

EAST AYRSHIRE COUNCIL

POLICY AND RESOURCES COMMITTEE – 14 NOVEMBER 2006

TREASURY MANAGEMENT ANNUAL REPORT FOR 2005/2006 AND REVIEW OF ACTIVITY FOR 2006/07

Report by Executive Head of Finance

1 PURPOSE OF REPORT

- 1.1** To inform Members of the Committee of the treasury activity for the financial year ended 31 March 2006. The report also covers the actual Prudential Indicators for 2005/06 in accordance with the requirements of the Prudential Code, and reviews current year performance.

2 BACKGROUND INFORMATION

- 2.1** The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:

- The Local Government in Scotland Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;
- The Act permits the Scottish Ministers to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (although no restrictions were made in 2005/06);
- Statutory Instrument (SSI) 29 2004, requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities, and therefore to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;

- 2.2** The Council undertakes capital expenditure to create, improve or enhance the life of its assets. These activities can be funded from related income such as capital receipts, capital grants with any residue which cannot be immediately paid for giving rise to a borrowing need. This borrowing need will be charged to revenue over a number of years. This area of capital expenditure activity is regulated by the CIPFA Prudential Code, which requires actual outturn to be reported in the following areas:

- Capital expenditure;
- Capital Financing Requirement;
- Debt;
- Ratio of financing costs to net revenue stream.

Additional indicators are included to ensure comprehensive annual reporting.

- 2.3** Part of the Council's treasury activities is to address any borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council. The wider treasury activities also include managing the Council's cash flows, its previous borrowing activities and the investment of surplus funds. These activities are structured to manage risk foremost, and then optimise performance in accordance with the CIPFA Code of Practice on Treasury Management.
- 2.4** The Code requires as a minimum the regular reporting of treasury management activities to: -
- (a)** Forecast the likely activity for the forthcoming year in this respect the annual strategy report was approved by this committee at its meeting on 30 March 2006.
 - (b)** Review actual activity for the proceeding year and comment on interim performance in the current financial year which is the purpose of this report.

3 PERFORMANCE SUMMARY 2005/06

3.1 The Council's Capital Expenditure and Financing 2005/06

During 2005/06 the total capital investment undertaken by the Council was £24.410M. This forms one of the required prudential indicators (a list of all mandatory indicators is at Appendix 1), and the table below shows how this was financed with the resultant need to borrow of £8.153M.

	General Fund	Housing	Total
	£'M	£'M	£'M
Total capital expenditure	14.434	9.976	24.410
Resourced from:			
Capital receipts	(0.634)	(8.830)	(9.464)
Capital grants	(5.543)	-	(5.543)
Revenue	(0.104)	(1.146)	(1.250)
Un-financed capital expenditure (additional need to borrow)	8.153	0.000	8.153

3.2 The Council's Overall Borrowing Need

The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This figure is a gauge for the Council's external debt position and represents all 2005/06 plus all historic net capital expenditure which has not yet been charged to revenue. This is equivalent to the outstanding balances on the Consolidated Loan Fund (CLF) which operates as the internal bank of the Council making capital advances to borrowing departments during the year to support their investment programmes, these advances are subsequently repaid to the CLF over the useful life of the asset, together with interest and expenses. The following table summarises the movement in the Council's Capital Financing Requirement (CFR) during 2005-06.

	General Fund	Housing	Total
	£'M	£'M	£'M
Opening balance 1 April 2005	125.697	63.199	188.896
Add : Un-financed capital expenditure 2005/06 (3.1 above)	8.153	-	8.153
Less : CLF repayments due in 2005/06 on historic debt	(5.429)	(1.127)	(6.556)
Less : Capital Receipts used to reduce historic debt	(0.698)	(7.381)	(8.079)
Closing balance 31 March 2006	127.723	54.691	182.414

3.3 Treasury Position at 31 March 2006

Whilst the Council's gauge of its underlying need to borrow is the CFR, the Executive Head of Finance can manage the Council's actual borrowing position by either borrowing to finance the CFR, choosing to utilise some temporary cash flow funds instead of borrowing (under-borrowing), or borrowing for future increases in the CFR (borrowing in advance of need).

During 2005/06 slippage in the capital programme meant that there was no increase in the underlying need to borrow and therefore external borrowing was held effectively static with the net movement representing the council's existing obligations to meet external loan repayments during 2005/06.

The short term investments held represent the general and specific reserves of the council combined with its working capital requirements. The level of these investments increased by £8.950M during 2005-06 predominantly as a result of the surplus cash generated by the reduction in the Capital Financing Requirement (3.2 above) not being offset by a corresponding reduction in external borrowing.

