

**TELFORD & WREKIN COUNCIL**

**CABINET - 23<sup>rd</sup> FEBRUARY 2009**

**PRUDENTIAL INDICATORS**

**REPORT OF THE CORPORATE DIRECTOR : RESOURCES AND HEAD OF FINANCE**

**1. Purpose**

- 1.1 To approve the prudential indicators for 2009/10 to 2011/12 required under the Prudential Code of Capital Finance in Local Authorities.

**2. Recommendations**

- 2.1 Members are asked to recommend that Council approves the prudential indicators proposed in this report as part of setting the budget for 2009/10.**

**3. Summary**

- 3.1 The Local Government Act 2003 replaced the previous system of Local Government Capital Finance with a new one, known as the Prudential System from 1 April 2004.
- 3.2 Under the Prudential System, instead of the historical practice of local authorities only being able to borrow in line with central government prescribed limits, each local authority must decide its own borrowing limits, taking account of its financial situation, medium term plans and in particular affordability.
- 3.3 CIPFA has developed a Prudential Code of Capital Finance in Local Authorities, which specifies indicators the Council must consider in determining how much it will borrow for capital purposes.
- 3.4 The code requires the Council to set a range of indicators for 2009/10. The indicators in respect of investments have been set based on the Guidance on Local Authorities Investments issued by CLG in April 2004.

#### 4. The CIPFA Prudential Code

- 4.1 In September 2003 CIPFA Council approved and subsequently published the final version of the code, and the concluding paragraph of its executive summary records;

*“The Prudential Code supports the systems of capital investment in local authorities. It is integrated within the wider statutory and management processes of local government. Key elements of the system continue to be determined by legislation, in particular the amount required to be charged to taxation by local authorities in respect of capital investment and the amount and method of government support for capital investment. These will be significant decisions when local authorities take decisions on capital investment. **However, the level of capital investment that can be supported will subject to affordability and sustainability and be a matter for local decision.**”*

- 4.2 The general approach of the code is to require the Council to set estimates and limits on its borrowing and features associated with borrowing. The underlying philosophy is that the Council should set limits that ensure borrowing is affordable in the medium to long term. Affordability is determined by the overall amount of borrowing and the interest rate at which it is done. Because borrowing is only permissible (and will remain so) for capital expenditure local authorities have traditionally borrowed at longer term fixed rates of interest (i.e. over 1 year, and typically over 20 years). This helps ensure stability over the medium term; for example a variable rate loan currently at 4.5% may be less attractive than a fixed rate loan at 4.8% if there is thought to be a reasonable possibility that variable rates will rise above 5.2% within a year. To help ensure financial stability the code requires authorities to consider the structure of their borrowing.
- 4.3 The code also requires authorities with significant investments to set indicators associated with lending money.
- 4.4 Practically the remaining paragraphs of this section consider the indicators and recommends what the indicators should be for 2009/10. In most cases indicators have to be set for 3 financial years ahead, so figures are also provided for 2010/11 and 2011/12. In proposing these indicators a pragmatic approach has been taken; i.e. known Council plans (including the present treasury structure) have been considered.
- 4.5 For each indicator, ***the CIPFA requirements of the code are set out in bold italics.*** The limits proposed by the Corporate Director : Resources for 2009/10 are then set out. An explanation is provided, unless the indicator and limits are completely self explanatory.

#### **4.6 Capital Expenditure and Capital Commitments Prudential Indicators**

**4.6.1 The local authority will make reasonable estimates of the total of capital expenditure that it plans to incur during the forthcoming financial year and at least the following two financial years. These prudential indicators shall be referred to as:**

##### ***Estimate of total capital expenditure to be incurred in years 1, 2 and 3***

4.6.2 The budget and capital report to Council for 2009/10 identifies programmed capital schemes, and subsequent year's capital needs. The estimates of capital expenditure to be incurred are therefore;

	Supported Borrowing	Prudential Borrowing	Grant Funded	Capital Receipts	Total
	£m	£m	£m	£m	£m
2009/10	6.846	16.157	16.594	5.201	44.798
2010/11	4.925	15.618	17.786	0.300	38.629
2011/12	4.779	-7.882	14.530	8.700	20.127

It is only the two columns relating to borrowing that impact on prudential indicators.

#### **4.7 Prudential Indicators of Affordability – Ratio Affordability Measure**

**4.7.1 The local authority will estimate for the forthcoming financial year and the following two financial years the ratio of financing costs to net revenue stream. This prudential indicator shall be referred to as estimates of ratio of financing costs to net revenue stream.**

4.7.2 In Telford & Wrekin's case this indicator makes more sense if LGR debt paid over to the County Council is included.

