NORTH LANARKSHIRE COUNCIL

AGENDA ITEM No. 12

REPORT

To: POLICY & RESOURCES (FINANCE) SUB-COMMITTEE		Subject: PRUDENTIAL CODE FOR CAPITAL FINANCE – PRUDENTIAL INDICATORS 2005/06 TO 2007/08
From: DIRECTOR OF FINANCE		
Date: 13th Jan 2005	Ref: JV/KH	

1. Introduction

1.1. The Prudential Code for Capital Finance in Local Authorities was introduced in April 2004 and brought about a change to capital spending controls from 1st April 2004. From that date, councils have freedom to invest in capital projects without the limitation of Section 94 controls, provided their programmes can be shown to be affordable, prudent and sustainable.

1.2. The Treasury Strategy Statement 2004/05 which was approved by Committee on 23rd March 2004, highlighted the key requirements of the Prudential Code, including the mandatory prudential indicators that are deemed essential for demonstrating that the Council's capital investment plans are affordable, prudent and can be sustained over time within a sound financial environment. These key indicators are monitored consistently and are presented quarterly to the Policy & Resources (Finance) Sub-Committee to assist members in ensuring that projected levels of capital expenditure remain in line with the requirements of the Code.

2. Prudential Indicators

2.1. This report builds on the framework introduced during 2004. The key mandatory indicators required by the Code are illustrated for 2005/06 through to 2007/08 and, with a view to more fully informing the decision making process, some additional local indicators have been included. In calculating these indicators, due recognition has been taken of both the CIPFA Code of Practice on Treasury Management, and the Prudential Code for Capital Finance in Local Authorities.

2.2. The Prudential Indicators which the Council is requested to approve are set out in the attached appendix, and include mandatory and local indicators, categorised as:

(i) Capital expenditure, Capital Financing Requirement and the Prudential Margin
(ii) Ratio of Financing Cost to Net Revenue Streams
(iii) Authorised Limit and Operational Boundary
(iv) Impact on Council Tax and Housing Rents
(v) Treasury Management Indicators

3. Conclusion

3.1. The indicators illustrated in the appendix provide members with the assurance that the key objectives of the Prudential Framework (i.e. prudence and affordability) have been satisfied. When taken together, the indicators illustrate that the increase in capital investment from 2005/06 onwards is both prudent and affordable. Healthy prudential margins from 2004/05 onwards justify the increased investment, the cost or affordability of which is contained within the existing financial strategies, resulting in no impact on council tax and housing rent levels.

4. Recommendations

4.1. The Committee is requested to approve the Prudential Indicators and the limits detailed within the attached appendix and to note that further reports will be brought forward which will monitor their effectiveness and robustness.

Director of Finance

Prudential Indicators for Approval, 2005/06 Appendix 1

1. Introduction

1.1. The key objectives of the Prudential Code are to ensure that the capital investment plans are affordable, prudent and sustainable, and to ensure that treasury management decisions are taken in accordance with good professional practice.

1.2. To facilitate members' decision-making regarding capital investment and treasury decisions, a variety of mandatory indicators are detailed below. Additionally, the report details new local indicators to more fully illustrate the Council's Treasury Management activity and circumstances.

1.3. The indicators are categorised into 5 broad headings. These include: -

(a) Capital expenditure, Capital Financing Requirement and the Prudential Margin
(b) Ratio of Financing costs to Net Revenue Streams
(c) Authorised Limit, Operational Boundary and External Debt
(d) Impact on Council Tax and Housing Rents
(e) Treasury Management Indicators

2. Capital Expenditure, Capital Financing Requirement and Prudential Margin

2.1. *Capital Expenditure*

2.1.1. The undernoted table sets out the capital expenditure plans for the Council over the 5-year period for 2003/04 through to 2007/08, for both General Service and H.R.A capital programmes. In June 2003, members approved additional capital expenditure of £15m for 2004/05 and 2005/06, which has been continued into 2006/07 and 2007/08 budgets. As is current practice, movements in capital expenditure will be monitored as part of the Council's capital programme reporting mechanisms. The remaining sections of this report aim to provide members with information that illustrates that proposed levels of capital investment are affordable, prudent and sustainable.

