Treasury Management Strategy Statement and Annual Investment Strategy

Mid-Year Review Report 2022/23

Police & Crime Commissioner for Lincolnshire

1. Background

1.1 Capital Strategy

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. These require all local authorities to prepare a Capital Strategy which is to provide the following: -

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability

1.2 Treasury management

The Police and Crime Commissioner for Lincolnshire (PCC) operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the PCC's capital plans. These capital plans provide a guide to the borrowing need of the PCC, essentially the longer term cash flow planning to ensure the PCC can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet PCC risk or cost objectives.

Accordingly, treasury management is defined as:

> "The management of the PCC's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2. Introduction

This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the PCC's treasury management activities;
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the PCC will seek to achieve those policies and objectives;
3. Receipt by the PCC of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy, for the year ahead, a Mid-year Review Report and an Annual Report, (stewardship report), covering activities during the previous year;
4. Delegation by the PCC of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions;
5. Delegation by the PCC of the role of scrutiny of treasury management strategy and policies to a specific named body. For the PCC the delegated body is the Joint Independent Audit Committee.

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2022/23 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The PCC's capital expenditure, as set out in the Capital Strategy, and prudential indicators;
- A review of the PCC's investment portfolio for 2022/23;
- A review of the PCC's borrowing strategy for 2022/23;
- A review of any debt rescheduling undertaken during 2022/23;
- A review of compliance with Treasury and Prudential Limits for 2022/23.

Recommendations

Please note (section 4) that there is a need to revise downwards the Capital Financing Requirement previously approved due to the economic and operational movements during the year.

Changes to the capital programme and capital financing requirement have been addressed in the capital and revenue monitoring reports. This review is to report on the treasury activity for the first half of 2022/23.

It is proposed that the contents of this report are noted and it is noted that there has been compliance with the Treasury Management Strategy.

3. Economics and interest rates

3.1 Economics update

- The second quarter of 2022/23 saw:
  - GDP revised upwards in Q1 2022/23 to +0.2% q/q from -0.1%, which means the UK economy has avoided recession for the time being;
  - Signs of economic activity losing momentum as production fell due to rising energy prices;
  - CPI inflation ease to 9.9% y/y in August, having been 9.0% in April, but domestic price pressures showing little sign of abating in the near-term;
  - The unemployment rate fall to a 48-year low of 3.6% due to a large shortfall in labour supply;
  - Bank Rate rise by 100bps over the quarter, taking Bank Rate to 2.25% with further rises to come;
  - Gilt yields surge and sterling fall following the "fiscal event" of the new Prime Minister and Chancellor on 23rd September.
- The UK economy grew by 0.2% q/q in Q1 2022/23, though revisions to historic data left it below pre-pandemic levels.
- There are signs of higher energy prices creating more persistent downward effects in economic activity. Both industrial production (-0.3% m/m) and construction output (-0.8% m/m) fell in July 2022 for a second month in a row. Although some of this was probably due to the heat wave at the time, manufacturing output fell in some of the most energy intensive sectors (e.g., chemicals), pointing to signs of higher energy prices weighing on production. With the drag on real activity from high inflation having grown in recent months, GDP is at risk of contracting through the autumn and winter months.
- The fall in the composite PMI from 49.6 in August to a 20-month low preliminary reading of 48.4 in September points to a fall in GDP of around 0.2% q/q in Q3 and consumer confidence is at a record low. Retail sales volumes fell by 1.6% m/m in August, which was the ninth fall in 10 months. That left sales volumes in August just 0.5% above their pre-Covid level and 3.3% below their level at the start of the year. There are also signs that households are spending their excess savings in response to high prices. Indeed, cash in households' bank accounts rose by £3.2bn in August, which was below the £3.9bn rise in July and much smaller than the 2019 average monthly rate of £4.6bn.
- The labour market remained exceptionally tight. Data for July and August provided further evidence that the weaker economy is leading to a cooling in labour demand. Labour Force Survey (LFS) employment rose by 40,000 in the three months to July (the smallest rise since February). But a renewed rise in inactivity of 154,000 over the same period meant that the unemployment rate fell from 3.8% in June to a new 48-year low of 3.6%. The single-month data showed that inactivity rose by 354,000 in July itself and there are now 904,000 more inactive people aged 16+ compared to before the pandemic in February 2020. The number of vacancies has started to level off from recent record highs but there have been few signs of a slowing in the upward momentum on wage growth. Indeed, in July, the 3my/y rate of average earnings growth rose from 5.2% in June to 5.5%.
- CPI inflation eased from 10.1% in July to 9.9% in August, though inflation has not peaked yet. The easing in August was mainly due to a decline in fuel prices reducing fuel inflation from 43.7% to 32.1%. And with the oil price now just below $90pb, we would expect to see fuel prices fall further in the coming months.
- However, utility price inflation is expected to add 0.7% to CPI inflation in October when the Ofgem unit price cap increases to, typically, £2,500 per household (prior to any benefit payments). But, as the government has frozen utility prices at that level for two years, energy price inflation will fall sharply after October and have a big downward influence on CPI inflation.

