

**HERTFORDSHIRE COUNTY COUNCIL**

**CABINET**

**MONDAY 9 FEBRUARY 2004 AT 2.00 P.M.**

**COUNTY COUNCIL**

**THURSDAY 12 FEBRUARY 2004 AT 10.30 A.M.**

*(please retain for County Council meeting)*

Agenda item no.

**Cabinet**

**2A**

**County Council**

**9B**

**TREASURY MANAGEMENT STRATEGY & IMPLEMENTATION OF THE PRUDENTIAL CODE FOR CAPITAL FINANCE**

Report of the Finance Director

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Executive Member: David Beatty

**1. Purpose of Report**

To set out the requirements of the CIPFA Prudential Code for Capital Finance in Local Authorities and to recommend a treasury management strategy for 2004/05 in accordance with the CIPFA Code of Practice for Treasury management in the Public Services.

This report will also need to be considered by the Council on 12 February and Members are asked to bring this report with them to that meeting.

**2. Summary**

The CIPFA Prudential Code for Capital Finance in Local Authorities is to be implemented from 1 April 2004. The code sets out a framework for self-regulation of capital spending, in effect allowing councils to invest in capital projects without any government set limit as long as they are affordable, prudent and sustainable.

The primary change is that the current credit approvals (Basic Credit Approvals (BCAs) and Supplementary Credit Approvals (SCAs)), will be abolished and there will be no restriction on capital investment, subject to Government reserve powers to restrict borrowing for national economic reasons. With the abolition of the current framework, Government support for capital investment will be provided through Supported Capital Expenditure (Revenue) – single capital pot element (for the BCA element) and Supported Capital Expenditure (Revenue) – separate programme element (for the SCA element). From 2004/05 the Council will be able to engage in additional unsupported borrowing provided this is affordable, prudent and sustainable.

The use of the Supported Capital Expenditure (Revenue) element in the capital finance FSS calculations for 2004/05 is similar to that of credit approvals. This means that the FSS will be adjusted to reflect the financing costs associated with Government supported borrowing, so that such borrowing will not impact on future council tax levels.

To facilitate the decision making process and support capital investment decisions the Prudential Code requires the Council to agree and monitor a number of prudential indicators. The indicators cover affordability, prudence, capital expenditure, external debt and treasury management. These indicators will also form the basis of in year monitoring and reporting.

The indicators are purely for internal use by the Council and are not to be used as comparators between councils, as differing investment histories and local circumstances mean that such comparisons would be meaningless. The benefit from monitoring will arise from following the movement in indicators over time and looking at year on year changes.

The prudential indicators that the Council need to consider and approve to comply with the Prudential Code are:

- Estimates of total planned capital expenditure
- The capital financing requirement (underlying need to borrow for a capital purpose)
- Authorised limit for external debt
- Operational Boundary for external debt
- The ratio of financing costs to the net revenue stream
- The incremental impact of capital investment decisions on the Council Tax

The proposed treasury management strategy for 2004/05 seeks to take advantage of expected interest rate rises, by borrowing early in the year when rates are lower and investing for longer periods.

A full schedule of prudential indicators that will require council approval is shown in Appendix A.

### **3. Conclusions**

This report needs to be considered in conjunction with the budget report also on this agenda.

The Cabinet need to consider the prudential indicators set out in this report and summarised in Appendix A and to make recommendations to the Council in respect of these indicators.

## 4. Background

### 4.1. The Prudential Code

The prudential indicators that the Council need to consider and approve to comply with the Prudential Code are:

- Estimates of total planned capital expenditure
- The capital financing requirement (underlying need to borrow for a capital purpose)
- Authorised limit for external debt
- Operational Boundary for external debt
- The ratio of financing costs to the net revenue stream
- The incremental impact of capital investment decisions on the Council Tax

These indicators are explained in the following paragraphs together with the proposed indicators to be used for the Council.

The Treasury Management indicators are discussed in the context of the treasury management strategy in paragraph 8 onwards.

### 4.2. Estimates of total planned capital expenditure

The total actual capital expenditure for 2002/03, latest estimate of capital expenditure for the current year, estimates of capital expenditure for future years and the proposed financing of the programme are set out below. The detail of the proposed programme can be found elsewhere in the budget report.

