

EAST AYRSHIRE COUNCIL

POLICY AND RESOURCES COMMITTEE – 8 FEBRUARY 2005

TREASURY MANAGEMENT ANNUAL STRATEGY REPORT FOR 2005/2006

Report by Executive Head of Finance

1. PURPOSE OF REPORT

- 1.1** To seek the approval of the Committee of the proposed Treasury Management Strategy for the financial year 2005/06. This incorporates certain mandatory prudential indicators – which are required to be set and approved by the Council in advance of the financial year.

2. BACKGROUND INFORMATION

- 2.1** Financial year 2005/06 is the second full year in which the CIPFA Prudential Code for Capital Finance (“the code”) will have been operated. The Code operates by the provision of prudential indicators which highlight particular aspects of the capital expenditure planning. Each indicator provided during the 2004/05 budget process has been updated and recalculated for the next three financial years. This is in accordance with the Prudential Code which requires that Council approves certain mandatory prudential indicators.
- 2.2** The purpose of the indicators is to provide a framework for capital expenditure decision making. These highlight the level of capital expenditure, the impact on borrowing and investment levels and the overall controls in place to ensure the activity remains affordable, prudent and sustainable.
- 2.3** Within this overall capital expenditure framework there is a clear impact on the Council’s treasury management activity, both on borrowing levels and the application of investment balances. As a consequence the treasury management strategy for 2005/06 incorporates the expected activity arising from this. This report also includes the treasury prudential indicators. The production of the treasury management strategy is in compliance with the CIPFA Code of Practice on Treasury Management.

3 CAPITAL INVESTMENT PROGRAMME & THE CAPITAL FINANCE REQUIREMENT (CFR)

- 3.1** The proposed capital programme can be partly financed by resources such as capital receipts, capital grants and other external funding sources. The remaining element which can not be directly financed from these sources will impact on the Council’s underlying need to borrow (the Capital Financing Requirement, or CFR). The summary capital expenditure, financing and the impact on the CFR are shown in the table at paragraph 3.5 below. This forms one of the required prudential indicators.

- 3.2** The Scottish Executive continue to provide direct loan charge support based upon a notional level of capital investment, expenditure above this limit is deemed as being unsupported and requires to be funded from the Council's own resources.
- 3.3** There are two main limiting factors on the Council's ability to undertake unsupported capital expenditure;
- (a) revenue resources must be available to support in full the implications of the capital expenditure, both borrowing costs and additional revenue costs;
- (b) the Scottish Executive may use a long stop control to ensure that either the total of all councils' plans do not jeopardise national economic policies, or in the event of an assessment by the Executive that local plans are unaffordable, it may implement a specific control to limit a Council's capital expenditure plans.
- 3.4** A key risk of the plan is that the level of government support has been estimated and is therefore subject to change. Similarly some of estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale.
- 3.5** The proposed General Services capital programme is the subject of a separate report to this meeting. The level of Housing capital spend for 2005/06 was approved by the Housing Committee at its meeting on 26 January 2005 as part of the consideration of rent levels. In order to meet the requirements of the prudential code committee is asked to approve the summary capital expenditure indicators below:

	2003/04 Actual £M	2004/05 Near Actual £M	2005/06 Estimated £M	2006/07 Estimated £M	2007/08 Estimated £M
Capital Expenditure					
Education	3.920	4.412	4.706	8.280	6.977
Social Work	0.338	0.700	2.165	3.620	0.350
Development Services	7.857	10.382	13.672	6.850	5.810
Neighbourhood Services	1.281	1.978	1.785	2.415	0.750
Policy & Resources	0.437	0.500	0.500	0.500	0.500
Homes & Technical	0.552	1.060	0.670	0.670	0.670
Council Issues	2.579	0.761	7.224	-	-
Total General Fund	19.964	19.763	30.722	22.335	15.057
HRA	10.037	11.453	12.427	13.660	15.027
Total Gross Capital Expenditure	27.001	31.246	43.149	35.995	30.084
Capital Receipts (HRA)	6.444	7.892	8.000	8.000	8.000
Capital Grants	5.742	8.837	12.784	4.610	2.357
Capital Reserves	-	-	-	-	-
Efficiency Savings	-	0.410	1.338	0.210	0.220
Revenue (CFCR)	3.561	3.561	3.561	3.561	3.561
Slippage – Prior Yr Schemes	-	-	5.145	2.450	-
Total Financing	15.747	20.700	30.828	18.831	14.138
Balance to Finance from External Borrowing	11.254	10.546	12.321	17.164	15.946
Being -					
HRA*	-	-	0.866	2.099	3.466
General Services	11.254	10.546	11.455	15.065	12.480

*The HRA is nil in 2003/04 and 2004/05 due to the use of capital receipts which offset any borrowing requirement.

