
**TREASURY MANAGEMENT ANNUAL REPORT AND
ACTUAL PRUDENTIAL INDICATORS 2005/06**

**Responsible Cabinet Member – Councillor Don Bristow,
Resource Management Portfolio**

Responsible Director – Paul Wildsmith, Director of Corporate Services

Purpose of Report

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

Introduction and Background

2. The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:
 - (a) 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;
 - (b) 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);
 - (c) Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;
 - (d) The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;
 - (e) 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;
 - (f) Under the Act the Department for Communities and Local Government (DC & LG) has issued Investment Guidance to structure and regulate the Council's investment activities.

3. This Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Sector and operates its treasury management service in compliance with this Code and the above requirements. The treasury management activities include managing the Councils cashflow, its borrowing activities and the investment of surplus funds. These activities are structured to manage risk as a priority and then optimise performance, borrowing activities are undertaken in a prudent, affordable and sustainable basis.
4. The Code requires as a minimum the regular reporting of treasury management activities to:-
 - (a) Forecast the likely activity for the forthcoming year (in the Annual Treasury Strategy Report); and
 - (b) Review actual activity for the proceeding year (this report).
5. This report sets out:-
 - (a) A summary of the strategy agreed for 2005/06;
 - (b) The Council's treasury position at 31 March 2006;
 - (c) Prudential Indicators and compliance with limits;
 - (d) A summary of the economic background affecting the strategy over 2005/06;
 - (e) Treasury Management activity during 2005/06;
 - (f) Performance and Risk.

The Treasury Management Strategy Agreed for 2005/06

6. The revised strategy (agreed by Council 26th January 2006) anticipated that during 2005/06 the Council will need to borrow an additional £20.717m to cover part of its Capital Programme.
7. The Annual Investment Strategy stated that the Council will carefully balance the use of specified investments and non- specified investments into the future to ensure there is appropriate operational liquidity. In the normal course of the Council's cashflow operations it is expected that both specified and non-specified investments will be utilised for the control of liquidity as both categories allow for short-term investments.
8. The use of longer term instruments (greater than one year from inception to repayment) will fall in the non-specified investment category. These instruments will only be used where the council's liquidity requirements are safeguarded. An estimate of long term investments (over 1 year) was included in the report on the Prudential Indicators update approved by the Council on 26th January 2006 and the following estimates for long term investments were included for the three years 2005/06 £10m. 2006/07 £10m and 2007/08 £10m

Treasury Position at 31 March 2006

9. The treasury position at the 31 March 2006 compared with the previous year was:-

Table 1

	31 March 2006		31 March 2005	
	Principal	Average Rate	Principal	Average Rate
PWLB and Money Market Debt	£86.603	4.69%	£72.228m	4.80%
Total Debt	£86.603m		£72.228m	
Cashflow Investments	£21.490m	4.66%	£15.400m	4.66%
Capital Investments	£24.900m	4.86%	£19.900m	4.67%
Total Investments	£46.390m		£35.300m	

10. The change in the treasury position was due to increased borrowing to cover capital expenditure financed by borrowing and increased cashflow due to the increases in general reserves throughout 2005/06. The rise in the rate of return on capital investments relates directly to those investments placed over 1 year.

Prudential Indicators and Compliance Issues

11. The Council is required by the Prudential Code to report the actual prudential indicators after the year end. **Appendix 1** provides a schedule of all the mandatory prudential indicators. In addition to the indicators highlighted in Appendix 1 the Council is required as a Prudential Indicator to:

- (a) Adopt the CIPFA Code of Practice.
- (b) Ensure that over the medium term borrowing will only be for a capital purpose (i.e. net external borrowing is less than the Capital Financing Requirement (CFR)).

12. The compliance, for these indicators, is highlighted elsewhere in the report.

13. Certain of these indicators provide either an overview or a limit on treasury activity, and these are shown below:

Table 2

	31 March 2006 Actual	31 March 2006 Revised* Indicator
Net borrowing position	£40.213m	£55.756m
Capital Financing Requirement	£79.593m	£93.231m

*Agreed by Council 26th January 2006

14. The Capital Financing Requirement (CFR) shows the Council's underlying need to borrow for a capital purpose, and this is a gauge for the Council's debt position shown above. In order to ensure that over the medium term borrowing net of investments will only be for a capital purpose, net borrowing should not, 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 above highlights that the Council has complied with this requirement.