- Nonetheless, the rise in services CPI inflation from 5.7% y/y in July to a 30-year high of 5.9% y/y in August suggests that domestic price pressures are showing little sign of abating. A lot of that is being driven by the tight labour market and strong wage growth. CPI inflation is expected to peak close to 10.4% in November and, with the supply of workers set to remain unusually low, the tight labour market will keep underlying inflationary pressures strong until early next year.
- During H1 2022, there was a change of both Prime Minister and Chancellor. The new team (Liz Truss and Kwasi Kwarteng) sought to super-charge the growth prospects for the UK economy. However, the, then, government's proposed huge fiscal loosening derived from significant tax cuts and unfunded support to households to help them with energy costs (which was estimated to cost up to £150bn or 5.7% of GDP over 2 years) came unstuck in spectacular fashion. The long list of tax measures announced at the "fiscal event" added up to a loosening in fiscal policy relative to the previous government's plans of £44.8bn (1.8% of GDP) by 2026/27. Proposed measures included the reversal of April's national insurance tax on 6th November, a cut in the basic rate of income tax from 20p to 19p in April 2023, the cancellation of next April's corporation tax rise, a cut to stamp duty and the removal of the 45p tax rate.
- Fears that the government had no fiscal anchor on the back of these announcements meant that the pound weakened again, adding further upward pressure to interest rates. Whilst the pound fell to a record low of $1.035 on the Monday following the government's "fiscal event", it has since recovered to around $1.12. That is primarily due to the replacement of the Truss-Kwarteng team by the more orthodox and fiscally conservative Sunak-Hunt team on 24th October.
- The MPC has increased interest rates at every meeting in 2022 and has raised rates to their highest level since the Global Financial Crisis. Even so, coming after the Fed and ECB raised rates by 75 basis points (bps) in their most recent meetings, the Bank of England's latest 75 basis points hike (3rd November) still looks relatively dovish, but was supported by MPC comments that the current market's pricing would suggest an eight quarter recession lasting to H1 2024 so perhaps rates will not need to increase to 5%+. Moreover, the UK's status as a large importer of commodities, which have jumped in price, means that households in the UK are now facing a much larger squeeze on their real incomes.
- We now expect the Monetary Policy Committee (MPC) to increase interest rates further from 3% to a peak of perhaps 4.75% in March 2023. The combination of the tight labour market and sticky inflation expectations means we expect the MPC to raise interest rates by a further 75bps at the policy meeting in December (to 3.75%) followed by further 50 basis point hikes in February and March (to 4.75%). If Bank Rate climbs to these levels the housing market looks set for a correction.
- Throughout 2022/23, gilt yields have been on an upward trend. They were initially caught up in the global surge in bond yields triggered by the surprisingly strong rise in CPI inflation in the US in May. The rises in two-year gilt yields (to a peak of 2.37% on 21st June) and 10-year yields (to a peak of 2.62%) took them to their highest level since 2008 and 2014 respectively. However, the upward trend was exceptionally sharp at the end of September as investors demanded a higher risk premium and expected faster and higher interest rate rises to offset the, then, government's extraordinary fiscal stimulus plans. The 30-year gilt yield rose from 3.60% to 5.10% following the "fiscal event", which threatened financial stability by forcing pension funds to sell assets into a falling market to meet cash collateral requirements. In response, the Bank did two things. First, it postponed its plans to start selling some of its quantitative easing (QE) gilt holdings until 31st October. Second, it committed to buy up to £65bn of long-term gilts to "restore orderly market conditions" until 14th October. In other words, the Bank restarted QE, although for financial stability reasons rather than monetary policy reasons.
- Since the Bank's announcement on 28th September, the 30-year gilt yield has fallen back from 5.10% to 3.66%. The 2-year gilt yield dropped from 4.70% to 3.12% and the 10-year yield fell back from 4.55% to 3.57% (as at 3rd November).
- After a shaky start to the year, the S&P 500 and FTSE 100 climbed in the first half of Q2 2022/23 before falling to their lowest levels since November 2020 and July 2021 respectively. The S&P 500

is 7.2% below its level at the start of the July-September quarter, whilst the FTSE 100 is 5.2% below it as the fall in the pound has boosted the value of overseas earnings in the index. The decline has, in part, been driven by the rise in global real yields and the resulting downward pressure on equity valuations as well as concerns over economic growth leading to a deterioration in investor risk appetite.