Capital Expenditure	2003/04 Actual (000s)	2004/05 Revised (000s)	2005/06 Estimates (000s)	2006/07 Estimate (000s)	2007/08 Estimate (000s)
Total spend	**62,634**	**101,814**	**103,170**	**93,739**	**93,355**
Financed by:					
Borrowing	28,093	31,588	37,085	41,397	43,576
Capital receipts	20,231	38,374	37,971	33,612	32,669
Cash grants	5,673	15,674	16,064	9,200	9,200
CFCR	8,637	16,178	12,050	9,530	7,910

Table 1

2.2. *Capital Financing Requirement*

2.2.1. The Prudential Code requires Councils to be aware of the Capital Financing Requirement (CFR) levels which correspond to their proposed levels of capital investment, since these are deemed to be representative of the Council's underlying need to borrow for capital purposes. Table 2 illustrates these figures for 2003/04 through to 2007/08, analysed between HRA and non-HRA services.

Capital Financing Requirement	2003/04 Actual (000s)	2004/05 Revised (000s)	2005/06 Estimate (000s)	2006/07 Estimate (000s)	2007/08 Estimate (000s)
CFR - Non Housing	155,275	161,170	166,162	171,947	177,436
CFR - Housing	260,457	270,344	278,714	288,421	297,628
Total CFR	**415,732**	**431,514**	**444,876**	**460,368**	**475,064**

Table 2

2.3. ***Comparison of Capital Financing Requirement with Net Borrowing (Prudential Margin)***

2.3.1. The Prudential Code requires the Council's capital investments to be affordable and prudent, and in order for members to satisfy themselves that borrowing levels are prudent and primarily for capital purposes only, the Capital Financing requirement discussed in para. 2.2 should be considered in tandem with the Council's expected level of borrowing, since Prudence is deemed to exist whenever net borrowing is less than the capital-financing requirement. Table 3 below illustrates the Prudential Margin from 2003/04 to 2007/08.

Prudential Margin	**2003/04 Actual (000s)**	**2004/05 Revised (000s)**	**2005/06 Estimate (000s)**	**2006/07 Estimate (000s)**	**2007/08 Estimate (000s)**
Net Borrowing	406,841	423,270	437,322	453,504	468,891
Capital Financing requirement	415,732	431,514	444,876	460,368	475,064
Prudential Margin	**8,891**	**8,244**	**7,554**	**6,864**	**6,173**

Table 3

2.3.2. Table 3 illustrates that healthy prudential margins will continue to exist from 2003/04 onwards, hence borrowing levels are prudent in comparison to the capital investment levels proposed.

3. Ratio of Financing costs to Net Revenue Stream

3.1. Since capital expenditure impacts on the revenue budget through financing charges, the Council needs to ensure that financing costs not only remain affordable, but also that they don't constitute an excessive proportion of the revenue resources available. To assist with this matter, ratios of borrowing costs to revenue forecasts for the next 3 years are illustrated in table 4 below. The table demonstrates that for example, non-HRA loan charges are estimated to represent between 5% and 6% of the total revenue budget available. Although the estimates gradually increase from 2004/05 onwards, the increase is not substantial; hence additional capital investment appears to be affordable and sustainable.

3.2 In noting the percentage on loan charges within the HRA budget, it is recognised that a major element of revenue costs in the Housing Account is the funding support to sustain the substantial investment programme; the other main elements of expenditure being repair costs and management costs. The level of loan charges is acceptable and deemed prudent and affordable within the framework of the Council's 30 year Housing investment plan.

Ratio of financing costs to net revenue stream					
	2003/04 Actual	**2004/05 Estimate**	**2005/06 Estimate**	**2006/07 Estimate**	**2007/08 Estimate**
Non-HRA	6.03%	5.30%	5.38%	5.49%	5.82%
HRA	30.79%	22.01%	21.64%	22.15%	22.86%

Table 4

4. Authorised Limit, Operational Boundary and External Debt

4.1. The Authorised Limit and Operational Boundary are the Prudential Indicators being used to control the overall level of borrowing supporting both capital investment requirements, and day to day revenue cash transactions.