Table 3

	2005/06
Revised Indicator - Authorised Limit	£108.414m
Revised Indicator - Operational Boundary	£94.273m
Maximum gross borrowing position during the year	£86.847m
Minimum gross borrowing position during the year	£72.802m

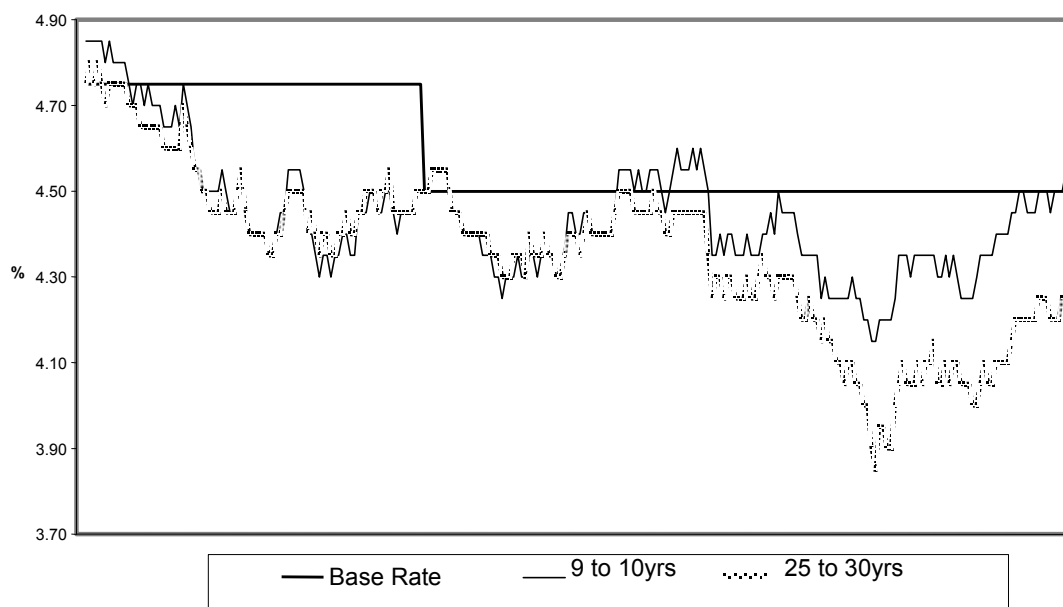
15. The Authorised Limit is the “Affordable Borrowing Limit” required by Section 3 of the Local Government Act 2003. The table demonstrates that during 2005/06 the Council has maintained gross borrowing within its Authorised Limit.
16. The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or above the Boundary are acceptable subject to the Authorised Limit not being breached. The Council also remained below the operational boundary throughout 2005/06.

Economic Background for 2005/06

17. 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. Table 4 below shows UK interest rates throughout 2005/06.

Table 4

UK Interest Rate Trends 2005/06



18. 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.

19. 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.
20. 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.
21. 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.
22. This demand, based on the structure of the market rather than economic factors, 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%.
23. 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 increased in February and March but still ended the year some 0.25% below where they had started.

Treasury Management Activity During 2005/06 Debt Position

24. **Borrowing** - Capital expenditure for the year was £37.024m, and loans were drawn to fund part of this capital spend and maturing debt. Loans drawn were:-

Table 5

Lender	Principal	Type	Interest Rate	Maturity	Average rate for new borrowing from PWLB for 2005/06
PWLB	£15.500m	Fixed interest rate	4.35%	Average 27 years	4.355% from Appendix 2

25. This compares with a budget assumption of borrowing at an interest rate of 5%.
26. The table below shows the actual activity for interest charges and repayment of debt against budget for 2005/06.