3.2 Interest rate forecasts

The PCC has appointed Link Group as treasury advisors and part of their service is to assist the PCC to formulate a view on interest rates. The PWLB rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to most authorities since 1st November 2012.

The latest forecast on 8th November sets out a view that both short and long-dated interest rates will be elevated for some little while, as the Bank of England seeks to squeeze inflation out of the economy.

The increase in PWLB rates reflects a broad sell-off in sovereign bonds internationally but more so the disaffection investors had with the position of the UK public finances after September's "fiscal event". To that end, the MPC has tightened short-term interest rates with a view to trying to slow the economy sufficiently to keep the secondary effects of inflation – as measured by wage rises – under control. Meantime, subsequent announcements by the Sunak-Hunt team (28th October) that public expenditure will be cut by £50bn and that taxes will rise, have underpinned gilt markets and reversed the losses suffered when the Truss-Kwarteng team were at the helm.

Our PWLB rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps, calculated as gilts plus 80bps) which has been accessible to most authorities since 1st November 2012.

Link Group Interest Rate View	08.11.22												
	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
BANK RATE	3.50	4.25	4.50	4.50	4.50	4.00	3.75	3.50	3.25	3.00	2.75	2.50	2.50
3 month ave earnings	3.60	4.30	4.50	4.50	4.50	4.00	3.80	3.30	3.00	3.00	2.80	2.50	2.50
6 month ave earnings	4.20	4.50	4.60	4.50	4.20	4.10	3.90	3.40	3.10	3.00	2.90	2.60	2.60
12 month ave earnings	4.70	4.70	4.70	4.50	4.30	4.20	4.00	3.50	3.20	3.10	3.00	2.70	2.70
5 yr PWLB	4.30	4.30	4.20	4.10	4.00	3.90	3.80	3.60	3.50	3.40	3.30	3.20	3.10
10 yr PWLB	4.50	4.50	4.40	4.30	4.20	4.00	3.90	3.70	3.60	3.50	3.40	3.30	3.20
25 yr PWLB	4.70	4.70	4.60	4.50	4.40	4.30	4.10	4.00	3.90	3.70	3.60	3.50	3.50
50 yr PWLB	4.30	4.40	4.30	4.20	4.10	4.00	3.80	3.70	3.60	3.40	3.30	3.20	3.20

4. Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2022/23 was approved by the PCC in July 2022.

The underlying TMSS approved previously requires revision in the light of economic and operational movements during the year. The proposed changes and supporting detail for the changes are set out below-

Prudential Indicator	2022/23 Original Indicator £m	2022/23 Revised Indicator £m
Authorised Limit	57	57
Operational Boundary	52	52
Capital Financing Requirement	51	47

5. The PCC's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The PCC's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

5.1 Prudential Indicator for Capital Expenditure

This table below shows the revised estimates for capital expenditure, which includes the proposed changes since the capital programme was agreed.

Capital Expenditure	2022/23 Original Estimate £'000s	2022/23 Revised Estimate £'000s
Building Schemes	1,165	1,496
Command & Control	2,004	2,335
ICT	2,258	2,433
Vehicles	2,102	2,282
Other	673	874
Total	**8,202**	**9,420**

The capital expenditure is forecast to increase by £1,218 from the original estimate. This is largely due to carry forward of the prior year budget; primarily the fleet budget due to delays in procuring vehicles.

5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the PCC by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2022/23 Original Estimate £'000s	2022/23 Revised Estimate £'000s
Total capital expenditure	**8,202**	**9,420**
Financed by:		
Capital grants and contributions	-	100
Revenue/Reserves	-	30
Capital Receipts	60	100
Total financing	**60**	**230**
Borrowing requirement	**8,142**	**9,190**

Total financing has increased by £170k. This is due to an increase in capital receipts and partner funding.

The borrowing requirement has increased by £1,048k as a result of the increase in the capital programme referred to on the previous page.

