TREASURY MANAGEMENT 2010/11- Mid Year Prudential Indicators and Treasury Management Monitoring Report

EXECUTIVE MEMBER: Councillor Elaine Woodburn
LEAD OFFICER: Joanne Wagstaffe, Corporate Director for Resources & Transformation
REPORT AUTHOR: Ann Fisher/Leanne Barwise, Senior Accounting Officer

Revisions to the regulatory framework of treasury management during 2009 introduced a requirement that the Council receive a mid year treasury review, in addition to the forward looking annual treasury strategy and backward looking annual treasury report required previously.

This report meets that requirement. It also incorporates the needs of the Prudential Code to ensure adequate monitoring of the capital expenditure plans and the Council's prudential indicators (PIs). The treasury strategy and PIs were previously reported to Council on 2nd March 2010. Revisions to future years are provided where required and this will be updated in the budget setting process.

Recommendations:

Executive is asked to:

1. Note the report and the treasury activity

2. Recommend to Council the approval of changes to the prudential indicators (Paragraphs 1.8 & 1.9) which are required as a result of technical accounting changes relating to PFI. The revised Operational Boundary to be set at £12m (previous £5m) and the revised Authorised Limit to be set at £17m (previous £9m)

1. INTRODUCTION

1.1. The capital expenditure plans and prudential indicators for capital expenditure are set out initially, as these provide the framework for the subsequent treasury management activity. The actual treasury management activity follows the capital framework (and the position against treasury management indicators shown at the end).

1.2. The underlying purpose of the report supports the objective in the revised CIPFA Code of Practice on Treasury Management and the CLG

1.3. The underlying economic environment remains difficult for the Council, foremost being the improving, but still challenging, concerns over investment counterparty risk. This background encourages the Council to continue maintaining investments short term and with high quality counterparties. The downside of such a policy is that investment returns remain low.

1.4. The Corporate Director for Resources and Transformation can report that the basis of the treasury management strategy, the investment strategy and the PIs are not materially changed, except as detailed below.

1.5. The Code of Practice on Local Authority Accounting in the UK 2009: A Statement of Recommended Practice (the 2009 SORP), which is applicable to Copeland's accounts for the year ended 31 March 2010, incorporated a new requirement for accounting for PFI schemes that is consistent with the adaptation of IFRIC12 Service Concession Arrangements. The impact of the new controls-based approach compared to the previous risks and rewards approach is that more PFI projects have been brought onto balance sheet for the public sector.

1.6. The result of this for Copeland is the recognition of the Copeland Centre as a fixed asset on the balance sheet, which will be depreciated over its useful life, i.e. life of agreement. A corresponding financial liability representing Copeland's obligation to make payments under the PFI was also recognised on the balance sheet.

1.7. Where a PFI contract comes 'on balance sheet' as a result of the IFRS based approach, there is a requirement to adjust the Capital Financing Requirement and Copeland needs to ensure its Operational Boundary and Authorised Limit is set accordingly. The treasury management report presented to Executive in September informed members of some provisional changes, as the PFI valuation were subject to audit confirmation. This was received with account sign off and as a result the Operational Boundary and Authorised Limit need reviewed.

1.8. As can be demonstrated in the table in Appendix A (Page 7), Copeland's Operational Boundary and Authorised Limit were not breached until the implementation of the change in rules for accounting for PFI under IFRIC 12. This change has resulted in the limits being exceeded in 2009/10. Point 1.9 below seeks to rectify this.

1.9. As a result of bringing the PFI 'on balance sheet' Copeland's total indebtness is now £11,672k as detailed in the table in Appendix A on page 8 and therefore Members are asked to approve to Council the revised Operational boundary and Authorised limit detailed at the top of page 3, which is necessary as a result in change of accounting practises only.

	Proposed Limit including PFI	Previous Limit excluding PFI
Revised OPERATIONAL BOUNDARY	£12 million	£5 million
Revised AUTHORISED LIMIT	£17 million	£9 million

2. ECONOMIC SITUATION FOR THE 6 MONTHS TO 30 SEPTEMBER 2010 – A SUMMARY

2.1 UK short-term interest rates fluctuated in a very narrow range in the first half of the financial year. Bank Rate was held at its record low of 0.5% in spite of above target inflation and evidence of a recovery in activity in most industrialised economies. The tenuous nature of the economic upturn, confidence that price pressures will abate and the still fragile state of the financial sector supported the case for the maintenance of an accommodative monetary policy.

