Chester-le-Street
District Council

Report to:	Council
Date of Meeting:	28 September 2006
Report from:	Accountancy Manager
Title of Report:	Treasury Management 2005/06
Agenda Item Number:	**15**

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1. PURPOSE OF THE REPORT

The annual treasury report is a requirement of the Council's reporting procedures and covers the treasury activity for 2005/06. The report also covers the actual Prudential Indicators for 2005/06 in accordance with the requirements of the Prudential Code.

2. CONSULTATION

2.1 The Director of Resources has been consulted on the report.

3. CORPORATE PLAN AND PRIORITIES

3.1 The report is wholly concerned with the authority's treasury management activities, which impact on the resources available to the Council to achieve its corporate priorities.

4. IMPLICATIONS

4.1 Financial

Treasury Management has significant financial implications for the Council. In 2005/06, interest from investments resulted in income of £256,000 for the General Fund and £43,000 for the Housing Revenue Account.

4.2 Risk

Section 5.12 of the report deals with the regulatory framework, risk and performance.

The Council has complied with all of the relevant statutory and regulatory requirements which limit the levels of risk associated with the treasury management activities. The adoption of both the Prudential Code and the Code of Practice for Treasury Management means both the capital expenditure is prudent, affordable and sustainable, and the treasury practices demonstrate a low risk approach.

5. ANNUAL TREASURY REPORT

5.1 Introduction and Background

5.1.1 The Council undertakes capital expenditure on long term assets. These activities can be funded immediately through capital receipts, capital grants etc., although any residue which cannot be immediately paid for will give rise to a borrowing need. This borrowing need will be charged to revenue over a number of years. The 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.

The remaining indicators are included to make the annual reporting comprehensive.

5.1.2 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. This area of activity is regulated by the CIPFA Code of Practice on Treasury Management.

5.1.3 Wider information on the regulatory requirements is shown in Section 5.12.

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

5.2.1 This forms one of the required prudential indicators (a list of all mandatory indicators is at Appendix A), and shows total capital expenditure for the year and how this was financed.

	2005/06 Actual £000	**2005/06 Estimate £000**
Total capital expenditure	9,154	12,481
Resourced by:		
Major Repairs Allowance	2,217	2,179
Capital receipts	5,263	8,266
Government grants	440	283
Other Grants/Contributions	792	685
Revenue	78	270
Unfinanced capital expenditure (additional need to borrow)	**364**	**798**

5.3 **The Council's Overall Borrowing Need**

5.3.1 The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This figure is a gauge for the Council's debt position and represents 2005/06 and historic net capital expenditure which has not yet been charged to revenue. The process for charging the capital expenditure to revenue is a statutory requirement and is called the Minimum Revenue Provision (MRP). The Council has the option to charge more than the statutory MRP each year through Voluntary Revenue Provision (VRP). The Council's CFR for the year is shown below, and represents a key prudential indicator.

Capital Financing Requirement	31 March 2006 Actual £m	31 March 2006 Original Indicator £m
Opening balance 1 April 2005	14.89	16.74
Plus unfinanced capital expenditure	0.36	1.23
Less MRP	0.14	0.57
Closing balance 31 March 2006	**15.11**	**17.40**

* - Includes deferred purchase and finance lease repayments

5.4 **Treasury Position at 31 March 2006**

5.4.1 The treasury position at the 31 March 2006 compared with the previous year was:

Treasury position	31 March 2006		31 March 2005	
	Principal	Average Rate	Principal	Average Rate
Fixed Interest Rate Debt	£14.67m	5.63%	£13.96m	5.68%
Variable Interest Rate Debt	£2.96m	4.80%	£1.10m	5.10%
Total Debt	**£17.63m**	**5.49%**	**£15.06m**	**5.65%**
Fixed Interest Investments	£8.08m	4.55%	£5.48m	4.87%
Variable Interest Investments	£0.00m	0.00%	£0.00m	0.00%
Total Investments	**£8.08m**	**4.55%**	**£5.48m**	**4.87%**
Net borrowing position	**£9.55m**		**£9.58m**	

5.5 **The Strategy Agreed for 2005/06**

5.5.1 The strategy provided for 2005/06 expected that supported borrowing would be no more than £800,000, and that investments would be made only with a counterparty that is on the Council's approved list and that no more than £2,000,000 is to be invested with any one counterparty at any time.