Revenue Budget

Year 1(2009/10) 1.50%

Year 2(2010/11) 1.55%

Year 3(2011/12) 1.65%

4.7.3 The indicator has been calculated as debt interest costs divided by budget requirement for the general fund element. The general fund indicator above shows a slight increase in the ratio (equivalent to an increase in capital financing costs over the next 3 years. This broadly matches the expected increase in the capital financing FSS and prudential borrowing).

#### 4.8 Prudential Indicators of Affordability – Incremental Council Tax Affordability Measures

*The local authority will*

- (i) forecast the total budgetary requirements for the authority based on no changes to the existing capital programme*
- (ii) forecast the total budgetary requirements for the authority with the changes to the capital programme included in the calculation*
- (iii) take the difference between (i) and (ii) and calculate the addition or reduction to Council tax that would result.*

*This prudential indicator will be referred to as estimates of the incremental impact of new capital investment decisions on the Council Tax and shall be expressed in the following manner £ xx.xx.*

4.8.1 The indicator is calculated by taking the estimates of capital included in the Capital Budget Report which is noted in 5.6.2, assuming it is financed through a mixture of borrowing and use of capital receipts (with interest at 5%, with Minimum Revenue Provision calculated in line with the MRP policy as detailed in the Treasury Strategy Report) and dividing them by the tax base (50,245.0). It also assumes that the only Government Approvals agreed at this stage are those for 2009/10, with those for the latter 2 years being only provisional at this stage. The indicator works on a cumulative basis (i.e. the year 2 indicator includes the full year cost of year 1 expenditure, together with the part year cost of that year's programme), but only takes half a year's interest cost in the year expenditure is incurred. The estimate has been split into 3 parts which are expenditure funded by prudential borrowing, capital receipts and government borrowing allocations. There are no principal repayments in respect of capital receipts and the revenue cost of utilising these government allocations should be funded by Revenue Support Grant although this is impacted on by the RSG damping mechanism which withholds a substantial part of the revenue funding due to the Council to support the cost of these allocations at present.

4.8.2 The estimate of the incremental impact on Council Tax (Band B) of capital decisions proposed over and above capital investment decisions that have already been taken by the Council are as follows;

<u>Year</u>	<u>Prudential Borrowing</u> £	<u>Use of Capital Receipts</u> £	<u>Government Supported Borrowing</u> £	<u>Total</u> £
2009/10	3.56	0.00	0.66	<b>4.22</b>
2010/11	8.83	0.00	2.14	<b>10.97</b>
2011/12	11.91	0.00	3.39	<b>15.30</b>

#### **4.8.3 Prudential Indicators of Affordability – Incremental Housing Rent Affordability Measures**

This Indicator does not apply to Telford & Wrekin Council.

#### **4.9 Estimates of Capital Financing Requirement**

***The local authority will make reasonable estimates of the total capital financing requirement at the end of the forthcoming financial year and the following two years. These prudential indicators shall be referred to as:***

***Estimate of capital financing requirement as at the end of years 1, 2 and 3.***

4.9.1 The capital financing requirement is a new concept in the Prudential System, but can simply be understood as the Council's underlying need to borrow money over the long term. The code requires that the figure is calculated gross, to include debt that is paid for by other authorities following LGR, so in Telford & Wrekin's case, these figures have limited meaning, and locally the indicator needs adjusting for LGR debt.

4.9.2 Table A shows the estimated cumulative capital financing requirement at a point in time

	<b>Total CFR</b>
31/3/2009	£133.3m
31/3/2010	£151.2m
31/3/2011	£165.9m
31/3/2012	£156.2m

4.9.3 The movement in the CFR is consistent with other planning assumptions.

#### **4.10 External Debt Prudential Indicators**

**4.10.1 *The local authority will set for the forthcoming financial year and the following two financial years a prudential limit for its total external debt, gross of investments, separately identifying borrowing from other long term liabilities. This prudential indicator shall be referred to as:***

***Authorised limit for external debt = authorised limit for borrowing + authorised limit for other long term liabilities for years 1, 2 and 3.***

4.10.2 The recommended Authorised Limit for External Debt for:

Year 1 (2009/10) is £300m for borrowing and £6m for other long term liabilities

Year 2 (2010/11) is £320m for borrowing and £7m for other long term liabilities

Year 3 (2011/12) is £320m for borrowing and £8m for other long term liabilities

4.10.3 This limit represents the maximum amount the Council may borrow at any point in time in the year. It has to be set at a level the Council considers is "prudent". (This limit is analogous to the limit on borrowing set out section 44 of the 1989 Act). Because it is ultra vires to exceed, the authorised limit must be set so as to avoid circumstances in which the Council would need to borrow more money than this limit.

