REPORT TO: POLICY COMMITTEE ON 5TH MARCH 2008

SUBJECT: CAPITAL INVESTMENT AND TREASURY MANAGEMENT PERFORMANCE INDICATORS

BY: CHIEF FINANCIAL OFFICER

1. REASON FOR REPORT

1.1 The purpose of this report is to ask Members to approve the indicators which will be used to measure the Council's performance in Capital Investment decisions.

1.2 This report is submitted to Committee in terms of Section II (2) of the Council's Administrative Scheme relating to approval of annual estimates for revenue and capital.

2. RECOMMENDATION

2.1 The Council is recommended to:

(i) Adopt the Prudential Indicators and Limits for 2008/09 contained in the report.

(ii) Approve the Treasury Management Strategy for 2008/09 and the Treasury Prudential Indicators for 2008/09.

3. BACKGROUND

3.1 The Local Government (Scotland) Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. This report revises the indicators for 2007/08 and 2008/09. Each indicator either summarises the expected activity or sets limits upon the activity, and reflects the outcome of the Council's underlying capital appraisal systems.

3.2 Within this overall prudential framework there is a clear impact on the Council's treasury management activity, either through borrowing or investment activity. As a consequence the treasury management strategy for 2008/09 is also included in this report together with the prudential indicators relating to the treasury activity.

3.3 Actual outturn figures for 2006/07 have previously been circulated to members as an information report in August 2007. These figures have been included in this report for comparison purposes.

4. Performance Indicators

4.1 The Capital Expenditure Plans

The Council's capital expenditure plans are summarised below and this forms the first of the prudential indicators. This expenditure can be paid for immediately (by resources such as capital receipts, capital grants etc.), but if resources are insufficient any residual expenditure will form a borrowing need.

A certain level of capital expenditure will be grant supported by the Scottish Government; anything above this level will be unsupported and will need to be paid for from the Council's own resources.

4.1.1 The Council is asked to approve the summary capital expenditure projections below; service details are shown in **Appendix 1.** This forms the first prudential indicator:

	2006/07 Actual	**2007/08 Revised**	**2008/09 Estimated**
	£'000	£'000	£'000
Capital Expenditure			
Non-HRA	21,021	18,845	38,568
HRA	4,461	6,895	3,770
Financed by:			
Capital receipts	2,817	3,612	2,218
Capital grants	5,551	7,179	13,874
Capital reserves	5,441	4,900	3,600
Revenue	2,444	1,150	880
Net financing need for the year	**9,229**	**8,899**	**21,766**

The Council's Borrowing Need (the Capital Financing Requirement)

4.2 The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources (grants or capital receipts). It is essentially a measure of the Council's underlying borrowing need.

The Council pays off an element of the accumulated debt each year through a revenue charge (the Scheduled debt Amortisation).

	2006/07 Actual	**2007/08 Revised**	**2008/09 Estimated**
	£'000	£'000	£'000
CFR – Non Housing	118,851	119,163	133,797
CFR - Housing	38,326	37,757	36,284
Total CFR	**157,183**	**156,920**	**170,081**
Movement in CFR	**5,119**	**(263)**	**13,161**

Net financing need for the year (above)	9,229	8,899	21,766
Scheduled debt amortisation and other financing movements	(4,110)	(9,162)	(8,605)
Movement in CFR	**5,119**	**(263)**	**13,161**

4.2.1 The Council is asked to approve the CFR projections below:

4.3 Limits to Borrowing Activity

4.3.1 Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well defined limits.

4.3.2 For the first of these the Council needs to ensure that its total borrowing net of any investments, 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 2008/09. This allows some flexibility for limited early borrowing for future years.