- 3.6 The net capital expenditure will impact directly on the level of the Capital Financing Reserve (CFR). The Council is asked to approve the CFR projections below:

	2003/04 Actual £M	2004/05 Near Actual £M	2005/06 Estimated £M	2006/07 Estimated £M	2007/08 Estimated £M
CFR – Non Housing	122.822	129.166	142.489	154.899	161.584
CFR – Housing	68.746	67.703	67.759	68.948	71.348
Total CFR	191.568	196.869	210.248	223.847	232.932
Net movement in CFR		5.301	13.379	13.599	9.085

- 3.7 The expected impact of the capital expenditure decisions on the Council's debt and investment position are shown below. The net borrowing requirement is the expected level of new borrowing by Services from the consolidated loans fund, less annual repayment of principal. This is therefore a measure of projected new external borrowing.

	2003/04 Actual £M	2004/05 Near Actual £M	2005/06 Estimated £M	2006/07 Estimated £M	2007/08 Estimated £M
EXTERNAL DEBT	192.503	192.092	197.091	209.132	222.521
Net Borrowing Requirement	(0.411)	4.999	12.041	13.389	8.866
Other Long Term Liabilities	-	-	-	-	-
Total Debt at 31 March	192.092	197.091	209.132	222.521	231.387
Total Investments at 31 March	(22.650)	(25.000)	(25.000)	(25.000)	(25.000)

4 LIMITS TO BORROWING ACTIVITY

- 4.1 The Council needs to ensure that net external borrowing does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2005/06 and the next two financial years. This allows some flexibility for limited early borrowing for future years.

	2004/05 Near Actual £M	2005/06 Estimate £M	2006/07 Estimate £M	2007/08 Estimate £M
Gross Borrowing	197.091	209.132	222.521	231.387
Investments	(25.000)	(25.000)	(25.000)	(25.000)
Net Borrowing	172.091	184.132	197.521	206.387
CFR	196.869	210.248	223.847	232.932

- 4.2 This target will be met in the current year and it is not anticipated that there will be any difficulty in attaining the target in the future financial years. This view takes account of current commitments, existing capital plans and the proposals included within the proposed 3 year capital plan.

4.3 A further two Prudential Indicators control the overall level of borrowing which can be reached. These are:

- (a) **The authorised limit** – This represents the limit beyond which borrowing is prohibited, and needs to be set and revised by members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 35 (1) of the Local Government in Scotland Act 2003.
- (b) **The operational boundary** – This indicator is based on the probable external debt during the course of the year; it is not a limit and actual borrowing could vary around this boundary for short times during the year. It should however act as an indicator to ensure the authorised limit is not breached.

4.4 Council approval of the authorised and operational limits is required:

- (a) Authorised limit and operational boundary for external borrowing:

	2004/05 Near Actual £M	2005/06 Estimate £M	2006/07 Estimate £M	2007/08 Estimate £M
Authorised Limit	211.800	225.252	238.416	248.296
Operational Boundary	206.997	220.324	233.187	242.733

5 AFFORDABILITY PRUDENTIAL INDICATORS

5.1 The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the overall Council finances. The Council is asked to approve the following indicators:

- (a) **Actual and Estimates of the ratio of financing costs to net revenue stream** – This indicator identifies the trend in the cost of capital (borrowing costs net of investment income) against the net revenue stream.

Ratio of financing costs to net revenue stream

	2003/04 Actual	2004/05 Near Actual	2005/06 Estimate	2006/07 Estimate	2007/08 Estimate
Non-HRA	6.018%	6.253%	6.529%	6.714%	7.072%
HRA	17.264%	17.630%	17.039%	17.535%	18.203%

5.2 The estimates of financing costs include current commitments and the proposals in the general services and HRA revenue estimates.

(a) Estimates of the incremental impact of capital investment decisions on the Council Tax – This indicator identifies the trend in the cost of proposed changes in the three year capital programme recommended in the revenue estimates compared to the Council’s existing commitments and current plans. The forward assumptions are based on the assumptions included in the budget, but will invariably include some areas, such as the level of government support, which is provided at indicative levels only.