5.3 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

Prudential Indicator – Capital Financing Requirement

The revised forecast Capital Financing Requirement is £4,054k lower than the original forecast amount.

Prudential Indicator – the Operational Boundary for external debt

	2022/23 Original Estimate £'000s	2022/23 Revised Estimate £'000s
Prudential Indicator – Capital Financing Requirement		
Capital Finance Requirement	51,124	47,070
Net movement in CFR	**4,736**	**6,131**
Prudential Indicator – the Operational Boundary for external debt		
Borrowing	27,489	27,481
Total debt (year end position)	**27,489**	**27,481**

Total debt remains within the operational boundary. The original estimate has been revised in respect of increased reserves and surplus cash flow, see section 6.

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2022/23 and next two financial years. This allows some flexibility for limited early borrowing for future years. The PCC has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2022/23 Original Estimate £'000s	2022/23 Revised Estimate £'000s
Borrowing	27,489	27,481
Total debt	**27,489**	**27,481**
CFR (year end position)	**51,124**	**47,070**

The Chief Finance Officer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited and needs to be set and revised by the PCC. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Prudential Indicator	2022/23 Original Indicator £m	2022/23 Revised Indicator £m
Operational Boundary	52	52
Authorised Limit for External Debt	57	57

6. Borrowing

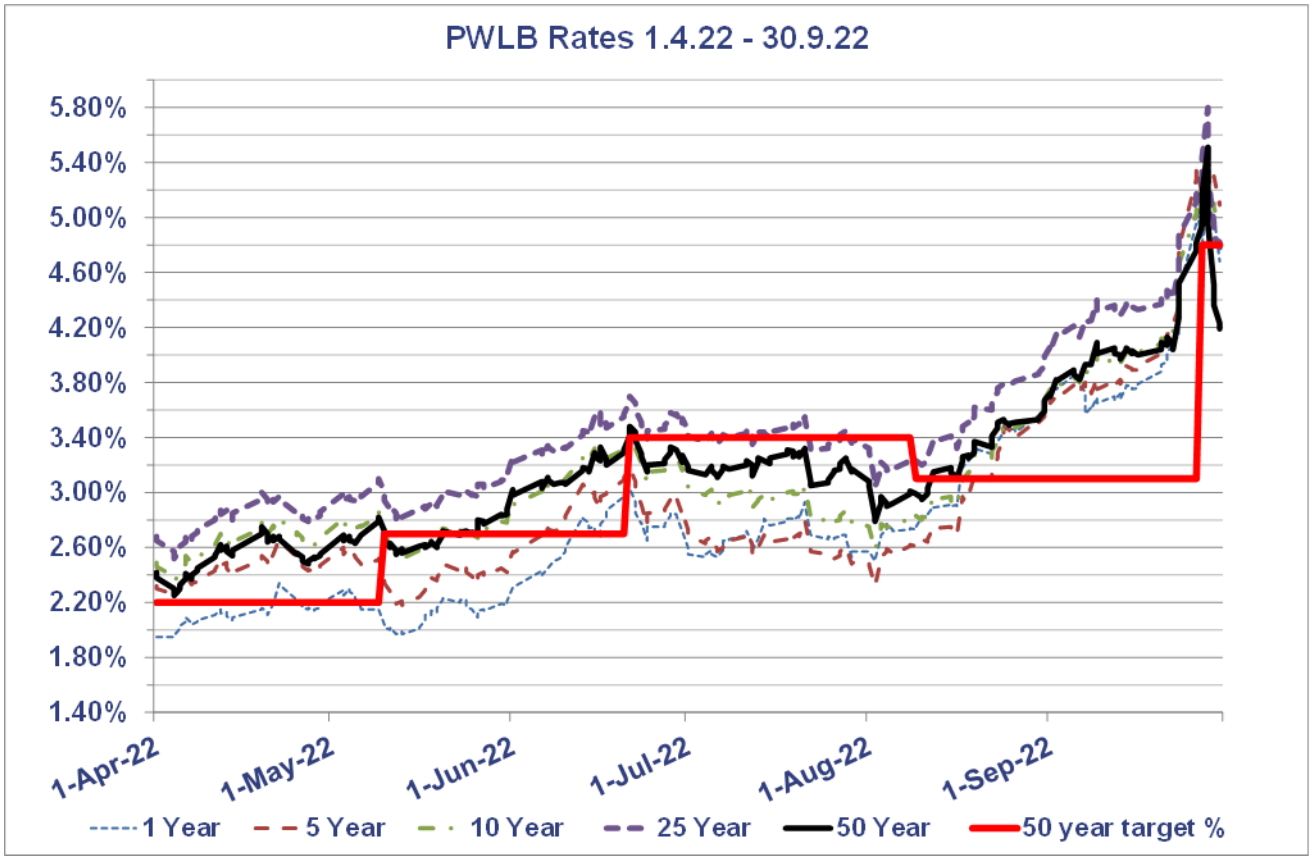
The PCC's capital financing requirement (CFR) for 2022/23 is £47.1m. The CFR denotes the PCC's underlying need to borrow for capital purposes. If the CFR is positive the PCC may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. The PCC currently has borrowings of £27m from the PWLB. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

