report

Meeting	**NOTTINGHAMSHIRE AND CITY OF NOTTINGHAM FIRE AND RESCUE AUTHORITY** **POLICY AND STRATEGY COMMITTEE**
Date	**22 November 2006** Agenda item number

REPORT OF THE CHAIR OF FINANCE AND RESOURCES COMMITTEE

CAPITAL STRATEGY

1. PURPOSE OF REPORT

To seek the approval of the Policy and Strategy Committee to the Capital Strategy recommended by the Finance and Resources Committee.

2. BACKGROUND

At its meeting on 15 September 2006 the Finance and Resources Committee considered a report on the Capital Strategy to be adopted by the Fire & Rescue Authority.

3. REPORT

The Capital Strategy (attached as Appendix A) sets out the strategy to be adopted for the determination of capital financing options, procurement and the potential for long term financing through vehicles such as the Private Finance Initiative.

4. FINANCIAL IMPLICATIONS

The formal adoption of a Capital Strategy will provide a framework for budgeting and capital planning.

5. PERSONNEL IMPLICATIONS

There are no personnel implications arising from this report.

6. EQUALITY IMPACT ASSESSMENT

An equality impact assessment is not required in relation to this report.

7. RISK MANAGEMENT IMPLICATIONS

The framework provided by a Capital Strategy will contribute to the management of capital resources.

8. RECOMMENDATIONS

That Members adopt the Capital Strategy as set out in the attached report.

9. BACKGROUND PAPERS FOR INSPECTION

None.

Councillor Penny Griggs
CHAIR OF FINANCE AND RESOURCES COMMITTEE

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APPENDIX A

report

Meeting	**NOTTINGHAMSHIRE AND CITY OF NOTTINGHAM FIRE AND RESCUE AUTHORITY** **FINANCE AND RESOURCES COMMITTEE**	
date	**15 September 2006**	agenda item number

REPORT OF THE CHIEF FIRE OFFICER

CAPITAL STRATEGY

1. PURPOSE OF REPORT

1.1 The purpose of this report is to report to Members of the Capital Strategy to be adopted by the Authority over the coming years. It draws together information from a number of sources namely the Capital Programme, the Medium Term Financial Strategy, the Prudential Code Report, the Treasury Management Strategy and strategies for IT, Fleet and Property.

1.2 The report concentrates on the strategy for investment of capital funds, the process for approval and procurement, financing and sustainability.

2. BACKGROUND

2.1 For many years the Fire & Rescue Authority has maintained a Capital Programme which has attempted to both maintain and enhance the capital base of the Authority with a view to the achievement of a number of key objectives which include:

i) The maintenance of operational assets to an appropriate standard to ensure that current service needs are met.
ii) Provide capital investment to reduce operating costs.
iii) Provide capital investment to enhance and improve service delivery.
iv) Maximise the use of resources by using a variety of capital financing mechanisms.
v) Ensuring that the capital investment strategy is sustainable in the longer term.
vi) Minimising the risk exposure of the Authority to capital market forces and interest rates.

2.2 The asset base of the Authority as at 31 March 2006 is shown in the balance sheet as £38.3m gross which reduces to £27.6m after depreciation. These assets have a capital financing requirement of £6.837m including £3.428m in outstanding leases. This figure represents the total potential indebtedness of the Authority at 31 March 2006.

2.3 The costs to the Revenue budget of servicing current levels of debt and leasing are of the order of £2m per annum.

2.4 The Authority has a Capital Programme over the years 2006/7 to 2008/9 as follows:

	2006/7 £m	2007/8 £m	2008/9 £m
Transport	2.084	1.410	1.810
Property	3.076	0.725	1.125
I.T	1.538	0.447	0.330
Total	6.698	2.582	3.265

2.5 This Capital Programme is based around a number of key assumptions:

i) The Heavy (Red) Fleet will not grow significantly.
ii) The optimum vehicle life for the Red Fleet is approximately 12 years with a design life of 15 years.
iii) The Light Vehicle Fleet will have a useful life for financing purposes of 5 years
iv) Pool vehicles and cars will have a financing life of 3 years.
v) To maintain the Estate in a reasonable state it will be necessary to refurbish or replace a major property at least every two years.
vi) The Authority's IT systems must be kept as up to date as is practicable.

2.6 The major assumption however is that the asset base must be capable of being maintained and sustained over time. What this means in practice is that the revenue support to the capital base needs to be continued in order that replacement and refurbishment can take place.

3. FINANCING STRATEGY

3.1 The Authority has a debt free legacy which, whilst highly beneficial in the short and medium term, creates a liability in the longer term. This is because the revenue budget has only ever been constructed to cover the costs of debt incurred since 1998 with the exception of leasing payments that were transferred from the County Council. This means in effect that the cost of refurbishing or rebuilding a property (for example) will need to be financed using new revenue support.

3.2 This position is referred to as the maturity of the Authority's capital base or the ability of the capital base to sustain itself. Although the Authority does not directly finance assets from debt. In simple terms this is a bit like the domestic scenario of repaying one loan before taking out another thus ensuring that the revenue costs do not rise significantly.

