for 2005/6 as follows :

Authorised Limit	£8,781,000
Operational Limit	£7,983,000
Upper limit for variable rate interest exposures	30%
Upper limit for fixed rate interest exposures	100%
Loan Maturity	
Under 12 months	less than 20%
12 months to 5 years	less than 20%
5 years to 10 years	less than 75%
Over 10 years Greater than 25%	less than 90%

16 BACKGROUND PAPERS FOR INSPECTION

None.

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