*Table 1: Summary of Capital Expenditure and Financing*

	<b>2002/03 Actual £'000</b>	<b>2003/04 Estimate £'000</b>	<b>2004/05 Estimate £'000</b>	<b>2005/06 Estimate £'000</b>	<b>2006/07 Estimate £'000</b>
Capital Expenditure	92,100	106,259	146,547	111,942	28,560
Financed by:					
Capital Receipts	17,670	32,341	35,808	25,528	12,113
Capital Grants	24,739	24,422	39,838	17,392	1,649
Direct Revenue Contributions	12,416	8,492	9,032	9,032	9,032
Capital Payback Contributions		1,692	3,656	2,876	2,417
Education Capital Reserve		277	2,330		
Other Contributions			2,050		
Creditors	311				
<b>Borrowing:</b>					
Supported	36,964	39,035	52,075	57,114	3,349
Unsupported			1,758		
<b>Total Financing</b>	<b>92,100</b>	<b>106,259</b>	<b>146,547</b>	<b>111,942</b>	<b>28,560</b>

Total financing appears to be falling over the next three years, but this is only because external financing figures for 2005/06 and 2006/07 will only be announced as part of the capital settlement for those years.

### 4.3. The Capital Financing Requirement

The Capital Financing Requirement measures the authority's underlying need to borrow for a capital purpose. In accordance with best professional practice, Hertfordshire County Council does not associate borrowing with particular items or types of expenditure. The authority has an integrated treasury management strategy and has adopted the CIPFA *Code of Practice for Treasury Management in the Public Services*. Hertfordshire County Council has, at any point in time, a number of cashflows both positive and negative, and manages its treasury position in terms of its borrowings and investments in accordance with its approved treasury management strategy and practices. In day to day cash management, no distinction can be made between revenue cash and capital cash. External borrowing arises as a consequence of all the financial transactions of the authority and not simply those arising from capital spending. In contrast, the Capital Financing Requirement reflects the authority's underlying need to borrow for a capital purpose.

Estimates of the end of year Capital Financing Requirement for the authority for the current and future years and the actual Capital Financing Requirement at 31 March 2003 are:

*Table 2: Capital Financing Requirement*

<b>31/03/03 Actual £'000</b>	<b>31/03/04 Estimate £'000</b>	<b>31/03/05 Estimate £'000</b>	<b>31/03/06 Estimate £'000</b>	<b>31/03/07 Estimate £'000</b>
235,580	257,867	301,092	345,869	335,090

CIPFA's *Prudential Code for Capital Finance in Local Authorities* includes the following as a key indicator of prudence:

*"In order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of capital Financing Requirement in the preceding year plus the estimates of any additional Capital Financing Requirement for the current and next two financial years".*

To compare to the Capital Financing Requirement numbers shown above with net external borrowing, the Council's gross borrowing and net borrowing figures for the comparable years are:

Table 3: Net Borrowing

	2002/03 £'000	2003/04 £'000	2004/05 £'000	2005/06 £'000	2006/07 £'000
Gross borrowing	158,252	218,080	275,096	332,210	335,559
Investments	100,850	125,000	140,000	145,000	150,000
Net borrowing	57,402	93,080	135,096	187,210	185,559

The Finance Director reports that the authority had no difficulty meeting this requirement in 2002/03, nor are any difficulties envisaged for the current or future years. This view takes into account current commitments, existing plans, and the proposals in this budget report.

#### 4.4. Authorised limit for external debt

This indicator represents the limit beyond which borrowing is prohibited, and needs to be set by members, with any subsequent revisions also requiring member approval.

It is recommended that the Council approves the following Authorised Limits for its total external debt gross of investments for the next three financial years. These limits separately identify borrowing from other long term liabilities such as finance leases. The Council is asked to approve these limits and to delegate authority to the Finance Director, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long term liabilities, in accordance with option appraisal and best value for money for the authority. Any such changes made will be reported to the Council at its next meeting following the change.