4.2. Chart 1 illustrates that borrowing levels during 2004/05 remained well below both the authorised limit and operational boundary. Given the level of borrowing and CFR (underlying need to borrow) levels illustrated in table 3, it is proposed that the authorised limit and operational boundary should be reduced to the new of £520 million and £485 million respectively to more accurately reflect the actual levels of borrowing. Details are included in tables 4 and 5.

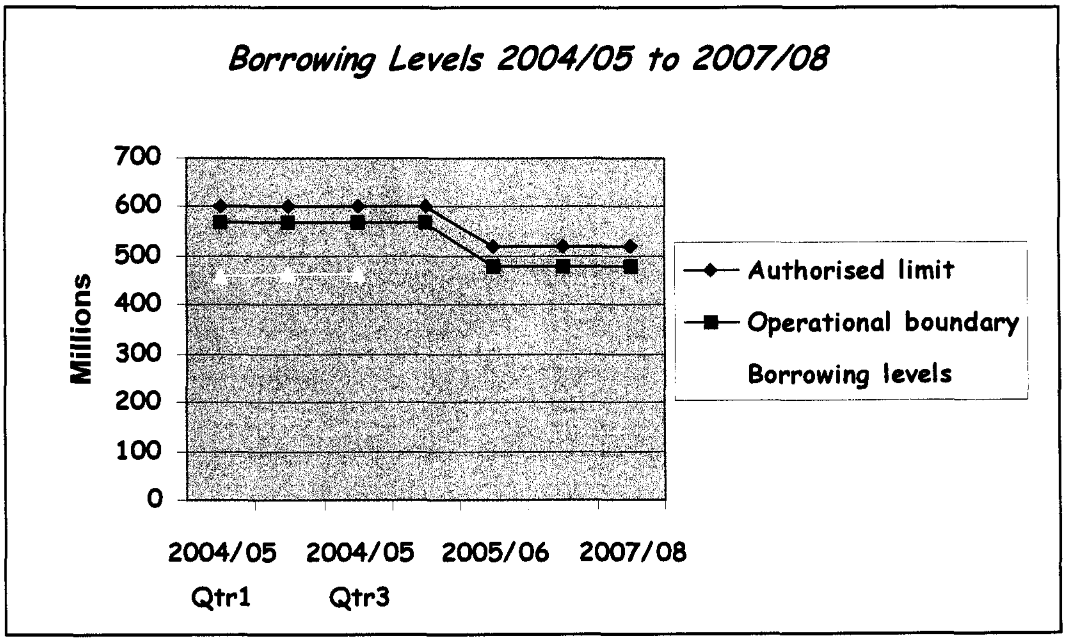

Chart 1

4.3. ***Authorised Limit.***

4.3.1. The authorised limit represents the maximum limit beyond which borrowing is prohibited. Although this limit is deemed to be affordable in the short-term, it is not a desirable or sustainable level of borrowing for the Council, and is therefore being set as the maximum allowable in each of the years 2005/06 through to 2007/08. The level set for 2004/05 is shown for comparison.

Authorised Limit	**2004/05 £000,000**	**2005/06 £000,000**	**2006/07 £000,000**	**2007/08 £000,000**
• Borrowing	600	519	519	519
• Other long term liabilities	0	1	1	1
	600	**520**	**520**	**520**

Table 5

4.4. ***Operational Boundary***

4.4.1. The operational boundary is based on the probable level of external debt during the course of the year, taking into consideration the Council's Treasury Management Practices and capital expenditure plans. The operational boundary also allows the flexibility to borrow, re-invest and undertake debt restructuring during the course of the year. It is therefore possible, and acceptable, for actual borrowing to vary around this boundary for short periods during the year, hence the department will continue to monitor borrowing levels to ensure that the authorised limit shown in table 5 above is not breached.