(i) Incremental impact of capital investment decisions on the Band ‘D’ Council Tax

	Proposed Budget 2005/06	Forward Projection 2006/07	Forward Projection 2007/08
Council Tax - Band D	£0.79	£4.17	£10.16

(b) Estimates of the incremental impact of capital investment decisions on Housing Rent levels – Similar to the Council tax calculation this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this budget report compared to the Council’s existing commitments and current plans, expressed as a change in weekly rent levels.

(ii) Incremental impact of capital investment decisions Housing Rent levels

	Proposed Budget 2005/06	Forward Projection 2006/07	Forward Projection 2007/08
Weekly Housing Rent levels	£0.03	£0.14	£0.30

6 TREASURY MANAGEMENT STRATEGY 2005/06 – 2007/08

6.1 Treasury Management is an integral part of the overall financial management of the Council. Its importance has increased as a result of the new freedoms provided by the prudential code. It covers the borrowing and investment activities and the effective management of the risks associated with these processes. Treasury Management activities are strictly regulated by statutory requirements and by the CIPFA Code of Practice on Treasury Management. This Council formally adopted the Code of Practice at its meeting on 2 May 2002, and as a result agreed a treasury management policy and practices statement.

6.2 The Treasury Management Policies and Practices require that the Executive Head of Finance reports on annual treasury strategy to this Committee outlining the forecast activity for the coming year. A further report is produced after the year end to report on actual activity for the year.

6.3 A key requirement of the strategy report is to explain the risks and the management of these risks that are associated with the treasury management service. This strategy report covers: -

- (a) The current treasury position
- (b) The expected movement in interest rates
- (c) The Council's borrowing and debt strategy
- (d) Required Treasury performance indicators
- (e) Specific Limits on Treasury Activity
- (f) Debt rescheduling

6.4 Current Treasury Position

6.4.1 All monetary transactions of the Council are pooled centrally and operated through the consolidated loan fund (C.L.F) which functions as a central banking function for the Council. Monies are thereafter "advanced" to Departments to meet revenue and capital commitments during the year. Interest is charged or credited to Departments based upon average monthly balances in the same way that a normal bank account would operate.

6.4.2 The Council's actual and estimated loan pool position as at 31 March 2004 and 31 March 2005 respectively is shown in the following table: -

		31/3/2004 Actual £M	Average Interest Rate	31/3/05 Estimate £M	Average Interest Rate
Fixed Rate Debt	PWLB	145.180	6.417%	123.971	6.532%
	Market	-	-	-	-
Variable Rate Debt	Market	45.600	3.760%	67.100	3.834%
	Other	1.310	5.235%	1.210	5.090%
Total Debt		192.090	5.778%	197.091	5.562%
Total Investments		-22.650	3.957%	(25.000)	4.250%
Net External Borrowing		169.440	6.022%	166.982	5.779%

6.5 Expected Movement in Interest Rates

6.5.1 The Councils treasury management advisors – Butlers provide an annual economic forecast which is summarised in the following paragraphs.

6.5.2 The Bank of England's November Inflation Report tended to support the more optimistic view on UK interest rates that has developed in the financial markets since the autumn. The tone of the document suggests the Monetary Policy Committee will be content to leave policy on hold, although the possibility of one more increase to a peak of 5% cannot be ruled out entirely at this stage.

- 6.5.3 The international backdrop appears to have become more benign. Overall growth in 2004 is expected to be at its strongest rate for 30 years but is expected to ease back in 2005, courtesy of tighter monetary conditions in the US, China and the UK and the deflationary impact of the rise in oil prices. Higher oil prices are likely to persist into the medium term, after which, new supply should help to alleviate the situation. Beyond 2005, global GDP growth is forecast to assume a steady profile.
- 6.5.4 In the UK, the economic backdrop appears to have become more settled. The housing market has finally begun to slow down and the Bank is hinting that house price inflation, rather than slowing to zero, could well move into modestly-negative territory. Significantly, the Bank suggests that the close relationship between house price inflation and spending growth has weakened. Consequently, falling house prices may not be accompanied by a sharp decline in consumers' expenditure. The continued buoyancy of the labour market may have something to do with this.
- 6.5.5 UK growth is expected to decelerate, although the Bank doubts the accuracy of the official industrial production data, which has been very weak for a number of months. Nevertheless, it suggests GDP growth will slow more quickly than had been projected in August. The extent of the deceleration may be more modest however. The depreciation in sterling should deliver a boost via an eventual improvement in the trade balance.
- 6.5.6 On the inflation front, the annual rate of increase in Consumer Price Inflation is expected to rise to 2% two years hence and a little more thereafter. Some supply bottlenecks, higher energy prices and the adverse effects of currency depreciation are cited as principal reasons for this. Nevertheless, the Bank does not anticipate a marked pick-up in labour costs and points to the fact that some rise in manufacturing inflation is being countered by greater stability in the service sector.
- 6.5.7 The report does stress that there are a huge number of uncertainties overshadowing the domestic as well as international backdrop. While some of these could lead the Bank to resume a process of policy tightening the Butler's economists consider that overall risks to growth and inflation are on the downside. The expected movement in interest rates are as follows:

Medium-Term Rate Forecasts – Annual Averages %

Percent	Base Rate	5-year Gilt	20-yr Gilt
2004/05	4.8	4.8	4.9
2005/06	4.6	4.7	4.8
2006/07	4.3	4.5	4.6
2007/08	4.8	5.0	5.1

- 6.5.8 The key risks to the forecasts surround the strength of the US recovery. Since this will be the key driver of world growth, and like the UK borrowing drives much of the growth, a fall in consumer confidence may see the US recovery falter and the upward pressure on UK short and long-term fixed rates will cease.
- 6.5.9 Similarly the US recovery may ignite the world economy seeing strong and sustainable world growth, increasing inflationary pressures and a higher than expected increases in short and long-term rates.

7 BORROWING AND DEBT STRATEGY 2005/06 -2007/08

- 7.1** The introduction of the Prudential Code and uncertainty over future interest rates increases the risks associated with the treasury strategy. As a result the Council should continue to adopt a cautious approach to its treasury strategy.
- 7.2** Long-term fixed interest rates are expected to rise and base rates are expected to remain relatively flat. The Executive Head of Finance will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above. It is likely that if base rates remain comparatively cheap borrowing will be maintained at relatively short term periods pending longer term rates falling.
- 7.3** With increasing interest rates debt restructuring is more likely to take place early in the financial year, although the Executive Head of Finance will monitor prevailing rates for any opportunities during the year.

8 INVESTMENT STRATEGY 2005/06 – 2007/08

- 8.1** The main principle governing the Council's investment criteria is the security and liquidity of its investments as opposed to absolute return, although the yield or return on the investment will remain an influencing factor. Adopting this main principle, action will be taken to ensure:
- (a)** There is liquidity within the investment portfolio. For this purpose consideration will be taken of the maximum periods for which funds may be prudently committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.
 - (b)** That a policy is maintained covering the categories of investment types selected to invest in, the criteria for choosing investment counterparties with adequate security, and the monitoring of their security.
- 8.2** The Executive Head of Finance maintains a counterparty list in compliance with the criteria set out within the approved Treasury Policies and Practices. This is reviewed on a regular basis in conjunction with the treasury advisors to ensure the maximum availability in investment opportunity.
- 8.3** Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of remaining stable during the first half of 2005/06, with a risk of falling after this. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts. It is likely that investment decisions will be made for longer periods with fixed investments rates to lock in good value and security of return. The Executive Head of Finance will undertake the most appropriate form of investment depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above.

8.4 Treasury Management Prudential Indicators and Limits on Activity

8.4.1 There are four treasury prudential indicators. The purpose of these prudential indicators is to contain the activity of the treasury function within certain limits, thereby reducing the risk or likelihood of an adverse movement in interest rates or borrowing decisions impacting negatively on the Council's overall financial position. However if these are set to be too restrictive they will impair the opportunities to reduce costs. The indicators are:

- (a) Upper limits on variable rate exposure – This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments.
- (b) Upper limits on fixed rate exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.
- (c) Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- (d) Total principal funds invested for greater than 364 days – These limits are set to reduce the need for early sale of an investment, and are based on the availability of investments after each year-end. The use of investments greater than 364 days, although under review, is currently prohibited in Scotland, so this indicator is set as nil. Indicative rates are proposed that would be adopted if legislation is enabled in the current financial year.