Table 4: Authorised Limit for External Debt

	2003/04 £'000 Comparator	2004/05 £'000	2005/06 £'000	2006/07 £'000
Borrowing	230,000	305,000	348,000	338,000
Other Long Term Liabilities		5,000	10,000	10,000
Net borrowing	230,000	310,000	358,000	348,000

The Finance Director reports that these Authorised Limits are consistent with the authority's current commitments, existing plans and the proposals in this budget report for capital expenditure and financing, and with its approved treasury management policy statement and practices. The Finance Director confirms that they are based on the estimate of most likely, prudent but not worst case scenario, with in addition sufficient headroom over and above this to allow for operational management, for example unusual cash movements. Risk analysis and risk management strategies have been taken into account; as have plans for capital expenditure and capital receipts,

estimates of the Capital Financing Requirement and estimates of cashflow requirements for all purposes.

#### **4.5. Operational Boundary for external debt**

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 the boundary for short times during the year. It acts as an indicator to ensure that the authorised limit is not breached.

The Council is asked to approve the following Operational Boundary for external debt for the same time period. The proposed Operational Boundary for external debt is based on the same estimates as the Authorised Limit but reflects directly the Finance Director's estimate of the most likely, prudent but not worst scenario, without the additional headroom included within the Authorised Limit to allow for example for unusual cash movements. The Operational Boundary represents a key management tool for in year monitoring by the Finance Director within the Operational Boundary, figures for borrowing and other long term liabilities are separately identified. The Council is also asked to delegate authority to the Finance Director, within the total Operational Boundary for any individual year, to effect movement between the separately agreed figures for borrowing and other long term liabilities, in a similar fashion to the Authorised Limit. Any such changes will be reported to the Council at its next meeting following the change.

*Table 5: Operational Boundary for External Debt*

	<b>2003/04 £'000 Comparator</b>	<b>2004/05 £'000</b>	<b>2005/06 £'000</b>	<b>2006/07 £'000</b>
Borrowing	219,000	273,000	332,000	335,000
Other Long Term Liabilities		2,000	5,000	5,000
Net borrowing	219,000	275,000	337,000	340,000

The Council's external debt at 31 March 2003 was £158.25m. It should be noted that actual external debt is not directly comparable to the authorised limit and operational boundary, since the actual external debt reflects the position at one point in time.

#### **4.6. The ratio of financing costs to the net revenue stream**

This indicator is intended to assist in the assessment of the affordability of the council's capital plans. It compares the net cost of borrowing (net of interest and investment income) to the council's estimated annual income from government revenue grants, national non-domestic rates and council tax.

Estimates of the ratio of financing costs to net revenue stream for the current and future years and the actual figures for 2002/03 are:

*Table 6: Ratio of financing costs to the net revenue stream*

<b>2002/03 Actual</b>	<b>2003/04 Estimate</b>	<b>2004/05 Estimate</b>	<b>2005/06 Estimate</b>	<b>2006/07 Estimate</b>
0.65%	0.56%	0.68%	0.95%	1.11%

The estimates of financing costs include current commitments and the proposals contained in this budget report.

#### **4.7. The incremental impact of capital investment decisions on the Council Tax**

This indicator identifies the year on year impact of the proposed changes in the three year capital programme recommended in this budget report compared to the council's existing commitments and current plans.

*Table 7: Council Tax Impact*

	<b>Proposed Budget 2004/05</b>	<b>Forward Projection 2005/06</b>	<b>Forward Projection 2006/07</b>
Council Tax impact – Band D	+£3.54	-£2.52	-£4.82

#### **4.8. Treasury Management Strategy**

The treasury management service covers the borrowing and investment activities and the effective management of associated risks. Its activities are strictly regulated by statutory requirements and a professional code of practice (the *CIPFA Code of Practice on Treasury Management in the Public Services*). The Council adopted the Code of Practice on 14 February 2002, and as a result adopted a treasury management policy statement at the same meeting.

The Policy requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming three years. A further report is produced and circulated to members after the year-end to report on actual activity for the year.

#### 4.9. Current Treasury Position

Table 8 below summarises the treasury position as at the end of the last financial year (31 March 2003) and the estimate for the position at the end of the current financial year (31 March 2004).

