DOCUMENT 9G

DERBY CITY COUNCIL

COUNCIL CABINET
9 November 2004

Report of the Director of Finance

Revisions to Prudential Indicators and Treasury Management Progress Report 2004/05

RECOMMENDATIONS

1.1 To recommend Council to approve a revised set of 2004/05 prudential indicators as set out in Appendix 2 to this report.

1.2 To note progress on Treasury Management in the context of the approved Treasury Management Strategy for 2004/05.

SUPPORTING INFORMATION

Prudential Indicators

2.1 The Prudential Indicators for 2004/05 were originally approved by the Cabinet, and subsequently by the Council at their meetings on 24 February and 1 March 2004 respectively. These indicators are required following the introduction of the Local Government Act 2003. This introduced a new system of capital controls which relies upon a set of prudential guidelines set by the Chartered Institute of Public Finance and Accountancy, CIPFA. Some of the indicators are sensitive to the scale of the capital programme, and consequently it is necessary to keep the indicators under review during the course of the year. A separate report on the agenda is updating the 2004/5 capital programme and this is the main reason why some revisions to the indicators are now being sought.

2.2 The indicators that are required to be set are grouped into the following categories:

- Plans for capital expenditure
- Borrowing Limits
- Affordability
- Treasury Management

2.3 They are to be set and reviewed having regard to the following:

- Affordability – for example the effect on the Council Tax
- Prudence and sustainability – for example the implications for external borrowing of the plans
- Value for money – for example through option appraisal
- Stewardship of assets – for example through asset management planning

- Service objectives – for example through strategic planning processes
- Practicality – for example the achievability of the forward plan.

2.4 Appendix 2 sets out a revised set of prudential indicators for which approval is sought. The revisions are set out and explained in detail in the sections below.

3. Plans for Capital Expenditure

3.1 The amendments to this indicator solely reflect the revisions to the capital programme, for which approval was sought earlier on this agenda in a separate report.

The revised indicators are as follows:

	General Fund	HRA	Total
	£m	£m	£m
2004/05	48.1	49.7	97.8
2005/06	28.9	27.3	56.2
2006/07	34.5	8.3	42.8

3.2 Actual capital expenditure for 2003/04 was £75.7m, of which £36.8m related to the General Fund and £38.9m to the HRA.

4. Borrowing Limits

4.1 The Capital Financing Requirement or CFR is the key indicator against which the Council's external borrowing is measured. The CFR is calculated for the current year using figures extracted from the Council's balance sheet, and represents the maximum amount that the Council had potential to borrow to finance capital investment in previous years. CFRs for future years are derived using the previous year's CFR, together with the increase in planned borrowing for the current year, less principal repayments. The changes in the CFR again reflect solely the approved revisions to the capital programme and its financing. The updated CFRs are as follows:

CFR	General Fund	HRA	Total
	£m	£m	£m
2004/05	167.4	169.4	336.7
2005/06	173.7	189.0	362.7
2006/07	188.7	189.8	378.5

4.2 The General Fund amounts originally included unsupported borrowing of £2.75m in 2004/05 and £2m in each of 2005/06 and 2006/07 as reported in February. Subsequent changes in the level of 2004/05 GF unsupported borrowing, consistent with the revised capital programme, are shown below:

Initial Approval Feb 2004	£2.75m
Revisions to Existing 2004/5 Programme	
Schemes slipped to 05/6	-£0.70m
Scheme cost reductions	-£0.07m
Revised Total Existing Schemes	£1.98m
Additional Cost Neutral Schemes	
Home Computer Initiative	£1.50m
Creative Industries Workspace	£0.62m
Rethink Rubbish	£0.65m
Other Vehicle Purchases	£0.49m
Revised Unsupported Borrowing Total 2004/5 (GF)	£5.24m

The revised unsupported borrowing total for 2005/06 has grown to £2.7m due to the 2004/5 slippage.

4.3 The Operational Boundary and Authorised Limit indicators for borrowing were set in February in the absence of any specific guidance in the Code as to what an appropriate level might be. The Operational Boundary was set at 10% above each year's proposed CFR to allow for variability in the timing of borrowing and spending. Although capital spending funded by borrowing has risen since the beginning of 2004/05, the overall borrowing forecast is still well within the limit set and it is therefore felt that no revision to the limit is necessary. Similarly, the Authorised Limit, which was set at 25% above each year's CFR, is considered to remain adequate and as such will not require amendment by the Council.