2.2 Long-term interest rates peaked in the early stages of the financial year. The rise was reversed in May. Confidence that the change of government will prompt a more aggressive approach to deficit reduction encouraged new investment in gilt-edged securities. More important, however, was the financial crisis in the euro-zone, triggered by the threat of a sovereign debt default by Greece. This, together with evidence of decelerating growth in the US, ensured continued demand for high quality government debt. Gilt yields and PWLB rates subsided towards their 2009 lows as a result.

2.3 Short-term rates are expected to remain on hold for a considerable time. The recovery in the economy is likely to remain insipid. The danger of a double-dip recession is fading but the crisis in the euro-zone, the prospects of tight economic policies at home and tenuous consumer confidence means the threat has not evaporated completely.

2.4 Long-term interest rates will continue to benefit from these considerations and might be pressured lower in the event of a fresh programme of Quantitative Easing (QE). Nevertheless, without this additional support, yields are probably close to their low point. Disappointment with the UK's inflation performance and the absence of QE would return yields to a gradually rising trend before the year is out.

Medium-Term Rate Estimates (*Source : Sector Treasury Management)*

Annual Average %	Bank Rate	Money Rates		PWLB Rates*		
		3 month	1 year	5 year	20 year	50 year
2008/09	3.9	5.0	5.3	4.2	4.8	4.5
2009/10	0.5	0.7	1.3	3.0	4.4	4.5
2010/11	0.5	0.7	1.5	2.4	4.2	4.3
2011/12	1.1	1.3	2.2	3.1	4.8	4.9
2012/13	2.3	2.5	3.3	4.0	5.0	5.1

* Borrowing Rates

3. TREASURY MANAGEMENT FOR THE 6 MONTHS TO 30 SEPTEMBER 2010

3.1 On 25th October 2010 our treasury advisors, Butlers Treasury Management, merged with their competitor, Sector Treasury Services Ltd. The transfer of business to Sector has not had any impact on the level of the treasury management service provided.

3.2 The Council still has the one remaining Market Loan in its debt portfolio, of £5 million. We continually assess the position of this loan with our Treasury Consultants, Sector, to see whether we are securing the best terms for the Council. At the current time, the advice is to leave this loan in its present form, as the penalty for repaying early would be prohibitive.

3.3 In recent months, the Council has opened a number of call and notice accounts with both the Royal Bank of Scotland and Barclays. These were opened at no cost to the Council. Not only do they provide another counterparty option (a necessity due to the current restrictions on the counterparty list) but we are able to place deposits with these institutions at a higher rate than can be achieved on the current money market.

3.4 Due to the uncertainty in the financial markets from November 2008, acting within the Treasury Management Strategy, the pool of available counter-parties (i.e. those financial institution/organisations that we can place money with), within the approved criteria, was restricted to safer instruments and institutions. Currently this involves the use of AAA rated Money Market Funds and institutions with higher credit ratings than those outlined in the investment strategy or which are provided support from the Government. In addition to this, since January 2009, all investments have been made for relatively short periods (3 to 4 months).

3.5 During the period to 30 September 2010 interest of £102k was received. This equates to an average rate of return on investments of 0.8% compared to a current average base rate of 0.5%. The 2009/10 average rate of return on investments was 1.96%. The current forecast for investment interest for 2010/11is £200k, compared to the annual budget of

£402k, a shortfall of £202k. This is reflected in the quarterly revenue budget monitoring reports to Executive.

3.6 A list of investments held at 30 September 2010 is attached at Appendix B. The current investment limit with any one counterparty is £5 million.

4. PROSPECTS FOR THE REMAINDER OF 2010/11 AND THEREAFTER

4.1 Looking forward to the remainder of 2010/11, shorter-term interest rates, on which investment decisions are based, are likely to remain subdued for some time, and a combination of counterparty risk and lack of value in longer term deposit rates are likely to see the continuation of an investment policy of maintaining shorter term, high quality investments.