Table 6

	Original Budget 2005/06	Revised Budget 2005/06	Actual 2005/06
Interest charges and repayment of debt	£4.274m	£4.142m	£4.221m
Average rate	4.70%	4.70%	4.69%

27. **Rescheduling** – Four loans were rescheduled during 2005/06 amounting to £5.974m and replaced with two new loans from the PWLB at interest rates of 3.90%. As a result annual savings of £0.015m will be made to the General Fund after taking into account the effect on the Housing Revenue Account
28. **Repayment** – During 2005/06 the Council repaid £1.125m of maturing variable PWLB debt.
29. **Market Loans** – During 2002/03 the Council took out 2 stepped interest rate loans through the money market. These loans had a low interest rate for an initial period followed by a higher rate for the rest of the fixed term period. During 2005/06 the accounting treatment of such loans changed and an average interest is to be used. This has increased the amount of interest charged into 2005/06. This additional interest has been transferred to a provision, which will be used in future years to offset any increased interest rate charges.
30. **Summary of Debt Transactions** – Because of the new accounting treatment for Stepped Market loans and new loans taken out during 2005/06, which have interest rates below the previous years average rate, the new average rate for 2005/06 has reduced from 4.80% to 4.69%.

Investment Position

31. **Investment Policy** – The Council's investment policy is governed by DC & LG Guidance, which is implemented in the annual investment strategy approved by Council on 10th March 2005. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.
32. Investments held by the Council consists of temporary surplus balances and capital receipts and other funds as detailed below:-
- (a) **Temporary Surplus Cash Balances**
The table below shows the actual activity against budget for 2005/06.

Table 7

	Original Budget 2005/06	Revised Budget 2005/06	Actual 2005/06
Average monthly investment	£12.000m	£15.500m	£20.630m
Average rate of return on investment	4.20%	4.50%	4.67%
Interest earned	£0.500m	£0.696m	£0.965m

(b) Capital Receipts and Funds

The table below shows actual activity against budget for 2005/06.

Table 8

	Original Budget 2005/06	Revised Budget 2005/06	Actual 2005/06
Average monthly investment	£24.900m	£24.900m	£24.900m
Average rate of return on investment	4.15%	4.80%	4.86%
Interest earned	£1.033m	£1.196m	£1.211m

33. In addition to the above further investment income was received relating to the Council's holding in Newcastle International Airport Ltd (NIAL), which were transferred from Durham County Council towards the end of 2003/04. £0.079m is due to be received for dividends on shares held, these dividends relate to 2005/06 and a further £0.017m was received in interest from loan notes issued by NIAL again for 2005/06.

Performance and Risk**Performance Indicators set for 2005/06**

34. The following performance indicators have been set for this service. These are distinct historic performance indicators, as opposed to the Prudential Indicators, which are predominantly forward looking.
- (a) Debt – Average overall rate paid compared to previous years. Actual 2004/05 4.80%. Actual for 2005/06 4.69%.
 - (b) Investments – Short term – Cashflow investment rate returned against comparative average rates. For actual performance see paragraph 35 below.
 - (c) Investments – Longer term- capital investment rates returned against comparative average rates. For actual performance see paragraph 35 below.

Summary of Average Investment Rates achieved

35. A representative set of indicators has been used in the table below to measure investment performance. As can be seen from the table, the actual investment rate achievements for 2005/06 exceeds the average of comparative rates for both the short term and long term investments.

Table 9

	Short Term Investments	Long Term Investments
	%	%
Actual	4.66	4.86
Average of Comparative Rates	4.51	4.55
Comparative Rates		
Local Authority 2 day rate	4.50	
Local Authority 7 day rate	4.50	
Local Authority 6 month rate		4.55
Local Authority 12 month rate		4.56
London Inter Bank Bid Rate 7 Day	4.53	4.53

Risk

36. The Council's Treasury Management function has complied with all of the 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.
37. Officers of the Council are aware of the risks of passive management of the treasury portfolio and, with the support of Butlers, the Council's advisers, has proactively managed the debt and investments over the year. 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 all fixed, utilising long-term loans.
38. Shorter term variable 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.

Conclusion

39. Savings of £0.815m have been made against an original budget of £2.947m and £0.430 against a revised budget of £2.562m. The revised budget was included in the Half Yearly

Treasury Management Report approved by Council on 26th January 2006. The savings of £0.430m over the revised budget were as the result of increased cashflow interest and interest and dividends from NIAL shares, but this is offset by increased debt charges mainly due to the provision set aside for increased future payments of interest for Stepped Loans.