5. Prudence

5.1 As explained in Section 4, the CFR for each year requires revision due to the increase in planned borrowing. The Council is required under the Prudential Code to demonstrate that the Council's external debt for each financial year, net of any debt transferred from other local authorities, does not exceed the planned CFR for the same year. Additionally it was felt prudent to produce a local indicator to demonstrate that all external debt forecast to be outstanding in each year, including transferred debt, will not exceed the corresponding CFR. The following demonstrates that both of these indicators are complied with:

	External Debt Excl tfrd debt £m	External Debt Incl tfrd debt £m	CFR £m
2004/05	273.0	323.9	336.7
2005/06	299.0	348.0	362.7
2006/07	314.8	361.9	378.5

5.3 At the end of 2003/04, the gross and net actual external debt for the Council was £269.6m and £216.7m respectively, compared to the CFR of £283.4m.

6. Affordability

6.1 The additional GF and HRA capital investment funded from borrowing, once carried out, will result in additional revenue servicing costs for the current and future financial years. The Code requires that a ratio of net revenue debt costs to the net revenue stream is produced to measure the relative levels of debt year on year. Based on the latest capital investment proposals, the indicators for Derby's GF and HRA will change as follows:

	Previous approval		Latest proposals	
	GF	HRA	GF	HRA
	£m	£m	£m	£m
2004/05	4.46%	19.38%	4.51%	20.60%
2005/06	4.42%	22.34%	4.59%	24.03%
2006/07	4.53%	22.63%	4.68%	25.40%

6.2 The incremental impact of this borrowing on the Council Tax and housing rents also needs to be calculated. The Council has adopted the convention of making this calculation based on capital financing costs net of external Government support, plus any net impact on revenue running costs. To date, the only identified net costs of the programme have been in relation to unsupported borrowing. All other borrowing will be supported through grants or FSS contributions and net of these is considered to have a broadly neutral impact on running costs.

6.3 The increases to the GF unsupported borrowing in 2004/05 are in relation to schemes that will generate net savings that broadly match the cost of additional borrowing. Cabinet approval has been given on that basis. The HCI and Creative Industries schemes will generate revenue savings or additional income. The Rethink Rubbish project and other vehicle purchases involve substitution of slightly cheaper borrowing costs for leasing costs. The remaining change to the overall unsupported borrowing programme due to savings in scheme costs are minimal, although the profiling between years has changed. The revised profiling of these costs between years, and the matching of savings to costs on spend to save schemes, can if necessary be smoothed through the application of or creation of reserves to match the financing costs.

6.4 In summary, it is not considered that the changes to the unsupported General Fund borrowing programme are sufficiently material to prompt a change in the existing calculation of its future incremental impact on the council tax.

7. Treasury Management

7.1 It is also a requirement of the Prudential Code that the Council has adopted the CIPFA Code of Practice for Treasury Management. The Council adopted the Code in 2002.

7.2 The other formal indicators required for Treasury Management relate to the split of borrowing and investments between fixed and variable rates, and also the maturity profile of long term loans. No revision is required to the limits previously set for investments and borrowings at fixed and variable rates. However, it is proposed to revise the upper and lower limits currently in place for the maturity structure of the Council's external debt. The current approved structure is as follows:

	Upper Limit	Lower Limit
	%	%
Under a year	15	0
> 1 year and < 2 years	15	0
> 2 years and < 5 years	30	5
> 5 years and <10 years	50	10
> 10 years	80	50

7.3 These indicators were only set for the first time in April 2004. It is now considered that the current upper limit structure imposes some unnecessary restrictions on long dated borrowing, which at present has relatively low interest rates. Unless the structure is revised, any further borrowing would currently have to be taken at less advantageous rates and for shorter periods, that is 10 years or less. It is not now considered that there should be any upper limit on the share of borrowing of over 10 years maturity. For borrowing of this term, the length of time to maturity means that the Council would still have adequate time to wait for appropriate market conditions to emerge if it needed to restructure the debt in the future. For consistency with this change, there can also be no lower limits below 10 years. The balance that it is considered must be retained within the portfolio is to ensure through lower limits that the Council has a reasonable proportion due to mature at 10 years or over, while retaining the low upper limits on debt due to mature in the relatively near future. To this end, it is proposed to revise the limits to the following:

	Upper Limit	Lower Limit	Actual October 2004
	%	%	%
Under a year	15	0	0
> 1 year and < 2 years	15	0	8.5
> 2 years and < 5 years	30	0	4.2
> 5 years and <10 years	50	0	7.7
> 10 years	100	50	79.6

7.3 The final Treasury Management indicator required is the limit on investments of one year and over in length. This limit has already been approved to be increased from £15m to £25m by the Cabinet on 20 July, and subsequently the Council, in response mainly to the growth in the investment portfolio. No further change is required.