	2006/07 Actual	**2007/08 Revised**	**2008/09 Estimated**
	£'000	£'000	£'000
Gross Borrowing	142,421	142,158	155,582
Investments	16,368	20,030	30
Net Borrowing	126,053	122,391	155,552
CFR	157,183	156,920	170,081

4.3.3 The Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

4.3.4 A further two prudential indicators control or anticipate the overall level of borrowing. These are:

The Authorised Limit for External Debt – This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. This is the statutory limit determined under the Local Government (Scotland) Act 2003.

The Operational Boundary for External Debt – This indicator is based on the expected maximum external debt during the course of the year; it is not a limit.

4.3.5 The Council is asked to approve the following Authorised Limit and Operational Boundary:

Authorised limit	**2006/07 Actual**	**2007/08 Revised**	**2008/09 Estimated**

	£'000	£'000	£'000
Borrowing	142,421	144,421	186,187
Operational Boundary	**2006/07 Actual**	**2007/08 Revised**	**2008/09 Estimated**
	£'000	£'000	£'000
Borrowing	142,421	144,421	181,187

4.4 Affordability Prudential Indicators

4.4.1 The previous indicators cover the overall capital and control of borrowing, but within the framework prudential indicators are also 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's finances. The Council is asked to approve the following indicators:

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

%	**2006/07 Actual**	**2007/08 Revised**	**2008/09 Estimated**
Non-HRA	7.18%	7.43%	6.82%
HRA	20.52%	19.85%	19.30%

The financing costs for 2007/08 are based on latest estimated costs and the figure for 2008/09 has been taken from the Financial Plan approved by Full Council on 14th February 2008.

4.4.3 **Estimates of the incremental impact of capital investment decisions on the Council Tax** – This indicator identifies the revenue costs associated with ***new schemes*** introduced to the capital programme recommended in the financial Plan 2008/09 compared to the Council's existing approved commitments and current plans.

4.4.3 **Incremental impact of capital investment decisions on the Band D Council Tax**

	2006/07 Actual	2007/08 Revised	Forward Projection 2008/09
Council Tax - Band D	£5.60	£8.68	£6.27

4.4.4 **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 Housing Capital Investment plan compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

4.4.5 **Incremental impact of capital investment decisions Housing Rent levels**

	2006/07 Actual	2007/08 Revised	Forward Projection 2008/09
Weekly Housing Rent levels	£(0.72)	£(0.11)	£(0.12)

This indicator shows the revenue impact on any newly approved schemes, although any discrete impact will be constrained by rent controls.

4.5 Treasury Management Strategy 2008/09

4.5.1 The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators in this report consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury service considers the effective funding of these decisions. There are specific treasury prudential indicators included in this strategy which require approval.

4.5.2 The Council's Treasury management activities are regulated by the 2002 revision of the CIPFA Code of Practice on Treasury Management in Local Authorities. The Council has adopted the Code and fully complies with its requirements which form part of the Financial Regulations (Section 11).

4.5.3 The proposed strategy for 2008/09 is based on Officer's views on interest rates supplemented by leading market forecasts provided by the council's Treasury Advisers. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced after the year-end to report on actual activity for the year.

4.5.4 The strategy covers the following:

- The Council's debt and investment projections;
- The expected movement in interest rates;
- The Council's borrowing and investment strategies;
- Treasury performance indicators;
- Specific limits on treasury activities;
- Local treasury issues;

4.5.5 **The Council's Current Treasury Position**

		31/03/07 Actual	Rate	31/03/08 Estimate	Rate
		£'000	%	£'000	%
Fixed Rate Debt	PWLB	**109,021**	**6.00**	**109,021**	**6.00**
	Market	-	-	-	-
Variable Rate Debt	PWLB	**0**	-	**0**	-
	Market	**33,400**	**3.74**	**33,400**	**3.74**
Total Debt		**142,421**	**5.47**	**142,421**	**5.47**
Other Long Term Liabilities		**0**	-	**0**	-

Expected Movement in Interest Rates

Medium to Long Term Rate Forecasts (averages)

	Base Rate	5-year Gilt	20-yr Gilt	50-yr Gilt
2007/08	5.6	5.3	4.9	4.5
2008/09	4.8	4.7	4.8	4.6
2009/10	4.8	4.8	4.7	4.6
2010/11	5.0	4.9	4.8	4.8
2011/12	5.2	5.3	5.2	5.1

4.6.1 Although the December 2007 and February 2008 cuts in Bank Base Rate (to 5.25%) ultimately came as no great surprise to the financial markets, it did reflect the Monetary Policy Committee's growing unease about the state of the UK economy.