The movement in the external debt portfolio of the Council during 2005/06 compared to the previous year is shown in the following table.

Category	O/S at	Net movement in Debt Level	O/S at
	1 April 2005 - £M		31 March 2006 - £M
Public Works Loan Board	123.663	(0.302)	123.361
Market Loans	67.100	-	67.100
Temporary Borrowings	0.000	-	0.000
European Investment Bank	0.287	(0.092)	0.195
Trusts & Bequests etc.	0.774	0.001	0.775
TOTAL BORROWING	191.824	(0.393)	191.431
Short Term Investments	(39.800)	(8.950)	(48.750)
NET EXTERNAL DEBT	152.024	(17.417)	142.681

In order to mitigate the risk from interest rate movements, limits are in place which restrict the ratio of fixed to variable rate debt to 60:40. The table below analyses the external debt between fixed and variable rates of interest at 31 March 2006. The average interest rates shown are as at 31 March 2006.

Category	Principal	% of Total	Average
			Interest Rate
Fixed Interest Rate Debt	172.061	89.88%	5.84%
Variable Interest Rate Debt	19.370	10.12%	5.05%
Total External Debt	191.431	100.00%	5.76%
Fixed Interest Investments	(46.500)	95.38%	4.56%
Variable Rate Interest	(2.250)	4.62%	4.40%
Total External Investments	(48.750)	100.00%	4.55%
NET EXTERNAL DEBT	142.681		

3.4 Performance Indicators

The headline performance indicator for treasury management is the average cost of servicing loans as reflected in the consolidated loans fund interest and expenses rate – the pool rate. The performance over the last 3 financial years is shown below.

Year	Opening Advances	Closing Advances	Average Advances	Interest & Expenses	Pool Rate
	£'M	£'M	£'M	£'M	%
2003/04	189.395	191.568	190.482	11.422	6.00%
2004/05	191.568	188.899	190.233	10.422	5.49%
2005/06	188.899	182.413	185.655	9.44	5.09%

The reduction in the annual average rate has been achieved by debt rescheduling to take advantage of the availability of lower interest rates in recent years, together with higher investments resulting in increased income received during the year. Future reductions in this rate are not anticipated as no further reductions in market interest rates are forecast. The rate for

2006/07 is forecast to increase slightly as some of the current loan portfolio exits the initial low interest period.

3.5 Prudential Indicators and Compliance Issues

The Prudential Code requires that the actual prudential indicators for the financial year 2005/06 are reported to members, these are included for information in Appendix 1. A number of these indicators provide either an overview or a limit on treasury activity, and these are explained below:

3.5.1 Capital Financing Requirement

In order to ensure that borrowing levels are prudent, over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. Net borrowing should not therefore, except in the short term, exceed the CFR for 2005/06 plus the expected changes to the CFR over 2006/07 and 2007/08. The table below confirms that the Council has complied with this at 31 March 2006.

	Original	Actual	ACHIEVED
Net borrowing position	184.132	141.907	YES
Capital Financing Requirement (CFR)	210.248	182.414	YES

The actual level of net borrowing and CFR were less than the original indicator value set in February 2005 as the levels of capital expenditure during both 2004/05 and 2005/06 were lower than anticipated. The net borrowing position was also reduced by the higher level of investment balances.

3.5.2 Authorised Limit & Operational Boundary

The Authorised Limit is the "Affordable Borrowing Limit" required by Section 35 of the Local Government in Scotland Act 2003. This is the Council's maximum borrowing level and was originally set at £225.252M for 2005/06.

The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or over the Boundary are acceptable subject to the Authorised Limit not being breached. This was originally set at £220.324M for 2005/06.

During 2005/06 the maximum level of actual borrowing was £191.824M and did not exceed either limit.

3.5.3 Maturity Structure of Fixed Borrowing

The amount of fixed rate debt due to mature in 10 years or more is 99.25% compared to the original target level of 95%. The target of 95% had been exceeded in 2004/05 due in the main to previous rescheduling which took advantage of fixed longer term interest rates. This limit was revised to 100% when the indicators for 2006/07 were set by this committee on 28 March 2006. This position will continue to be reviewed as part of the overall portfolio management process.

3.6 Investments Held by the Council

Councils in Scotland are legally restricted in the range of investment products which they can use and investments are therefore placed with institutions such as banks, building societies and other local authorities. During the year the Council maintained an average investment balance of £46.546M and received an average return of 4.74%. The comparable performance indicator is the average 7 day investment rate as offered by the market, which was 4.57%.