8. Treasury Management Progress Report

8.1 A progress report on borrowing and investment activity to date in 2004/05 is set out in Appendix 3. The main highlights to note are that…

- Most borrowing has already been taken in 2004/5 at within budgeted rates, and risks of any future increase in rates have therefore been covered in respect of the current year's programme. The average cost of borrowing has continued to reduce from historic levels due to this activity.

- Short term investment returns have once again consistently and significantly outperformed Bank of England base rate.

- These activities will have a positive effect on the General Fund, and the estimated impact will be calculated and reported as part of arrangements for 2004/5 revenue budget monitoring.

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Background papers:	Council Cabinet Report 24 February 2004 'Prudential Code for Capital and Treasury Management Strategy'
List of appendices:	Appendix 1 – Implications Appendix 2 – Prudential Indicator Summary Update Appendix 3 – Treasury Management Progress Report

IMPLICATIONS

Financial

1. As detailed in the report

Legal

2. The Council is obliged to set and review prudential indicators in order to comply with the Local Government Act 2003. Unless the Government uses its powers under Section 4 of that act, the Council is free to set any reasonable indicators consistent with its other policies.

Personnel

3. None

Equalities impact

4. None

Corporate objectives and priorities for change

5. The recommendations seek to enable change consistent with all of the Council's priorities. The progress report on Treasury Management demonstrates effective actions to implement the Council's priority of minimising increases in the council tax and increasing value for money.

TREASURY MANAGEMENT - PROGRESS REPORT TO 30 SEPTEMBER 2004

1. Introduction

1.1 Treasury Management activities are carried out within a statutory framework based around to CIPFA's revised Code of Practice for Treasury Management in Local Authorities, which was adopted by this Council on 26 March 2002 and sets out minimum reporting requirements. The Council has in accordance with the Code adopted a Treasury Management Strategy which sets out the approach to borrowing and investments. It was until recently a requirement of the Code to bring a progress report to members during the year, and it is considered that it remains good practice to do so and, if necessary, amend strategies in response to market developments. This report sets out progress in the period 1 April 2004 to 30 September 2004.

2. Borrowing

2.1 The main features of the strategy agreed by Cabinet in February 2004 were the following, subject to a general need to retain some flexibility in reacting to changes in market conditions…

- The Council should continue with the approach of taking mostly long dated debt, in so far as borrowing is necessary, with the preference for long over medium and short dated loans being subject to review if market conditions change. Standard variable rate borrowing would generally be avoided.

- Consideration would be given under delegated powers to any options available to reschedule further long term loans in 2004/05 which may be running at disadvantageous interest rates, or where savings can be made to reduce the debt charge costs to the authority. Derby's external treasury advisors would continue to provide rescheduling forecast models to determine the financial implications.

- Consideration would be given under delegated powers to enter into further LOBO loans should market conditions appear advantageous, but the scope of this would be limited by the treatment of such loans as variable under the overall borrowing limits set by the Council. If LOBOs are used in a debt restructuring to replace existing short dated loans of similar length to the fixed period in the LOBO, there is no additional exposure to short dated volatility from use of the LOBO.

2.2 The strategy for 2003/04 identified a potential borrowing requirement of up to £38.8m based on the original capital programme. This has since been increased to £57.3m as the capital programme has expanded, due mainly to additional Government approval of £16m borrowing for Derby Homes and additional unsupported borrowing.