5.6 **Actual debt management activity during 2005/06**

5.6.1 **Borrowing** - Loans were drawn to finance the net capital spend and naturally maturing debt. The loans drawn were:

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£0.70m	Fixed interest rate	4.70%	25.5 years

5.6.2 **Rescheduling** – No debt rescheduling took place during 2005/2006.

5.6.3 **Repayment** – No repayment of maturing debt took place in 2005/2006.

5.6.4 **Summary of Debt Transactions** – The overall position of the debt activity resulted in a fall in the average interest rate by 0.05%.

5.7 **Prudential Indicators and Compliance Issues**

5.7.1 Some of the required prudential indicators provide either an overview or specific limits on treasury activity. These are shown below:

5.7.2 **Net Borrowing and the CFR** - 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 highlights that the Council has complied with this requirement.

	31 March 2006 Actual	31 March 2006 Original Indicator
Net borrowing position	**£9.55m**	**£11.26m**
Capital Financing Requirement	**£15.11m**	**£17.40m**

5.7.3 **The Authorised Limit** - The Authorised Limit is the "Affordable Borrowing Limit" required by s3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2005/06 the Council has maintained gross borrowing within its Authorised Limit.

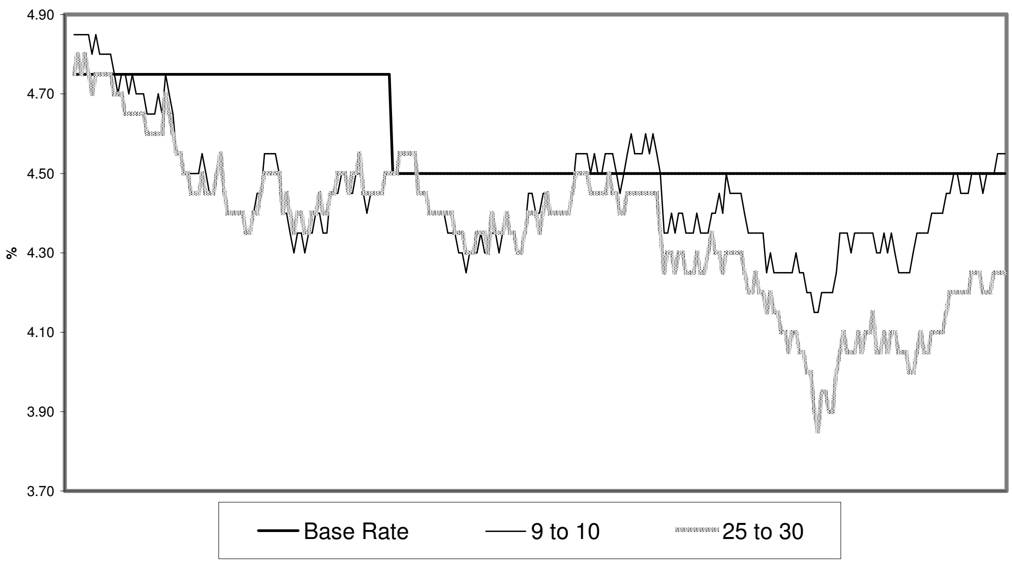
5.7.4 **The Operational Boundary** – The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

5.7.5 **Actual financing costs as a proportion of 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.

	2005/06
Original Indicator - Authorised Limit	**£20.50m**
Maximum gross borrowing position during 2005/06	**£19.65m**
Original Indicator - Operational Boundary	**£17.40m**
Average gross borrowing position during 2005/06	**£15.57m**
Minimum gross borrowing position during 2005/06	**£14.65m**
Financing costs as a proportion of net revenue stream	**6.09%**

5.8 Economic Background for 2005/06

UK Interest Rate Trends 2005/06



5.8.1 UK interest rates remained within a tight range during the 2005/06 financial year. Base rates opened the period at 4.75% and ended a quarter-point lower at 4.5%. In spite of this, longer-dated fixed interest rates fluctuated more, rising and falling in response to notable shifts in market expectations.