No new external borrowing has been undertaken so far in 2022/23. The capital programme is being kept under regular review due to the effects of inflationary pressures, shortages of materials and labour. In the short term, capital spend will be financed through internal borrowing. Our borrowing strategy will, therefore, also be regularly reviewed and then revised, if necessary, in order to achieve optimum value and risk exposure in the long-term.

PWLB maturity certainty rates (gilts plus 180bps) year to date to 30th September 2022

Gilt yields and PWLB rates were on a generally rising trend throughout H1 2022, the exception being a short rally in gilts in July/August. However, they rose exceptionally sharply towards the end of September.

The 50-year PWLB target certainty rate for new long-term borrowing started 2022/23 at 2.20% and finished the half year at 4.80%, albeit we forecast rates to fall back to 3.10% by the end of September 2025.



HIGH/LOW/AVERAGE PWLB RATES FOR 01.04.22 – 30.09.22

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.95%	2.18%	2.36%	2.52%	2.25%
Date	01/04/2022	13/05/2022	04/04/2022	04/04/2022	04/04/2022
High	5.11%	5.44%	5.35%	5.80%	5.51%
Date	28/09/2022	28/09/2022	28/09/2022	28/09/2022	28/09/2022
Average	2.81%	2.92%	3.13%	3.44%	3.17%
Spread	3.16%	3.26%	2.99%	3.28%	3.26%

- The current PWLB rates are set as margins over gilt yields as follows: -.
    - **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
    - **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)

7. Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate and following the various increases in the margins added to gilt yields which have impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

8. Compliance with Treasury and Prudential Limits

It is a statutory duty for the PCC to determine and keep under review the affordable borrowing limits, During the half year ended 30th September 2022, the PCC has operated within the treasury and prudential indicators set out in the PCC's Treasury Management Strategy Statement for 2022/23. The Director of Finance &

Corporate Services reports that no difficulties are envisaged for the current or future years in complying with these indicators.

All treasury management operations have also been conducted in full compliance with the PCC's Treasury Management Practices.

9. Annual investment strategy

The Treasury Management Strategy Statement (TMSS) for 2022/23, which includes the Annual Investment Strategy, was approved by the PCC in July 2022. In accordance with the CIPFA Treasury Management Code of Practice, it sets out the PCC's investment priorities as being:

- Security of capital
- Liquidity
- Yield

The PCC will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the PCC's risk appetite. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

As shown by the interest rate forecasts in section 3.2, it is now impossible to earn the level of interest rates commonly seen in previous decades as all short-term money market investment rates have only risen weakly since Bank Rate was cut to 0.10% in March 2020 until the MPC meeting on 24th September 2021 when 6 and 12 month rates rose in anticipation of Bank Rate going up in 2022.

The Monetary Policy Committee has over recent months tightened (increased) short-term interest rates with a view to trying to slow the economy sufficiently to keep the secondary effects of inflation under control. This has resulted in higher yield on investments than anticipated against budget. The PCC's revised forecasted investment return for 2022/23 is now £250k. It is likely that this will be further revised by the year end due to increased interest rates.

Creditworthiness

Following the Government's "fiscal event" on 23rd September, both S&P and Fitch have placed the UK sovereign debt rating on Negative Outlook, reflecting a downside bias to the current ratings in light of expectations of weaker finances and the economic outlook.

Investment Counterparty criteria

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

CDS prices

It is noted that sentiment in the current economic climate can easily shift, so it remains important to undertake continual monitoring of all aspects of risk and return in the current circumstances.

Investment balances

The average level of funds available for investment purposes during the half year was £22m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of

precept payments, receipt of grants and progress on the capital programme. The PCC held £25.7m of investments as at 30th September 2022 (£14.2m at 31 March 2022 and £30.1m at 30 September 2021).