4.6.2 The November 2007 Inflation Report highlighted the threat of a comparatively steep decline in economic growth during 2008. Until then there had been few decisive signals that this process had commenced. However, more recently, the economic data has been transmitting an increasing amount of evidence that this may indeed be the case.

4.6.3 The downward movement of the two key housing market indicators (the Nationwide and Halifax Indices) and the Chartered Institute of Purchasing and Supply surveys of the manufacturing and service sectors pointed towards a marked deceleration in activity on a broad front and may well have been interpretated by the policy doves as a sure sign that the effects of last summer's credit squeeze are beginning to spread beyond the confines of the financial markets.

4.6.4 The squeeze on credit represents a sharp and involuntary tightening of domestic monetary policy. The fact that it is likely to take some time to evaporate suggests that consumers' expenditure will eventually respond through a marked contraction.

4.6.5 This, along with an easing of capacity constraints as the economy slows down, is expected to reduce inflation pressures and ensure CPI growth reverts to the 2% central target over the medium term.

4.6.6 Nevertheless, the Bank of England does note that the upside risks to inflation remain. Many of the current pressures are externally generated e.g. oil, food, commodity prices etc, and will not respond to UK interest rate policy.

4.6.7 Hopes rest upon the anticipated deceleration in international activity reversing at least some of these trends. Meantime, the MPC is hoping that domestic inflation expectations do not deteriorate and that weakening household consumption prevents companies passing cost increases on to the retail level. The outcome of this scenario will not be known for some time.

4.6.8 Bond markets (which underpin the Council's borrowing rates) will remain aware of the risks policy makers are taking with inflation for the sake of engineering a gradual and moderate dip in economic growth. Concerns about the health of the financial sector will persist for some time and these concerns are expected to exert a downward trend in bond yields in the near term. This position could however be counterbalanced by measures being taken by central banks in response to inflationary pressures.

4.7 Borrowing Strategy 2008/09

4.7.1 The uncertainty over future interest rates increases the risks associated with treasury activity. The Council will continue to take a cautious approach to its treasury strategy.

4.7.2 Long-term fixed interest rates are expected to be higher over the medium term (5-10 years). The Chief Financial Officer, under delegated powers, 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 longer term fixed rates will be considered earlier if borrowing rates deteriorate. This may include borrowing in advance of future years requirements which is permitted by the prudential scheme.

4.7.3 The Chief Financial Officer will monitor prevailing rates for any opportunities during the year to restructure debt. However, a key change in the options for borrowing and rescheduling occurred on 1 November 2007, when PWLB changed its interest rate structure to a more sensitive pricing method which increased the relative cost of repaying debt.

4.8 Investment Counterparty and Liquidity Framework

4.8.1 The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:

- It has sufficient liquidity in its investments. For this purpose it will set procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.
- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.

4.8.2 The Scottish Government is expected to issue revised Investment Guidance to allow investment for periods longer than a year. This change is expected to come into force on 1 April 2008, depending on legislative time. Up until the time the guidance is enacted the Council will continue its current policy of maintaining all investments for less than one year.

4.8.3 When and if new investment legislation is introduced by the Scottish Government, a revised Investment Strategy will be submitted to Members for approval.

4.8.4 The Chief Financial Officer will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit to Council for approval as necessary.