5.8.2 The year started on a pessimistic note. The apparent failure of consumer spending and the housing market to respond to the Bank of England's policy base rate rises – in train since November 2003 – supported suggestions that base rates had further to rise before peaking in the later stages of 2005.

5.8.3 These concerns faded quickly, in spite of an unfavourable international background where the rise in US interest rates showed no signs of abating. UK economic data suggested the economy was slowing down faster than had been assumed just a few months earlier. As evidence of this slowdown gathered, expectations of a return to a more stable monetary policy strengthened.

5.8.4 Base rates were finally cut by 0.25% to 4.5% in August and hopes of further reductions in the autumn and spring 2006 were widespread. However optimism faded as signs of a recovery in UK activity increased whilst the international interest rate backdrop deteriorated.

5.8.5 Long-term (PWLB) fixed interest rates followed an erratic path. Some declines were seen in the first half of the year as concerns about the combination of economic activity and inflation faded. However, it was technical factors that proved to be the main driving force behind long-term fixed interest rates. These comprised strong flows of international funds to bonds and very heavy UK pension fund demand for fixed income assets.

5.8.6 Technical demand came to a head in late 2005 and early 2006. New bond supply to the UK market was insufficient to satisfy this and long-term fixed interest rates were driven to historic lows. This trend was seen most clearly for very long interest rates and the rate on the new 45-50 year PWLB loan (introduced in early December 2005) reached a low of 3.7%.

5.8.7 The downward trend did not continue. Strong demand associated with international fund inflows and UK pension fund investment weakened as investors chose not to chase yields to yet lower levels. In addition to this, fears that overseas interest rates had a good deal further to rise in the face of strengthening activity in the US, Japan and the Euro-zone encouraged a switch away from bond investments. As a result, long-term interest rates rebounded in February and March but still ended the year some 0.25% below where they had started.

5.9 <u>Investment Position</u>

5.9.1 **Investment Policy –** The Council's investment policy is governed by ODPM Guidance, which has been implemented in the annual investment strategy approved by Council on 24 February 2005. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

5.10 <u>Investments held by the Council</u>

The Council does not have the expertise or resources to actively use a wide range of investment products and therefore performance tends to be more stable but lower over the longer term than for professionally managed funds (whose performance may fluctuate more). The Council maintained an average balance of £6.692m and received an average return of 4.61%. The comparable performance indicator is the average 7-day LIBID rate, which was 4.54%.

5.11 <u>Performance Indicators set for 2005/06</u>

5.11.1 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. The latest CIPFA Treasury Management Statistics, which are for the year 2004/2005, show:

Debt – Borrowing – Gross average rate of interest on all external debt for this Council was 5.69% as compared to all English non-metropolitan Districts rate of 6.40%

Investments – this Council's average rate of interest on all external investments was 4.50% as compared to all English non-metropolitan Districts rate of 5.19%.

5.12 **Regulatory Framework, Risk and Performance**

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

- The Local Government 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 Secretary of State 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 (SI) 3146 2003, as amended, develops the controls and powers within the Act;
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;
- Under the Act the ODPM has issued Investment Guidance to structure and regulate the Council's investment activities.

5.12.2 The Council has complied with all of the above relevant statutory and regulatory requirements which limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

5.12.3 The Council is aware of the risks of passive management of the treasury portfolio and, with the support of Butlers, the Council's advisers, has proactively managed its treasury position. The Council has continued to utilise historically low borrowing costs and has complied with its internal and external procedural requirements. There is little risk of volatility of costs in the current debt portfolio as the interest rates are predominantly fixed, utilising long-term loans.

5.12.4 Shorter-term rates and likely future movements in these 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 annual investment strategy, accurately forecasting future returns can be difficult.

6. **RECOMMENDATIONS**

The Council is recommended to:

- Approve the actual 2005/06 prudential indicators within the report.
- Note the treasury management stewardship report for 2005/06.

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Version 1.0

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