3.3 As the capital base of the Authority is not yet fully mature it does not have the necessary revenue resources available to sustain it's capital base into the longer term and will therefore require additions to the revenue budget year on year to meet the costs of the capital programme.

3.4 Whilst it is important to remain focussed on the balance between the assets of the Authority and the indebtedness of the authority it is equally important to note that there is no requirement for there to be a relationship between the lives of the assets and the maturity of loan debt financing them. What this means in effect is that the Authority does not, for example, take out a loan to buy a building and then take out another to finance a Fire Appliance. Capital investment monies are spent on the purchase of assets and then the totality of this expenditure may be financed using a number of vehicles such as short term loans, revenue contributions, finance leases, longer term loans or operating leases.

3.5 This balance between indebtedness and assets needs to be considered however as in the worst case scenario an Authority could find itself unable to sustain future capital programmes because it's debt burden from long term loans is too high. Similarly a debt burden that is too conservative will stifle investment.

3.6 The financing strategy of the Authority has been limited in the past by central government regulation and intervention and has meant that the majority of the shorter life assets have been financed by leasing. Only longer term property type assets have been financed from borrowing. This has meant, of course, that the maturity pattern of financing has largely followed the lives of the assets almost by default. It will be necessary however to ensure that, in the future, when a greater volume of debt can be financed from borrowing that the maturity profile of debt is broadly in line with the asset life profile.

3.7 The over arching financing strategy therefore is to manage the Authority's debt in accordance with the Prudential Code and take advantage where possible of beneficial market conditions for advance borrowing and smoothing out the effects of financing throughout the three year period covered by the Medium Term Financial Strategy. This does not mean however that forms of financing other than borrowing will not be considered.

3.8 It will also need to be considered that as assets grow older they consume an increasing proportion of the maintenance budgets. Replacement of these assets will have a beneficial effect on these budgets and so some of the additional financing costs may be offset.

3.9 The Prudential Code limits and targets set by the Authority allow a great deal of flexibility over loan maturity and will permit these decisions to be made. A relatively short term "planning horizon" of only three years, however does not adequately reflect the issues of sustainability which are so important in the Service. This is taken account of with the fleet by a planning horizon of 12-15 years.

3.10 It is important that the Property Strategy Group begin to develop a 25 year or longer strategy because:

i) The Service has 30 properties including HQ, SDC and 25 Stations. Many of the stations were built in the 1960/70's to a CLASP design which is now showing signs of age. Given that in real terms the Service can only undertake one or two major projects per annum the implication, clearly, is that it will take about 18 years to refurbish, replace, or rebuild the estate. If this target cannot be achieved there is a real risk in future years that property will deteriorate at a faster rate than it can be replaced.
ii) Property projects tend to be large in both scope and value.
iii) Property is a long life asset. Building a Fire Station is quite different from an office block, which will have intrinsic value in its current state at some time in the future. The reality of a Fire Station is that if the Service no longer requires it then the best that could be achieved in terms of a sale would be the land value only.

3.11 The property strategy must be driven by the Integrated Risk Management Plan (IRMP) and other Service based aspirations which sometimes by their very nature are not long term. It will be necessary therefore to consider creative solutions for property provision.

3.12 Information Technology assets present a different kind of problem. Invariably these are short life assets and therefore do not require long term planning. The issue with IT however, is that whilst the assets my be short life the systems that they support are invariably medium to long term requirements and the costs of replacing IT systems are exceptionally high when all costs are considered.

4 PRIVATE FINANCE INITIATIVE

4.1 It would be inappropriate for a report on Capital Strategy not to consider the use of alternative financing vehicles such as the Private Finance Initiative (PFI). This was once described as “the only game in town” for Capital Financing and Government have encouraged its use due to the nil effect it has on the Public Sector Borrowing Requirement (PSBR). Other reasons quoted are that risk is best transferred to those best equipped to deal with it (i.e. the private sector) and that the private sector are more efficient at construction and facilities management. It may also, of course, be that PFI “Assets” are off balance sheets and therefore do not count as public expenditure.

4.2 In essence the theory behind PFI deals is that a private developer or special purpose vehicle (SPV) will design and build a public building and effectively lease it back to the commissioning Authority. There are various ways that this can work but usually the developer or SPV retain ownership of the site at the end of the lease period (usually 30 years).

4.3 In order for a PFI bid to be successful the Authority must not just lease back a building but also all the core services within it such as heating, lighting, grounds maintenance, catering etc. and there are specific rules about the percentage of the annual charge that must relate to these peripheral services.

4.4 The main reason an Authority would want to enter into a PFI contract is because of the incentives offered by government to do so. These can be significant in terms of grant support via the scheme for PFI credits and would certainly make a PFI appear attractive.

4.5 The accountancy profession is clearly divided over the issue with some professionals believing that PFI is a legitimate and useful financing vehicle whereas others regard it with great suspicion. What is clear however is that the financial advantages to PFI should not be overlooked and PFI should at least be considered.