Operational Boundary	**2004/05 £000,000**	**2005/06 £000,000**	**2006/07 £000,000**	**2007/08 £000,000**
• Borrowing	570	484	484	484
• Other long term liabilities	0	1	1	1
	570	**485**	**485**	**485**

Table 6

4.5. *External Debt*

4.5.1. The Prudential Code requires councils to publish details of the most recent actual external debt figure contained in their balance sheet. As at 31st March 2004, North Lanarkshire Council had approximately **£457m** of external debt outstanding. This is not directly comparable with either the Authorised Limit or Operational Boundary, since the actual external debt figure simply reflects the Council's debt position at that one point in time i.e. 31st March 2004, and borrowing does fluctuate during the course of year to reflect for example, cash flow requirements, timing of loan repayments and so on.

5. Impact on Council Tax and Housing Rents

5.1. The fundamental objective in the consideration of the affordability of the Council's capital plans is to ensure that capital investment levels are sustainable, which is primarily judged by considering the **impact the increased programme has on Council Tax and Housing rent levels.**

5.2. *Impact on Council Tax Levels*

5.2.1. Table 7 summarises the proposed capital programme for General Services up to 2007/08Recent Prudential Code guidance made reference to the fact that councils should demonstrate as a matter of routine and best practice, the incremental impact that changes to the existing capital programme will have on Council tax levels. This is set out below:-

Capital Expenditure	Base Programme 2004/05 Approved Feb 2004 (000s)	2005/06 Capital Investment Proposed (000s)	2006/07 Capital Investment Proposed (000s)	2007/08 Capital Investment Proposed (000s)
Total spend	53,862	62,806	54,050	53,755
Financed by:				
Borrowing	30,700	30,700	33,500	33,500
Capital receipts	9,450	15,042	11,350	11,055
Cash grants	13,712	16,064	9,200	9,200
CFCR	0	1,000	0	0
Incremental Change to Base Programme.		*+8,944*	*+188*	*-107*
Changes to loan charges		*+1.250*	*+1.5*	*+1.5*
Indicative impact on Council Tax band D		*£12*	*£14*	*£14*
Impact as % of Band D total		*1.15%*	*1.30%*	*1.26%*

Table 7

5.2.2. Table 7 illustrates that proposed capital investment levels could potentially increase Band D Council Tax levels by £12 and £14 in 2005/06, 2006/07 and 2007/08 respectively. However, the Council's robust financial strategy has enabled the additional loan charges required to fund the increased investment programme to be managed within the framework of the Council's planned budget resources. Therefore, there will **no impact on council tax levels beyond that which is set out in the Financial Plan.** The above figures is for indicative purposes only.

5.3. *Impact on Housing Rent Levels*

5.3.1. Similar to table 7 above, the HRA capital programme for 2004/05 programme approved by members is used to determine the potential impact that increasing capital investment may have on housing rent levels.

Capital Expenditure	Base Programme 2004/05 Approved Feb 2004 (000s)	2005/06 Capital Investment Proposed (000s)	2006/07 Capital Investment Proposed (000s)	2007/08 Capital Investment Proposed (000s)
Total spend	**38,666**	**40,364**	**39,690**	**39,600**
Financed by:				
Borrowing	5,863	6,385	7,897	10,076
Capital receipts	20,593	22,929	22,262	21,614
CFCR	12,210	11,050	9,530	7,910
Incremental Change to Base Programme.		***+1,698***	***+1,023***	***+934***
Movement in Loan charges and CFCR		***-1,420***	***-1,104***	***-997***
Indicative impact on Housing Rents per annum		***-£36***	***-£29***	***-£27***
Impact as % of weekly rents		***-1.55%***	***-1.21%***	***-1.09%***

Table 8

5.3.2. Table 8 illustrates that capital investment levels proposed for 2005-06 to 2007/08 could potentially reduce house rents by £36, £29 and £27 per annum respectively, given the anticipated reductions in Loan Charges and CFCR. However, given that the Council's thirty-year housing programme reflects the Housing Stock Condition Survey and option appraisal exercise, house rents will remain within the targets set to compensate for other cost pressures including contract inflation and the management of the Council's housing portfolio.

6. Treasury Management Indicators

6.1. ***Interest Rate Exposures***

6.1.1. The Prudential Code requires the Council to set limits regarding its maximum exposure to both fixed and variable interest rates, and to then contain the activity of its Treasury function within these self-determined upper limits.

