AGENDA ITEM No. 12

NORTH LANARKSHIRE COUNCIL

REPORT

To: POLICY & RESOURCES (FINANCE) SUB-COMMITTEE		Subject: PRUDENTIAL CODE ON CAPITAL FINANCE – PRUDENTIAL INDICATORS 2006/07 TO 2008/09
From: DIRECTOR OF FINANCE		
Date: 4 January, 2006	Ref: JV/KH/JQ	

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 2005/06 approved by Committee on 22nd March 2005 highlighted the key requirements of the Prudential Code, including the mandatory prudential indicators deemed essential for demonstrating the Council's capital investment plans as affordable, prudent and sustainable over time and within a sound financial environment. These key indicators are continuously monitored and 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 2006/07 through to 2008/09 and, with a view to more fully informing the decision making process; local indicators are also 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, Operational Boundary and External Debt
(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 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 proposed capital investment plans for 2006/07 onwards are prudent and affordable. Healthy prudential margins from 2005/06 onwards justify the investment levels, 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

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 local indicators that 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 2004/05 through to 2008/09, for both General Service and H.R.A capital programmes. However capital expenditure plans for 2008/09 in respect of General Services have yet to be developed, and therefore, all data detailed throughout the report regarding 2008/09 is subject to amendment over the coming year. Details of this and other movements in planned 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 the proposed levels of capital investment illustrated in table 1 below are affordable, prudent and sustainable.

Capital Expenditure	**2004/05 Actual (000s)**	**2005/06 Revised (000s)**	**2006/07 Estimates (000s)**	**2007/08 Estimate (000s)**	**2008/09 Estimate (000s)**
Total spend	**106,688**	**115,423**	**104,798**	**100,924**	**73,821**
Financed by:					
Borrowing	22,358	36,650	33,776	36,707	19,206
Capital receipts	44,183	44,988	45,580	39,459	36,729
Cash grants	22,194	19,680	13,040	13,211	7,500
CFCR	17,953	14,105	12,402	11,547	10,386

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 2004/05 through to 2008/09, analysed between HRA and non-HRA services.

Capital Financing Requirement	**2004/05 Actual (000s)**	**2005/06 Revised (000s)**	**2006/07 Estimate (000s)**	**2007/08 Estimate (000s)**	**2008/09 Estimate (000s)**
CFR - Non Housing	308,185	317,548	323,138	329,325	322,547
CFR - Housing	113,986	117,531	119,600	121,891	119,382
Total CFR	**422,171**	**435,079**	**442,738**	**451,216**	**441,929**

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 2004/05 to 2008/09.

Prudential Margin	**2004/05 Actual (000s)**	**2005/06 Revised (000s)**	**2006/07 Estimate (000s)**	**2007/08 Estimate (000s)**	**2008/09 Estimate (000s)**
Net Borrowing	399,563	426,395	432,989	440,402	430,050
Capital Financing requirement	422,171	435,079	442,738	451,216	441,929
Prudential Margin	**22,608**	**8,684**	**9,749**	**10,814**	**11,879**

Table 3

2.3.2. Table 3 illustrates that healthy prudential margins will continue to exist from 2004/05 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 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 4.96% and 6.16% of the total revenue budget available. Although the estimates gradually increase from 2005/06 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					
	2004/05 Actual	**2005/06 Estimate**	**2006/07 Estimate**	**2007/08 Estimate**	**2008/09 Estimate**
Non-HRA	4.96%	5.88%	6.02%	6.16%	TBC
HRA	21.29%	21.64%	19.13%	19.10%	19.36%

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 quarters 1 and 2 of 2005/06 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 2005/06 authorised limit and operational boundary approved levels of £520 million and £485 million are retained, since these reflect the actual levels of borrowing experienced to date. Details are included in tables 4 and 5.

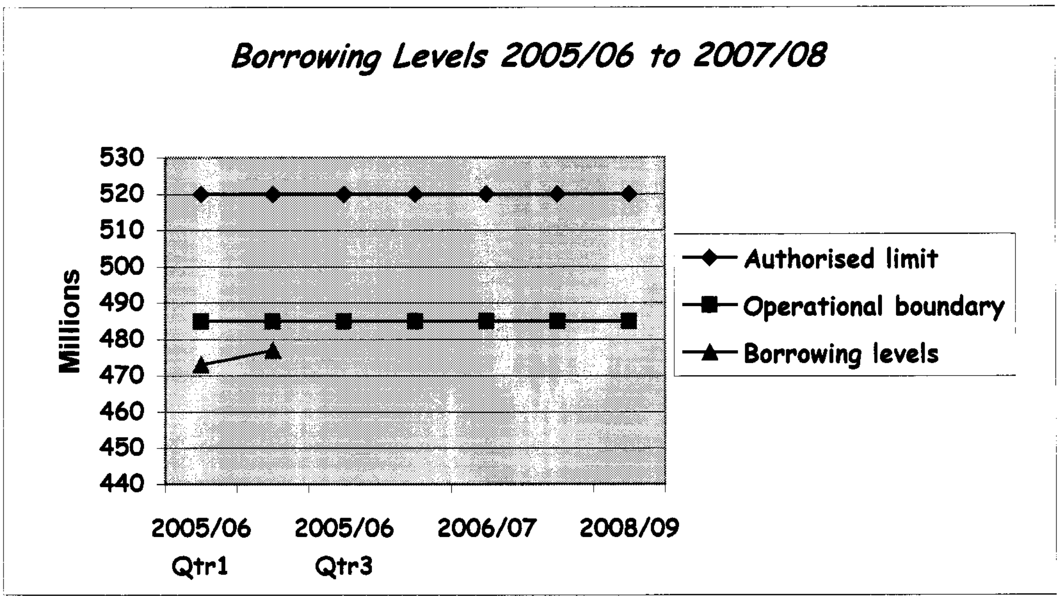

Chart 1

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 2006/07 through to 2008/09. The level set for 2005/06 is shown for comparison.