3.7 Operational Limits

The Council seeks to comply with best practice in all areas of treasury management. During 2005/06 the following limits were set and adhered to: -

LIMIT	PURPOSE	ACHIEVED
The ratio of fixed rate loans to variable rate should not exceed 60:40	Limits the exposure to increases in interest rates and provides budget certainty	YES
The maximum amount of debt maturing in 1 Year not to exceed 25%	To limit any exposure to high interest rates when renewing maturing debt	YES
No broker should handle more than 75% of annual treasury transactions	To prevent over reliance on one broker and ensure competition within market is utilized	YES
No more than 20% of total investments at any time should be placed with one counterparty	To limit exposure with any one counterparty	YES

4 INTERIM PERFORMANCE DURING 2006/07

The following provides an interim analysis of the Council's treasury management activities during the period April to September 2006.

4.1 Interest Rates

In approving the treasury strategy for 2006/07 members noted that long-term fixed interest rates were expected to rise modestly and base rates were expected to fall initially by ¼% before rising again in 2007/08. In practice rates have remained relatively flat with a modest ¼% increase in the base rate in August 2006 which had already been discounted by the market. The consensus view is that there is still the potential for a further ¼ % rise before the end of the calendar year. However there is no threat to the medium and longer term rates with the majority view being no significant changes for the foreseeable future. This is based on current economic data and economists' forecasts which are continually monitored.

4.2 Borrowing Strategy

To date during 2006/07 there has been no requirement to borrow long term to finance capital expenditure. This is due both to the slippage in the original programme and the spend profile of the revised programme. The need to

borrow will continue to be monitored closely as slippage in capital spending has led to a reduced Capital Financing Requirement. Therefore any borrowing in 2006/07 will only occur if long term interest rates remain comparatively cheap and it is considered advantageous to lock into the low rates available to fund future planned capital expenditure or to improve the maturity profile of existing loans.

4.3 Investment Strategy

The investment portfolio continues to be managed to ensure both liquidity and optimum rates of interest. During the six months to 30 September 2006 the Council maintained an average investment balance of £55.995M and the average investment rate achieved on the 30 September was 4.77% is slightly higher than the overall rate for 2005/06.

4.4 Performance Indicators

It is expected that the Council's pooled interest rate will outturn at a higher level than the 2005/06 figure of 5.09%. The outturn will depend in part on the overall levels of investments held and the associated income received during the year which will be influenced by the interest rates available, this position will continue to be monitored during the year.

4.4 Treasury Operational Limits

The limits set for the treasury function for the first half of 2006/07 have been complied with.

5 FINANCIAL/ LEGAL/ AUTHORITY IMPLICATIONS

Nil

6 POLICY IMPLICATIONS

The treasury management policies and practices have been complied with during the year.

7 RECOMMENDATIONS

It is recommended that members note the contents of the report.

Alex McPhee
Executive Head of Finance

LS 20 Oct 2006

LIST OF BACKGROUND PAPERS NIL

Members wishing further information should contact Lorna Service, Exchequer Manager, Telephone (01563) 576405.

ACTUAL PRUDENTIAL INDICATORS 2005/06

	2005/06 Original £'M	2005/06 Actual £'M
1. Capital Expenditure		
General Fund	25.577	14.434
Housing	12.427	9.976
Total	38.004	24.410
2. Capital Financing Requirement (CFR)		
General Fund	142.489	127.723
Housing	67.759	54.691
Total	210.248	182.414
3. Total External Borrowing		
Borrowing	209.132	191.431
Other Long Term Liabilities	-	-
Total Debt	209.132	191.431
Investments	(25.000)	(48.750)
Net Borrowing	184.132	142.681
4. Authorised Limit	225.252	191.824
5. Operational Boundary	220.324	191.824
6. Ratio of Financing Costs to Net Revenue Stream		
General Fund	6.53%	6.03%
Housing	17.04%	14.59%
7. Incremental Impact of Capital Investment on Council Tax	£7.02	£7.02
8. Incremental Impact of Capital Investment on Housing Rents	£0.03	£0.00
9. Upper Limits on Fixed Interest rates	95%	89.88%
10. Upper Limits on Variable interest rates	40%	10.12%
11. Maturity Structure of Fixed rate Borrowing (against maximum position in year)	Limit	Actual
Under 12 Months	20%	0.01%
12 Months – 2 Years	20%	0.01%
2 Years – 5 Years	50%	0.05%
5 Years – 10 Years	75%	0.36%
10 Years and above	95%	99.57%
12. Maximum principal funds invested	100% < 1 Year	100% < 1 Year
13. Adoption of CIPFA Code of Practice-	Yes	Yes