6.1.2. The Council's current loan portfolio consists of both fixed and variable rate debt, plus a variety of variable rate investments. The Code requires authorities to set limits that monitor its exposure to the effects of changes in interest rates, by expressing its net interest payments as percentages. To comply with the requirements of the Code, and in accordance with the Council's approved Treasury Management Strategy regarding exposure to variable rate loans, table 9 highlights these limits.

Interest Rate Exposures: -	2005/06	2006/07	2007/08
Upper Limits on fixed interest rates	110%	105%	105%
Upper Limits on variable interest rates	25%	25%	25%

Table 9

6.1.3. In addition to the mandatory indicator regarding fixed and variable interest rate exposure, members are also asked to consider and approve some local indicators, that better illustrate the Council's anticipated treasury management strategy.

6.1.4. Based on information available as at 31st December 2004, it is anticipated that the Council's loan portfolio for 2005/06 to 2007/08 will be exposed to interest rate changes as follows:

Content of loan portfolio	2005/06		2006/07		2007/08	
	Value	%	Value	%	Value	%
	£000s		£000s		£000s	
Interest Council is due to pay:						
Loans with Fixed rate debt	30,352	**97.37%**	30,246	**97.47%**	30,528	**97.71%**
Loans with Variable rate debt	820	**2.63%**	784	**2.53%**	717	**2.29%**
	31,172	**100%**	31,030	**100%**	31,245	**100%**
Interest Council is due to receive:						
Variable rate investments	- 2,479	**100%**	- 1,868	**100%**	- 1,087	**100%**
Net Loan Interest Payments	**28,693**		**29,162**		**30,158**	

Table 10

6.1.5. Table 10 highlights for example that the Council anticipates net loan interest payments of approximately £29 million for 2005/06. Of this total, £30.352 million relates to loans that are fixed rate debt, and for which interest payments are guaranteed until the loans mature. Conversely, £0.82 million relates to loans which are variable rate, and £2.479 million relates to investments which the Council anticipates receiving interest from. Variable rate loans and investment interest are subject to changes in interest rates, and will be monitored as part of the Council's Treasury Management Strategy on an ongoing basis.

6.2. ***Maturity Structure of Borrowing***

6.2.1. The Prudential Code requires the Council to specify upper and lower limits regarding the maturity structure of its fixed rate borrowing in order to minimise the risk associated with the Council having to replace large sums of fixed rate debt at a time when there may be uncertainty over interest rate exposure.

6.2.2. Table 10 illustrated that the Council has high levels of fixed rate debt, however the current maturity profile of this debt is unlikely to be a major risk factor for the Council. Table 11 below illustrates the limits of fixed rate maturity which members are requested to approve as per the prudential code. These limits allow for any fixed debt falling due for repayment as part of a debt restructuring exercise. For comparison and decision-making purposes, local indicators relating to the maturity profiles regarding fixed rate debt as anticipated at 1st April 2005, 2006 and 2007 are also illustrated.

Maturity Structure of borrowing	< 12 months	12 months to 2 years	2 to 5 years	5 to 10 years	10 years + above
Upper limit maturing on fixed rate debt	**5%**	**5%**	**10%**	**25%**	**90%**
Maturity profile; fixed debt 1/4/05	0.35%	2.92%	5.22%	13.95%	77.57%
Maturity profile; fixed debt 1/4/06	2.65%	1.59%	3.99%	17.37%	74.40%
Maturity profile; fixed debt 1/4/07	0.28%	2.72%	7.10%	18.61%	71.29%

Table 11

6.3. ***Total principal funds invested for more than 364 days***

6.3.1. The Prudential Framework created enhanced investment opportunities for local authorities, so in order to ensure that councils contain their exposure to potential losses arising from having to repay long-term investments early, the Code requires authorities to set upper limits on funds being invested for more than 364 days.

6.3.2. The Council currently has no plans to radically alter its investment strategy and has no proposals to invest funds for periods of more than 364 days, in any of the forthcoming years.

7. Conclusion

7.1. The Prudential Code requires the Council to agree, monitor and where necessary revise, the mandatory prudential indicators that have been outlined in this document. These indicators will be updated and reported to Committee as part of the Finance Department's Performance Management Framework, and quarterly reporting of Treasury Management activity.