*Table 8: Current Treasury Position*

		<b>31/3/03 Actual</b>	<b>Rate</b>	<b>31/3/04 Estimate</b>	<b>Rate</b>
<b><u>Borrowing</u></b>					
Fixed Rate Debt	PWLB	£138.72m	5.60%	£138.68m	5.60%
	Market	£16.4m	4.02%	£36.4m	3.50%
Variable Rate Debt	PWLB	£3.13m	3.99%	£43.0m	4.10%
	Market	-	-	-	-
Total Debt		£158.25m	5.43%	£218.08m	5.14%
Other Long Term Liabilities		-		-	
<b>Total</b>		<b>£158.25m</b>	<b>5.43%</b>	<b>£218.08m</b>	<b>5.14%</b>
<b><u>Investments</u></b>					
Fixed Investments		£100.33m	3.97%	£125.0m	3.70%
Variable Investments		-		-	
<b>Total Investments</b>		<b>£100.33m</b>	<b>3.97%</b>	<b>£125.0m</b>	<b>3.70%</b>
<b>Net Borrowing</b>		<b>£57.92m</b>		<b>£93.08m</b>	

#### 4.10. Interest Rates

Butlers, the Council's treasury management advisers, have provided the following forecast of interest rates for the next twelve months.

*Table 9: Base Rate Forecast*

		<b>Base Rate</b>
	Current	3.75%
2004	March	4.00%
	June	4.25%
	September	4.50%
	December	4.50%
2005	March	4.50%

*Source: Butlers*

This shows an expected gradual rise in interest rates over the next twelve months. It is believed that the Bank of England will wish to counter the threat to inflation from an increase in domestic and international activity by raising rates. However they are also concerned about raising rates too quickly, due to the potential damaging impact upon debt servicing costs in the personal sector.

The medium-term outlook for rates is as follows:

*Table 10: Medium Term Forecast*

	<b>Average Base Rate</b>
2003/04	3.7%
2004/05	4.4%
2005/06	4.6%
2006/07	4.8%

*Source: Butlers*

#### **4.11. Borrowing Strategy**

The Finance Director, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates, the risks of changes in rates and the requirements of the Capital Programme.

One loan of £11.7m is due for repayment in October 2004. It is planned to replace this loan and to borrow up to the Operational Boundary of £275m (discussed in 4.5 above) to fund the Capital Programme. It is likely that longer-term rates will be relatively cheap early in 2004/05 and so if this remains the case, borrowing will be undertaken early in the year.

The need for borrowing and the level of interest rates will be monitored during the year by the Finance Director with the advice of Butlers to determine precisely how much to borrow and when. The decision regarding the borrowing periods will be driven by prevailing interest rates and the need to even out the maturity profile of the borrowing portfolio (see Table 13).

#### **4.12. Investment Strategy**

The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers' own forecasts. Currently the market is pricing stronger increases than the forecasts suggest. In this situation, investments will be made for longer periods with fixed rates to lock in good value and security of return.

The Finance Director, under delegated powers, will undertake the most appropriate form of investment depending on the prevailing interest rates at the time, and the Council's cash flow requirements. All investments will be made in accordance with the Council's Treasury Management Policy Statement, this strategy document and prevailing legislation and regulations.

The expected average cash balance is shown below with the expected interest rate and interest earned for the current year and the following three years:

*Table 11: Cash Balances*

<b>Estimates</b>	<b>2003/04</b>	<b>2004/05</b>	<b>2005/06</b>	<b>2006/07</b>
Average Cash Balance	£125m	£140m	£145m	£150m
Average Interest Rate	3.7%	4.3%	4.5%	4.7%
Expected Interest Earned	£4.63m	£6.02m	£6.53m	£7.05m

#### **4.13. Treasury Management Prudential Indicators**

The introduction of the Prudential Code sees the replacement of the Section 45 limits imposed by the Local Government and Housing Act 1989, with four new prudential indicators:

- Upper limits on variable rate exposure - This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments.
- Upper limits on fixed rate exposure - Similar to the previous indicator this covers a maximum limit on fixed interest rates.
- 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.
- Total principal funds invested - 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 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 Council is asked to approve the following prudential indicators:

(a) Upper limits on fixed and variable rates

Table 12: Limits on Fixed and Variable Rates

	2004/05	2005/06	2006/07
	Upper	Upper	Upper
Limits on fixed interest rates	100%	100%	100%
Limits of variable interest rates	30%	30%	30%

This means the Finance Director will manage fixed interest rate exposures within the range 70% to 90% and variable interest rate exposures within the range 0% to 30%. This is a continuation of current practice.