4.10.4 Other long term liabilities include items that would appear on the balance sheet of the Council that are analogous to borrowing. For example, the capital cost of leases would be included.

#### 4.11 **Operational Boundary**

***The local authority will also set for the forthcoming financial year and the following two years an operational boundary its total external debt, gross of investments, separately identifying borrowing from other long term liabilities. This prudential indicator shall be referred to as the:***

***Operational Boundary = operational boundary for borrowing + operational boundary for other long term liabilities for years 1, 2 and 3.***

4.11.1 The operational boundary is a measure of the most money the Council would normally borrow at any time during the year. The code recognises that circumstances might arise when the boundary might be exceeded temporarily, but suggest a sustained or regular pattern of borrowing above this level ought to be investigated, as a potential symptom of a more serious financial problem. It should be noted that although this boundary has been set at £220m for 2008/09, it is estimated that the average external debt and other long term liabilities will be around £186m. Given the likely trend of the capital financing requirement in 5.9.2. a higher operational boundary is appropriate for 2009/10 and 2010/11.

4.11.2 The Recommended Operational boundary for External debt is

Year 1 (2009/10) is £280m for External debt for and £4m for other long term liabilities

Year 2 (2010/11) is £300m for External debt for and £5m for other long term liabilities

Year 3 (2011/12) is £300m for External debt for and £6m for other long term liabilities

## 4.12 Treasury Management Prudential Indicators

4.12.1 The Council adopted the ***CIPFA Code of Practice for Treasury Management in the Public Services*** at its meeting in February 2002. Treasury Management Practices (TMPs) have been established by the Corporate Director : Resources in line with the advice of Sector Treasury Services, and are kept up to date. ***The first prudential indicator in respect of treasury management is that the local authority has adopted the CIPFA Code*** is therefore met.

## 4.13 Interest Rate Exposure

4.13.1 ***The local authority will set, for the forthcoming year and the following two years, limits to its exposures to the effects of changes in interest rates. These prudential indicators will relate to both fixed interest rates and variable interest rates and will be referred to respectively as the upper limits on fixed and variable interest rate exposures.***

4.13.2 There is no requirement in the code to set lower limits; however, given the risks associated with having excessively high relatively short fixed, or variable rate borrowing, it is suggested that lower limits are set locally for longer maturing fixed rate borrowing.

4.13.3 **Variable rate exposures**  
***Borrowing that is at variable rates LESS Investments that are variable rate investments***

Because a large proportion our investments are at variable rates and exceed in total the level of debt we currently have (and historically a high proportion of that has been at fixed rates) we are unable to set the limit as a percentage and will therefore set it in absolute terms of the net principal sum (which is negative) The limits proposed, together with their make up, are as follows;

	Net Variable Limit
	£m
2009/10	0
2010/11	0
2011/12	0

I.e. total of variable rate borrowing will never exceed total of variable rate investments.

4.13.4 The upper limit replaces the existing (1989 Act) Section 44 limit “the maximum proportion of borrowing which is subject to variable rate interest”. Whilst £0m has been set forward as a limit, in practice it would be unusual for the exposure to exceed -£20m. The actual exposure is negative due to the levels of fixed long term borrowing (more than 1 year), and that our investments are mostly all variable. Limits for years 2 & 3 assume no

substantial change in market conditions. What this indicator does show is that we should invest in more fixed instruments at the appropriate time.

- 4.13.5 Because of our position in having substantial investments it would be helpful to set a local indicator for setting a maximum exposure for variable rates as a percentage of total investment plus total debt. For the purposes of this local indicator supranational bonds are treated as fixed investments as they are accounted for as such. The limit proposed would be as follows;

	Upper Limit
2009/10	80%
2010/11	80%
2011/12	80%

#### 4.13.6 **Fixed Interest Rate Exposure**

***The local authority will set, for the forthcoming year and the following two years, both upper and lower limits for its exposure to fixed interest rate risk calculated as follows and each expressed as total borrowing less total investments:***