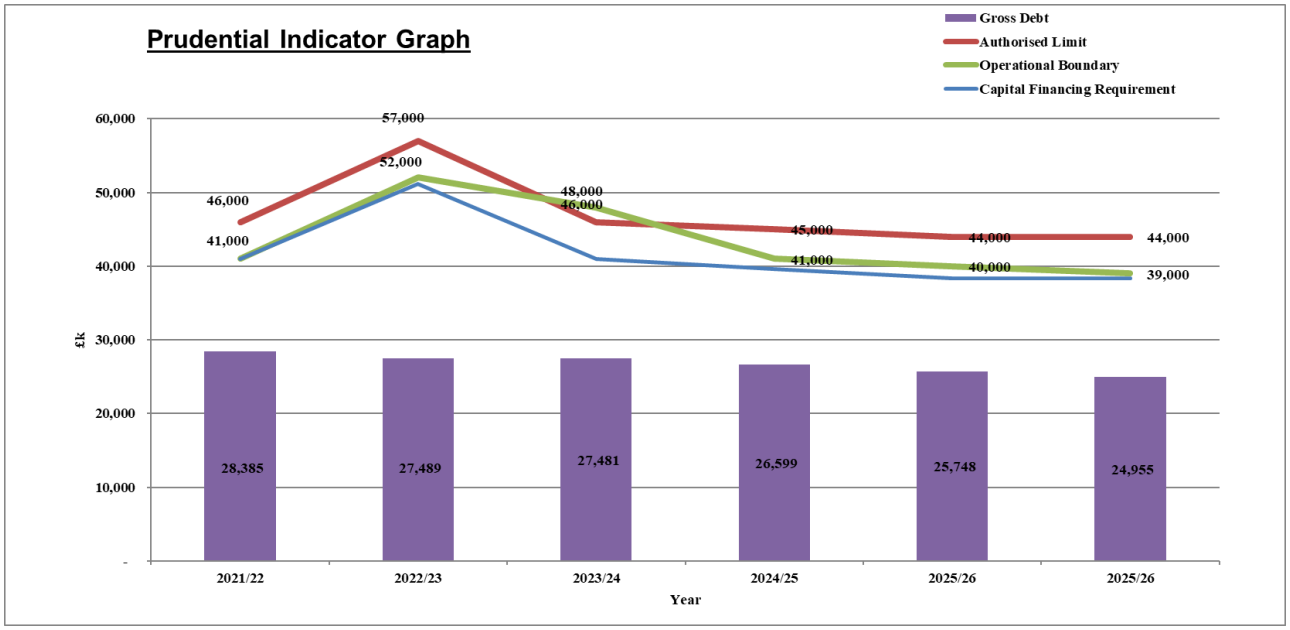
A full list of investments held as at 30 September 2022 is in Appendix 2.

Approved limits

The Director of Finance & Corporate Services confirms that the approved limits within the Annual Investment Strategy were not breached during the period ended 30th September 2022.

APPENDIX 1: Borrowing

Comparison of borrowing parameters to actual external borrowing



APPENDIX 2: Investment List as at 30 September 2022

The Police And Crime Commissioner For Lincolnshire

Current Investment List

Borrower	Principal (£)	Interest Rate	Start Date	Maturity Date	Lowest LT / Fund Rating	Historic Risk of Default
MMF Aberdeen Standard Investments	4,000,000	1.54%		MMF	AAAm	
MMF BlackRock	1,700,000	1.66%		MMF	AAAm	
MMF Insight	4,000,000	1.69%		MMF	AAAm	
DMO	5,000,000	1.80%	09/09/2022	03/10/2022	AA-	0.000%
Goldman Sachs International Bank	5,500,000	2.10%	05/07/2022	30/12/2022	A+	0.011%
Standard Chartered Bank (ESG)	5,500,000	2.08%	05/07/2022	05/01/2023	A+	0.012%
Total Investments	**£25,700,000**	**1.86%**				0.008%

Note: An historic risk of default is only provided if a counterparty has a counterparty credit rating and is not provided for an MMF or USDBF, for which the rating agencies provide a fund rating. The portfolio's historic risk of default therefore measures the historic risk of default attached only to those investments for which a counterparty has a counterparty credit rating and also does not include investments which are not rated.

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	6	7
Up to 5yrs	Up to 5yrs	Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yr	Up to 6mths	Up to 100days	No Colour