The Council is asked to approve the following prudential indicators:

- (a) Adoption of CIPFA Code – This has been incorporated within the Treasury Management Policies and Practices.
- (b) Interest rate Exposure: -

	2005/06 Upper Limit	2006/07 Upper Limit	2007/08 Upper Limit
Debt – fixed rate interest	95%	95%	95%
Debt – variable rate interest	40%	40%	40%

- (c) Maturity of Long Term External Debt: -

Maturity Period	Upper Limit	Lower Limit
Under 12 months	20%	0%
12 months to 2 years	20%	0%
2 years to 5 years	50%	0%
5 years to 10 years	75%	0%
10 years and above	95%	25%

(d) Upper Limit on Sums Invested for more than 364 Days

Investment Period	Upper Limit
Under 12 months	100%
12 months to 2 years	20%
2 years to 5 years	10%
5 years to 10 years	5%
10 years and above	5%

(The proposed investment limits are indicative and may be revised if anticipated investment guidance is received from the Scottish Executive)

8.5 Performance Indicators

8.5.1 The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

- (a)** External Borrowing - Average rate of borrowing for the year compared to average available.
- (b)** Comparison of average rate of interest and expenses incurred during the financial year – “Pool Rate”.

The results of these indicators will be reported in the Treasury Annual Report for 2004/05.

8.6 Revenue Implications 2005/06 Onwards

8.6.1 The following table sets out the assumptions made about interest and expenses together with debt redemption in setting the annual debt charges estimates for 2003/04 and the subsequent 2 financial years.

<u>LOANS FUND REVENUE ACCOUNT</u>	<u>2005/06 £M</u>	<u>2006/07 £M</u>	<u>2007/08 £M</u>
Interest	13.335	13.685	14.230
Interest on Internal Balances	0.500	0.550	0.600
Loans Fund Expenses	0.300	0.300	0.300
Annual Cost of Premiums	0.440	0.440	0.440
Principal Redemption In Year	5.425	6.225	7.080
Investments – Interest Received	(0.500)	(0.500)	(0.500)
Total Costs to Recharge in Year	19.500	20.700	22.150
<u>Service Allocation</u>	<u>2005/06 £M</u>	<u>2006/07 £M</u>	<u>2007/08 £M</u>
General Fund Services	14.000	15.000	16.200
Housing Revenue Account	5.500	5.700	5.950
Total	19.500	20.700	22.150

8.6.2 These estimates will provide a base position against which the performance of the loans fund will be monitored and reported on during the financial year.

8.7 Debt Rescheduling

- 8.7.1 During 2004/2005 a rescheduling exercise was carried out in which £21.500M of Public Works Loan Board debt with an average interest rate of 5.759% was repaid and replaced with 2 market loans with maturity periods of 48 and 50 years at an interest rate, fixed initially for 7 years of 3.99%. A premium of £2.431M was incurred which will be amortised over the replacement period. The expected annual savings are estimated at £0.330M and these have been incorporated within the revenue estimates.
- 8.7.2 Further opportunities to manage the external debt portfolio through prudent rescheduling will be sought taking necessary advice from our appointed Treasury Advisors as necessary.

8.8 Treasury Advisors

- 8.8.1 At the meeting of this Committee on 3 October 2002, it was agreed to re-appoint Butlers as Treasury Management Advisors for a period of 3 years. During this period of their appointment they have provided a comprehensive treasury management service which has included the identification of a number of debt rescheduling opportunities which have resulted in considerable savings being recognised.
- 8.8.2 It is the view of the Executive Head of Finance that to ensure continuity in the approach adopted in respect of treasury management, and in particular debt and investment strategy the existing contract should be extended. Accordingly with reference to section 9(3) of standing orders relating to contracts authority is sought to enter into a process of negotiation with the existing service provider to extend the agreement for a further period of 3 years, at an estimated annual cost of £15,000.

9 FINANCIAL IMPLICATIONS

- 9.1 The revenue implications shown in paragraph 8.6.1 have been included within the respective estimates for the General Fund and the Housing Revenue Account for 2005/06.

10 POLICY/LEGAL IMPLICATIONS

- 10.1 The Treasury Management Policies and Practices will be updated to reflect the revised operating limits set out paragraph 8.4.

11 RECOMMENDATIONS

It is recommended that the Committee: -

- 11.1 recommended to the Council that the Prudential Indicators set out in paragraphs 3.5; 3.6; 3.7; 4.1; 4.4; 5.1; 5.2 are approved;
- 11.2 authorise the Executive Head of Finance to negotiate the extension of the existing treasury advisory service; and
- 11.3 otherwise, note the content of the report.

Alex McPhee

Executive Head of Finance

RB
16 January 2005

LIST OF BACKGROUND PAPERS NIL

Any person who wishes any further information on this report should contact Robin Baker, Financial Controller, Tel 01563 576331