2.3 Interest rates on borrowing moved as shown below during the last 6 months:

Rates	Apr 04	May 04	June 04	Aug 04	1 Oct 2004
	%	%	%	%	%
Base rate	4.000	4.250	4.500	4.750	4.750
PWLB 3 years	4.700	4.950	5.300	5.100	4.850
PWLB 7-8 years	4.850	5.150	5.350	5.150	4.950
PWLB 20 - 25 years	4.850	5.100	5.150	4.950	4.850
PWLB 25 – 30 years	4.800	5.050	5.050	4.850	4.800

2.4 New PWLB (Treasury) loans of £52.5 million had been taken to 1 October 2004, and principal has been repaid on maturing annuity PWLB loans. This represents most of the potential borrowing requirement for 2004/5. The period of the loans varies from 25 to 29 years and the average rate achieved on this new borrowing is 4.9498%, which is fairly typical of the PWLB rates shown in the table over the period as a whole. All new borrowing has been through the PWLB. The impact of this activity has been to further reduce the average rate of overall PWLB borrowing (including existing loans) from 5.511% at the beginning of the financial year to 5.39%. To date, no rescheduling of debt has taken place.

2.5 The following should be noted when interpreting this activity…

- The Council has acted to limit risks relating to 2004/5 activity by taking the bulk of borrowing early in 2004/5, at slightly below the budgeted rate of 5% for new borrowing. Our advisers continue to consider that PWLB medium and long rates will rise during the remainder of 2004/5 and into 2005/6, although they have now moderated the extent of their earlier forecast increases.

- Long term interest rates remain low in historic terms, as evidenced by the reduction in average borrowing rates for the portfolio.

- The decision to take loans early in the financial year will also influence the net balance of costs charged between the General Fund and Housing Revenue Account, for technical reasons, to the advantage of the former. This is a one-off effect in 2004/5 only. The impact will be reported as part of 2004/5 budget monitoring.

- There will be opportunities in the future to restructure debt should the need arise. As long dated loans have been taken, there will be ample time to wait for when market conditions are right. This has been a consideration in avoiding new loans with maturities from 5 to 15 years, for which rates are currently higher.

- The debt profile curve has now flattened markedly, and this has eliminated the case for borrowing at variable rates, consistent with the adopted Strategy which avoids such borrowing. This also means that, in the short term, the Council has been able to achieve interest rates when investing surplus cash that match these rates.

- The impact of this early borrowing has also been to temporarily increase the level of the investment portfolio, as explained below.

2.6 At this point, there does not appear to be any need to change the adopted borrowing strategy, although activities must continue to be guided by market conditions.

3. Short Term Investments

3.1 In accordance with the Code of Practice the primary objectives of the Council's investment strategy is to obtain the best rate of return whilst maintaining effective control of associated risks. The adopted strategy sets out in some detail:

- the maximum periods for which funds should be committed
- minimum and maximum limits (%) to be invested in each investment type
- which investments will be classified as non-specified and subject to additional restrictions
- the degree of prior advice to be sought before use of non-specified investments
- limits on the split of fixed and variable interest rates for investments

3.2 The adopted strategy commits the Council to placing most of its investments for terms of between 1 and 364 days, although Cabinet has during 2004/5 already an agreed increase in the Prudential Code limit for longer (non-specified) investments of up to 2 years from £15m to £25m. This was in response to growth in the investment portfolio so as to retain flexibility in the use of forward deals – that is, commitments to make investments in the future. For similar reasons, revised limits on investments with individual building societies have also been agreed. No further changes are being sought to the strategy.

3.3 The early borrowing in 2004/5 and a profile of capital spending towards the end of 2004/5 are the reasons why the level of the Council's investments rose from £63m at 1 April 2004 to £110m at 30 September 2004. This does not conflict with the adopted borrowing strategy, the purpose of which has been to generate sufficient funds now to avoid substantive borrowing in 2005 and 2006 when rates are expected to be higher. The consequence is that the size of the investment portfolio is expected to fall significantly in the remainder of 2004/5 and to be generally lower in 2005/6.

3.4 Bank of England base rate rose from 4.0% at 1 April to 4.75% by 1 October and market rates have followed.

3.5 The average rate of return achieved on the 153 new investments placed by the Council during this period is 4.93%, excluding forward deals. Investment returns will rise further as the Council has now in place £15m of forward deals for investments taking effect in 2005 at rates between 5.25% and 5.80%. Market sentiment has since changed and rates of this level are no longer available. Week by week, average investment returns including investments in place prior to April 2004 have also consistently outperformed BoE base rate in 2004/5 to date.

3.6 This investment performance has been achieved without compromising the limitations on activity that maintain effective control of risks.

3.7 The impact of these high investment returns, and the growth in the investment portfolio, will be reflected in future reports to Cabinet on revenue budget monitoring.