***Fixed interest rate exposures***

***Borrowing that is at fixed rates LESS Investments that are fixed rate investments***

***Expressed as a percentage or absolute of total borrowing less investments.***

- 4.13.7 The limits (expressed as an absolute of total fixed borrowing less total fixed investments) proposed are as follows;

	Upper Limit	Lower Limit
2009/10	£190m	-£10m
2010/11	£200m	-£10m
2011/12	£210m	-£10m

- 4.13.8 As for variable rates it is appropriate to set a local indicator for fixed rate exposure. This is fixed rate investments plus fixed rate borrowing divided by total investments plus total borrowing. The proposed limit is as follows:

	Upper Limit	Lower Limit
2009/10	90%	20%
2010/11	90%	20%
2011/12	90%	20%

In principle, it may be necessary / desirable for all borrowing at a point in time to be at a fixed rate, although in practice this would be unusual. The lower limit is effectively the counterpart to the upper limit for variable rate exposure.

4.14 **Prudential limits for the maturity structure of fixed rate borrowing**  
***The local authority will set for the forthcoming year both upper and lower limits with respect to the maturity structure of its borrowing, calculated as follows***

***Amount of projected borrowing that is fixed rate maturing in each period***  
***Expressed as a Percentage of***  
***Total projected borrowing that is fixed rate at the start of the period.***  
***where the periods in question are***

- ***Under 12 months***
- ***1 year and within 2 years***
- ***2 years and within 5 years***
- ***5 years and within 10 years***
- ***10 years+***

4.14.1 The proposed prudential limits are as follows;

Period (years)	Lower Limit %	Upper Limit %
Under 12 months	0	20
1-2 years	0	25
2-5 years	0	50
5-10 years	0	75
over 10 years	25	100

4.14.2 Whilst these are the proposed limits, as a broad longer term strategy, in any financial year borrowing would normally be managed to end the year with the maturity profile broadly as follows;

Maturity	Broad Indicative Range	Actual % for 31/03/08
Under 12 months	0-10% of all borrowing	3%
1-2 years	0-15%	0%
2-5 years	5-15%	0%
5-10 years	5-20%	0%
Over 10 years	40-100%	97%

There has been a peak in rates in the 1-15 year period over the last few years, and therefore loans in this period have been extensively restructured, so the amounts are currently slightly lower than our broad indicative range. With historically low long term PWLB interest rates during recent years the Council has continued to take advantage of these rates by borrowing longer term.

4.14.3 Under the investment guidance issued by CLG the Council needs to set indicators for **principal sums invested for periods longer than 364 days.** It is recommended that we set the following limit

Maximum principal investment that can be invested for more than 364 days

Financial Year	Upper Limit
2009/10	90%
2010/11	90%
2011/12	90%

## **5 Contribution to Strategic Aims**

A proper treasury management strategy underpins the overall financial management of all the Council's activities.

## **6. Legal Implications**

- 6.1. CIPFA's Prudential Code is regarded as mandatory guidance associated with the new Local Government Act 2003.

## **7. Financial Implications**

- 7.1 The prudential indicators provide a framework in 2009/10 in which the Council conducts its treasury activities, consistent with good treasury risk management.
- 7.2 The code indicates that "in all cases, the process of setting prudential indicators for treasury management should be accompanied by a clear and integrated forward treasury management strategy, and a recognition of the pre-existing structure of the authority's borrowing and investment portfolios." The indicators proposed here take account of the existing structure of borrowing and all reasonable restructuring activity that might occur.
- 7.3 The code requires the following matters to be taken into account when setting or revising prudential indicators
- (a) option appraisal for all projects, i.e. value for money
  - (b) asset management planning, i.e. stewardship of asset
  - (c) strategic planning for the authority, i.e. service objectives
  - (d) achievability of the forward plan, i.e. its practicality
  - (e) implications for external borrowing, i.e. prudence
  - (f) implications for Council Tax and housing rents, i.e. affordability.

Items (a)-(c) are largely considered in the current arrangements as part of the asset management planning / corporate capital strategy processes. Items (d) and (f) in financial terms have been taken account of by the Corporate Director : Resources in presenting the budget and item (e) is inherent to the prudential indicator setting process.

## **7. Links with Corporate Priorities**

The report has financial links with all the council's priorities

## **9. Opportunities & Risks**

The opportunities and risks associated with the report have been identified and assessed. Arrangements will be put in place to manage the risks and maximise the opportunities that have been identified.

## **10. Background Papers**

Local Government Act 2003

CIPFA Prudential Code for Capital Finance in Local Authorities

Guidance on Local Authority Investments