Authorised Limit	**2005/06 £000,000**	**2006/07 £000,000**	**2007/08 £000,000**	**2008/09 £000,000**
• Borrowing	519	519	519	519
• Other long term liabilities	1	1	1	1
	520	**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	**2005/06 £000,000**	**2006/07 £000,000**	**2007/08 £000,000**	**2008/09 £000,000**
• Borrowing	484	484	484	484
• Other long term liabilities	1	1	1	1
	485	**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 2005, North Lanarkshire Council had approximately **£461m** 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 2005, 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***

5.1.1 Table 7 summarises the proposed capital programme for General Services up to 2008/09. It should be noted that an estimate of planned resources has been included for 2008/2009 to reflect the minimum level of borrowing and receipts. This will be further updated as future years' programmes are developed. Recent 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 2005/06 Approved Feb 2005 (000s)**	**2006/07 Capital Investment Proposed (000s)**	**2007/08 Capital Investment Proposed (000s)**	**2008/09 Capital Investment Proposed (000s)**
Total spend	**62,806**	**63,046**	**57,777**	**31,500**
Financed by:				
Borrowing	30,700	33,500	33,500	15,000
Capital receipts	15,042	16,506	11,066	9,000
Cash grants	16,064	13,040	13,211	7,500
CFCR	1,000	0	0	0
Incremental Change to Base Programme.		***+240***	***-5,069***	***-31,306***
Changes to loan charges		***+£1,250***	***+£1.250***	***0***
Indicative impact on Council Tax band D		***£12***	***£12***	***£0***
Impact as % of Band D total		***1.11%***	***1.07%***	***0%***

Table 7

5.1.2 Table 7 illustrates that proposed capital investment levels utilising prudential code funding of £15m per annum could potentially increase Band D Council Tax levels by £12 in 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 be **no impact on council tax levels beyond that which is set out in both current or future Financial Plans.** The above figures are for indicative purposes only.

5.2 ***Impact on Housing Rent Levels***

5.2.1 Similar to table 7 above, the HRA capital programme for 2005/06 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 2005/06 Approved Feb 2005 (000s)**	**2006/07 Capital Investment Proposed (000s)**	**2007/08 Capital Investment Proposed (000s)**	**2008/09 Capital Investment Proposed (000s)**
Total spend	**40,364**	**41,752**	**43,147**	**42,321**
Financed by:				
Borrowing	6,385	276	3,207	4,206
Capital receipts	22,929	29,074	28,393	27,729
CFCR	11,050	12,402	11,547	10,386
Incremental Change to Base Programme.		***+1,388***	***+2,783***	***+1,957***
Movement in Loan charges and CFCR		***-973***	***-813***	***-898***
Indicative impact on Housing Rents per annum		***-£25.17***	***-£21.71***	***-£24.78***
Impact as % of weekly rents*-1.06*		***%***	***-0.88%***	***-0.98%***

Table 8

5.2.2 Table 8 illustrates that capital investment levels proposed for 2006-07 to 2008/09 would have a marginal impact on rent levels. 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: -	**2006/07**	**2007/08**	**2008/09**
Upper Limits on fixed interest rates (net of investments)	110%	110%	110%
Upper Limits on variable interest rates (net of investments)	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 2005, it is anticipated that the Council's loan portfolio for 2006/07 to 2008/09 will be exposed to interest rate changes as follows:

Content of loan portfolio	2006/07		2007/08		2008/09	
	Value	**%**	**Value**	**%**	**Value**	**%**
	£000s		£000s		£000s	
Interest Council is due to pay:						
Loans with Fixed rate debt	30,565	**97.35%**	30,967	**97.69%**	30,682	**97.84%**
Loans with Variable rate debt	831	**2.65%**	731	**2.31%**	678	**2.16%**
	31,396	**100%**	31,698	**100%**	31,360	**100%**
Interest Council is due to receive:						
Variable rate investments	- 2,916	**100%**	- 2,479	**100%**	- 2,191	**100%**
Net Loan Interest Payments	**28,480**		**29,219**		**29,169**	

Table 10

6.1.5 Table 10 highlights for example that the Council anticipates net loan interest payments of approximately £28.48 million for 2006/07. Of this total, £30.565 million relates to loans that are fixed rate debt, and for which interest payments are guaranteed until the loans mature. Conversely, £0.831 million relates to loans which are variable rate, and £2.916 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 2006, 2007 and 2008 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 1/4/06	2.62%	0.30%	5.16%	12.55%	79.37%
Maturity profile; fixed debt 1/4/07	0.31%	1.34%	4.02%	16.27%	78.06%
Maturity profile; fixed debt 1/4/08	1.35%	1.43%	4.81%	17.50%	74.91%

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.