4.2 Forecasts (as shown in the table at 2.4) expect rates to begin rising over the course of 2011/12. It is currently difficult to have confidence as to exactly how strong the UK economic recovery is likely to be. There are huge uncertainties in all forecasts. Counterparty risk should become more subdued and with the expectation of an increasing Bank Rate, value will begin to return to longer term investments. If there is clear evidence of this taking place, an amendment to the investment strategy to cautiously extend investments may be considered, and indeed appropriate.

4.3 The Council's investment strategy is safeguarding the re-payment of the principal and interest of its investments on time – the investment return being a secondary objective. Following on from the economic background above, the current investment climate has one over-riding risk consideration, that of counterparty risk. The current counterparty criteria is under regular review, however no further amendments to the Treasury Management and Investment Strategies are sought at this point in time. The revised draft Treasury Management and Investment Strategy for 2011/12 will be considered at the December meeting for final approval in February 2011.

4.4 The situation regarding borrowing remains unchanged from that reported to the February Executive and the Council will continue to take a cautious approach. In the event that borrowing is necessary, the Corporate Director for Resources and Transformation, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time and taking into account contemporaneous forecasts. Executive agreement would be sought and any amendment to the Treasury Management Strategy would be sought from Council.

5 IMPACT ON CORPORATE PLAN

5.1 By ensuring that the Council utilises its resources effectively, Treasury Management supports the delivery of the Corporate Plan.

List of Appendices

Appendix A: Prudential Indicators as at 30 September 2010

Appendix B: Investments as at 30th September 2010

List of Background Documents: Treasury Management Strategy Statement, Investment Strategy and Minimum revenue Provision Strategy Report 2010/11 to Full Council 2nd March 2010, Treasury Management Annual Report 2009/10 to Executive September 2010

Appendix A

KEY PRUDENTIAL INDICATORS

This Appendix to the report provides an update, as at 30th September 2010, on:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The effect of these PIs on the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

Capital Expenditure (PI)

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure by Service	2010/11 Revised Estimate	Change from Strategy	2011/12 Revised Estimate	Change from Strategy	2012/13 Revised Estimate	Change from Strategy
Total	5,727	(1,873)	4,168	2,138	1,680	0

The capital budget was agreed on 2 March 2010, the fluctuations are due the re profiling of a number of schemes over the three year period 2010/11-2012/13. This will be further updated after Resource Planning Working Group considers the draft capital programme for the three years 2011/12-2013/14, as it prepares the draft budget proposal for Executive to consider before recommending the budget to Council.

Impact of Capital Expenditure Plans

Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements for this capital expenditure. The borrowing element of the table increases the underlying indebtedness in the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure £000's	2010/11 Revised Estimate	Change from Strategy	2011/12 Revised Estimate	Change from Strategy	2012/13 Revised Estimate	Change from Strategy
Supported	5,727	(1,873)	4,168	2,138	1,680	0
Unsupported	0	0	0	0	0	0
Total spend	5,727	(1,873)	4,168	2,138	1,680	0
Financed by:						
Capital receipts	3,082	89	1,435	138	966	0
Capital grants	2,613	32	727	0	714	0
Revenue	32	6	6	0	0	0
Total Financing	5,727	127	2,168	138	1,680	0
Borrowing Need	**0**	**(2,000)**	**2,000**	**2,000**	**0**	**0**

Changes to the Capital Financing Requirement (PI), External Debt and the Operational Boundary (PI)

The table shows the CFR, which is the underlying external need to borrow for a capital purpose. It is increased each year by any new borrowing need (as above), and decreased by any statutory revenue charge for the repayment of debt (the Minimum Revenue Provision).

The table also shows the expected debt position over the period *before* the change in rules for accounting for PFI under IFRIC 12. This is termed the Operational Boundary.