4.6 One of the major downsides to PFI is the level of professional fees that are payable and the fact that these remain much the same irrespective of the value of the project. The key is to “parcel up” a number of projects into a larger scheme to both attract more private sector interest and get the maximum value for these costs.

4.7 Where PFI could be of great advantage however is in a situation such as that in Nottinghamshire where a large number of properties will require replacement over a short period.

5. FINANCING DECISIONS

5.1 There is a presumption within a number of external documents that financing decisions are made at the point of purchase of an asset. It is however considered that this is the worst possible time to make such a decision for a number of reasons:

i) At the point of acquisition the Asset is already owned and the only decision that can then be made is how to finance it (not whether to).
ii) The decision as to whether to purchase the Asset in the first place would be better made with some view as to the revenue implications of that decision.
iii) A decision made at the time of acquisition would imply strongly that the financing was to be directly linked to the Asset which it is not.

5.2 What is required is a much more robust, and yet in may ways simpler, process which considers the likely financing costs at the time of the approval using a simple generic “standard cost” model. Actual financing decisions can then be made when the funds are required.

5.3 The actual financing decision will depend upon a number of factors:

i) Expected useful life of the asset
ii) Residual value
iii) Available tax breaks for finance providers
iv) Economic outlook for interest rates
v) Certainty of termination date
vi) Overall net present value calculations

All of these issues will be considered as part of the financing options appraisal before deciding whether to use a leasing vehicle for finance. If it is decided to use internal or loan financing then the actual finance decision will not be taken until such time as the Treasury Management Strategy indicates that it is prudent to do so.

6. PROCUREMENT PROCESS

6.1 The procurement process is in a number of stages and is considered to be an integral part of business and financial planning.

6.2 A desire for capital investment is usually driven either by a requirement to replace or refurbish an existing asset or a desire to acquire a new asset for the purposes of enhancing service delivery. In the case of the former the Asset Management Plan will indicate where investment is required, whilst, for the latter, the business planning process will drive the investment requirement.

6.3 Business planning and capital planning are iterative processes as senior managers will attempt to frame the investment requirements within an affordable framework. Projects will be prioritised within these financial limitations and a draft capital programme will be built up.

6.4 The budgets given within the Capital Programme at this stage will only be indicative and, whilst they will be as accurate as they can be, there will be some scope for variation. Member approval will be sought if this variation is significant.

6.5 One of the problems that has been experienced in the past has been that the Capital Programme as agreed by the Authority can sometimes not be delivered in full due to external events. Attempting to react to this by accelerating other projects forward from future years can often frustrate business plans and therefore is to be avoided. In future Capital Programmes are to be overprogrammed with projects which can be accelerated and meet business objectives to enable available resources to be moved quickly between projects.

6.6 The inclusion of a project within the Capital Programme does not constitute an approval to embark upon the project. All this does is put the necessary estimated funds in place. The approval to commit further resources must come when the full details of the project are known. A project approvals process is in place in order that the full implications of a project can be considered, such as:

i) Project based Risk
ii) Cost Benefit Analysis
iii) Health and Safety Implications
iv) Project Priority
v) Options appraisal

vi) Financing options
vii) Regional implications/opportunities for collaboration
viii) Compliance with procurement strategies local/regional/national

6.7 The Performance and Co-ordination Team will act in the role of an authorisations panel to prioritise and approve projects.

6.8 Key to the success of this process is the completion of the procurement process via a post implementation review process. This will enable lessons to be learned and an assessment to be carried out to ensure that project benefits have been delivered.

7. CONCLUSION

7.1 To reiterate what has been outlined above the Capital Strategy of the Authority seeks to achieve a number of objectives which have been detailed in paragraph 2.1 above.

7.2 The above Strategy will certainly contribute to these objectives particularly if aligned with longer term strategic planning.

7.3 The Authority should be prepared to consider alternative financing vehicles such as PFI in the future.

8. RISK MANAGEMENT IMPLICATIONS

The risks that the Authority faces if the Capital Strategy is incorrect or unachievable are significant. The maintenance of an appropriate asset base is key to the delivery of high quality and relevant services. There is no doubt that a Capital Strategy is a long term strategy but if neglected will quickly result in impacts on the Revenue Account and Revenue Budget which will result in service reductions or taxation increases.

9. PERSONNEL IMPLICATIONS

There are no implications for personnel within this report.

10. EQUALITY IMPACT ASSESSMENT

There are no issues for equalities within this paper.

11. FINANCIAL IMPLICATIONS

The financial implications are set out in full within report.

12. RECOMMENDATIONS

12.1 That Members recommend that Policy & Strategy Committee approve the Capital Strategy as set out above.

12.2 That Members support the conduct of a study into the feasibility of entering into PFI contracts for the provision of Fire Stations and other buildings.

12.3 That Members support the over-programming of Capital to ensure that capacity for investment is maximised.

13. BACKGROUND PAPERS FOR INSPECTION

- Medium Term Financial Strategy
- Treasury Management Strategy
- Prudential Code Report.

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