(b) Maturity Structure of fixed borrowing

Table 13: Maturity Profile

	2004/05		2005/06		2006/07	
	Lower	Upper	Lower	Upper	Lower	Upper
Under 12 mths	0%	10%	0%	10%	0%	10%
12 mths to 2 yrs	0%	20%	0%	20%	0%	20%
2 yrs to 5 yrs	0%	30%	0%	30%	0%	30%
5 yrs to 10 yrs	0%	30%	0%	30%	0%	30%
10 yrs and above	0%	90%	0%	90%	0%	90%

The long-term aim is to have an evenly spread maturity profile, with an equal amount of debt maturing every year. However, this will not always be the case, as prevailing interest rates will sometimes determine the best value period for borrowing.

(c) Total Principal Sums invested

Table 14: Principal Sums Invested

Total Principal Sums invested	2004/05	2005/06	2006/07
Maximum	£200m	£210m	£220m
Average	£140m	£145m	£150m

The Council is required to set the maximum principal sums it expects to have invested at any point in time. This is proposed to be significantly higher than the average expected balance due to the Council's cashflow pattern.

If the revised Investment regulations allow, the Council may consider investing for periods in excess of 364 days. Such investments would be a maximum of £10m at any one time.

#### **4.14. New Investment Regulations**

As a result of the introduction of the Prudential Code, the Government on 1<sup>st</sup> April 2004 will implement new investment regulations. Draft regulations were issued by the ODPM on 15 December 2003, for comments by 30 January 2004. In order to comply with Council reporting timescales, the requirements of the draft regulations have been included below.

The majority of the Council's investments are held for cash flow reasons and are therefore not considered appropriate for longer term investment. At least 60% will be maintained as short-term or specified investments. These are sterling investments made for less than one year.

The definition of specified investment includes investments with:

- UK Government
- Local authorities
- AAA rated Money Market Funds
- Bodies which have been awarded a high credit rating by a credit rating agency.

The County Council definition of high credit rating is "a banking institution with a Fitch minimum short-term rating of F1 and a minimum long-term rating of A". This is stated in the Lending Limits policy agreed by the County Council on 13 February 2003.

All other investments are non-specified, but the only ones the County Council would expect to make use of are:

- Building Societies, who do not have credit ratings. Their limits are based on their asset value.
- Wholly-owned subsidiary banks, without credit ratings. However none of these institutions can be on the lending list, unless the parent meets the minimum criteria.

Credit and maturity limits are applied to each institution on the lending list in accordance with the Lending List policy, to reflect the varying ratings awarded to the institutions. The criteria were prepared with advice of Butlers, the Council's Treasury management advisers.

The credit rating of counterparties will be monitored regularly, as a policy at least monthly. However the Council receives credit rating advice from its advisers, Butlers, on a daily basis as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty

failing to meet the criteria will be removed from the list immediately by the Finance Director and if required new counterparties which meet the criteria, will be added to the list.

#### **4.15. Treasury Management Performance Indicators and Financial Implications**

The Code of Practice on Treasury Management requires the Council to set performance indicators. These are district historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. The Council compares its average rate earned on investments to the 7 day LIBID rate, and looks to reduce the average rate payable on its borrowings year on year.

In 2003/04, it is anticipated that £4.6m will be earned on investments at an average rate of 3.7%. It is expected that interest of £9.053m will be paid on long term borrowing in the year at an average rate of 5.14%.

The average cash balance in 2004/05 is expected to be £140m and the average rate of interest earned 4.3%, producing interest of £6.02m. It is anticipated that interest of £11.8m will be paid on long term borrowing in 2004/05 at an average rate of 4.88%.