- **Banks** – the Council will use banks which have at least the following Fitch or equivalent ratings:
  - **Short Term** – **F1**
  - **Long Term** – **AA**
  - **Individual / Financial Strength** – **C** (Fitch / Moody's only)
  - **Support** – **3** (Fitch only)
- **Bank Subsidiary and Treasury Operations** – the Council will use these where the parent bank has the necessary ratings outlined above.
- **Building Societies** – the Council will include all Societies which meet the ratings for banks outlined above.
- **UK Government (Debt Management Office)**
- **Local Authorities**

4.8.5 The monetary value limit for institutions on the Council's Counterparty List is £5 million for any single organisation:

It is anticipated that the Council will have £20m invested in short term deposits at 31 March 2008 (£17.5m at 31 March 2007).

4.8.6 **Investment Strategy 2008/09**

Expectations on shorter-term interest rates, on which investment decisions are based continue to be uncertain at this time. The investment community appear to be undecided about how far and fast rates can be expected to fall. The Chief Financial Officer, under delegated powers, will undertake the most appropriate form of investments depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above.

4.9 Treasury Management Prudential Indicators and Limits on Activity

4.9.1 There are three further treasury prudential indicators. The purpose of these prudential indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However, if these indicators are set to be too restrictive they will impair the opportunities to reduce costs. The indicators are:

- Upper limits on variable interest rate exposure – This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments.
- Upper limits on fixed interest 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 within the same financial year, and are required for upper and lower limits.

4.9.2 The Council is asked to approve the following prudential indicators:

£m	**2008/09**		
	Upper		
Limits on fixed interest rates based on net debt	100%		
Limits on variable interest rates based on net debt	25%		
Maturity Structure of fixed interest rate borrowing 2008/09			
	Lower	**Upper**	
Under 12 months	0%	15%	
12 months to 2 years	0%	50%	
2 years to 5 years	0%	50%	
5 years to 10 years	0%	75%	
10 years and above	0%	100%	
Maximum principal sums invested > 364 days			
Principal sums invested > 364 days*	£0m	£0m	£0m

*The use of investments greater than 364 days is currently prohibited by Scottish legislation and so this indicator has been at nil, until new legislation is enacted.

4.10 Other Performance Indicators

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. These are:

- Debt – Average rate of borrowing for the year
- Debt – Average rate movement year on year
- Investments – Returns achieved above the 7 day LIBID rate

The results of these indicators will be reported in the Treasury Annual Report for 2007/08.

5. <u>SUMMARY OF IMPLICATIONS</u>

(a) Corporate Development Plan/Community Plan/Service Improvement Plan

The development of the Prudential Code Indicators for capital Investment and the Treasury Management Strategy is in agreement with working principle of Sound management of Resources.

(b) Policy and Legal

The Local Government in Scotland Act 2003 provides the powers to borrow and invest as well as providing controls and limits on these activities

The Council's treasury management activities are regulated by a number of professional codes, statutes and guidance documents.

The Council has adopted the Chartered Institute of Public Finance and Accountancy Code of Practice for Treasury Management in the Public Sector.

The primary requirements of the Code are: -

- The formulation of a Treasury Management Policy Statement, which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices, which set out the manner in which the Council will seek to achieve those policies and objectives.

(c) Resources (Financial, Risks, Staffing and Property)

There is little risk of volatility of costs in the current debt portfolio as the interest rates are predominantly at fixed, long term levels. Shorter term variable rates and the likely future movements in these variable rates predominantly determine the Council's investment return. These returns can therefore be volatile, and, whilst the risk of loss of principal is minimised through the lending list, forecasting accurate returns can be difficult.

(d) Consultations

This report has been produced in consultation with Butlers Treasury Services.

5 CONCLUSION

6.1 The Prudential Indicators and Borrowing Strategy in this report will be used to monitor and control the Capital Investment Programmes for General services and Housing to ensure that they are affordable, prudent and sustainable in the longer term.

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Background Papers: Various working papers held within Finance and ICT
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