£000's	2010/11 Revised Estimate	Change from Strategy	2011/12 Revised Estimate	Change from Strategy	2012/13 Revised Estimate	Change from Strategy
Prudential Indicator – Capital Financing Requirement						
CFR – Non Housing	317	(1,636)	2,317	364	2,317	364
Net movement in CFR	0	(2,000)	2,000	2,000	0	0
Prudential Indicator – External Debt / the Operational Boundary						
Borrowing	5,100	0	5,100	0	5,100	0
Other long term liabilities	0	0	0	0	0	0
Total Debt 31 March	5,100	0	5,100	0	5,100	0

This table shows the expected debt position over the period *after* the change in rules for accounting for PFI under IFRIC 12.

£000's	2010/11 Revised Estimate	Change from Strategy	2011/12 Revised Estimate	Change from Strategy	2012/13 Revised Estimate	Change from Strategy
Prudential Indicator – Capital Financing Requirement						
CFR – Non Housing	8,462	6,509	10,462	8,509	10,462	8,509
Net movement in CFR	0	(2,000)	2,000	2,000	0	0
Prudential Indicator – External Debt / the Operational Boundary						
Borrowing	5,100	0	5,100	0	5,100	0
Other long term liabilities (PFI)	6,572	6,572	6,335	6,335	6,112	6,112
Total Debt 31 March	11,672	6,572	11,435	6,335	11,212	6,112

Limits to Borrowing Activity

The first key control over the treasury activity is a PI to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose*. Net external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2010/11 and next two financial years. This allows some flexibility for limited early borrowing for future years.

£000's	2010/11 Revised Estimate	Change from Strategy	2011/12 Revised Estimate	Change from Strategy	2012/13 Revised Estimate	Change from Strategy
Gross Borrowing	5,000	0	5,000	0	5,000	0
Less Investments	(15,361)	(4,277)	(11,324)	2,713	(13,110)	1,085
Net Borrowing	(10,361)	(4,277)	(6,324)	2,713	(8,110)	1,085
CFR	8,462	6,509	10,462	8,509	10,462	8,509

The Corporate Director for Resources and Transformation reports that no difficulties are envisaged for the current or future years.

A further PI controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and this 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 in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

* Borrowing Rates

Authorised limit for external debt £000's	2010/11 Revised Estimate	Change from Strategy	2011/12 Revised Estimate	Change from Strategy	2012/13 Revised Estimate	Change from Strategy
Borrowing	9,000	0	9,000	0	9,000	0
Other long term liabilities (PFI)	8,000	8,000	8,000	8,000	8,000	8,000
Total	17,000	8,000	17,000	8,000	17,000	8,000

Treasury Strategy 2010/11 – 2012/13

Debt Activity during 2010/11

Future Borrowing and Debt Rescheduling

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

Long-term fixed interest rates are currently low but expected to rise over the three year planning period. The Bank Rate is expected to remain at 0.5% until mid 2011, before rising gradually.

The Authority is not expected to need any new borrowing in the foreseeable future, providing we make capital receipts as forecast. If borrowing does become needed the Corporate Director for Resources and Transformation, 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. The current key difficulty is that future borrowing will increase cash holding at a time when counterparty risk remains high and investment returns are low. In this scenario borrowing is likely to be postponed until cash flow need is more apparent. Although the Authority has no future borrowing planned, the 1% increase in the PWLB rates announced recently in the Comprehensive Spending Review would increase future borrowing costs and therefore may make market debt more attractive. The expected borrowing need is set out below:

£000's	2010/11 Revised Estimate	Change from Strategy	2011/12 Revised Estimate	Change from Strategy	2012/13 Revised Estimate	Change from Strategy
Borrowed at 30/09/10	5,100	0	5,100	0	5,100	0
Expected need	0	0	0	0	0	0
Total Borrowing	5,100	0	5,100	0	5,100	0

Opportunities for debt restructuring or repayment is continually monitored. Action will be taken when the Corporate Director for Resources and Transformation feels it is most advantageous.

INVESTMENTS AS AT 30th SEPTEMBER 2010

As at 30th September 2010 the Council held investments totaling £24,038,000, ranging from call accounts to loans with maturity dates up to 15th December 2010, with the following institutions:

Bank of Scotland
Lloyds TSB
NatWest
Norwich and Peterborough Building Society
Principality Building Society
Royal Bank of Scotland
RBS MMF
Santander
Skipton Building Society