40. The consolidated rate of interest paid on borrowing has reduced slightly from 4.80% to 4.69%, but this is still one of the lowest of all authorities in the country.
41. Investment interest performance compares well with general market interest rates.
42. The Authority has complied with the Council's procedures and external requirements.

Outcome of Consultation

43. No formal consultation has been undertaken regarding this report.

Legal Implications

44. This report has been considered by the Legal Services Manager for legal implications in accordance with the Council's approved procedures. There are no issues which the Legal Services Manager considers need to be brought to the specific attention of Members, other than those highlighted in the report.

Section 17 of the Crime and Disorder Act 1998

45. The contents of this report have been considered in the context of the requirements placed on the Council by Section 17 of the Crime and Disorder Act 1998, namely, the duty on the Council to exercise its functions with due regard to the likely effect of the exercise of those functions on, and the need to do all that it reasonably can to prevent, crime and disorder in its area. It is not considered that the contents of this report have any such effect.

Council Policy Framework

46. The issues contained within this report do not represent change to Council policy or the Council's policy framework.

Decision Deadline

47. For the purpose of the 'call-in' procedure this does not represent an urgent matter.

Recommendation

48. It is recommended that Cabinet :-
 - (a) Approve the actual 2005/06 Prudential Indicators within the report and included in Appendix 1.
 - (b) Note the Treasury Management Annual Report for 2005/06.

Reasons

49. The recommendations are supported by the following reasons:-

- (a) To comply with the Prudential Code for Capital Finance.
- (b) To comply with the Treasury Policy Statement adopted by this Council.

Paul Wildsmith
Director of Corporate Services

Background Papers

- (i) Accounting Records
- (ii) Annual Investment Strategy 2005/06
- (iii) Prudential Indicators and Treasury Management Strategy Report 2005/06

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Estimated and Actual Treasury Position and Prudential Indicators 2005/06

	Figures are for the financial year unless otherwise titled in italics	2005/06 Actual	2005/06 Revised Indicator	2004/05 Actual
1	Capital Expenditure	£37.024	£55.369	£29.864
2	Capital Financing Requirement (CFR) at 31 March			
	Housing	£26.401m	£28.593m	£25.188m
	Non Housing	£53.192m	£64.638m	£45.674m
	Total	£79.593m	£93.231	£70.862m
3	Treasury Position at 31 March			
	Borrowing	£86.603m	£92.988m	£72.228m
	Other long term liabilities	£0.244m	£0.243m	£0.286m
	Total Debt	£86.847m	£93.231m	£72.514m
	Investments	£46.023m	£37.475m	£35.300m
	Net Borrowing	£40.824m	£55.756m	£37.214m
4	Authorised Limit (<i>against maximum position</i>)	£86.847m	£108.414m	£72.514m
5	Operational Boundary	£86.847m	£94.273m	£72.514m
6	Ratio of Financing costs to net revenue Stream	1.19%	2.3%	1.38%
7	Incremental impact of capital investment decisions on the Band D council tax	£1.76	£4.95	£2.58
8	Incremental impact of capital investment decisions on the housing rent levels	Nil	Nil	Nil
9	Upper limits on fixed interest rates (<i>against maximum position</i>)	100%	100%	98.2%
10	Upper limits on variable interest rates (<i>against maximum position</i>)	0%	40%	1.8%
11	Maturity structure of fixed rate borrowing (<i>against maximum position</i>)			
	Under 12 months	%	25%	0.3%
	12 months to 2 years	0%	40%	1.5%
	2 years to 5 years	0%	60%	0%
	5 years to 10 years	6%	80%	8.0%
	10 years and above	94%	100%	90.2%
12	Maximum principal funds invested > 364 days (<i>against maximum position</i>)	£6.75m	£10.00m	£6.75m

Average Fixed Maturity Interest Rates for the PWLB over 2005/06 (%)

	1yr	1 1/2yrs	2 yrs	2 1/2yrs	3yrs	3 1/2yrs	4 yrs	4 1/2yrs	5yrs	5 to 6yrs
Average	4.42792	4.43157	4.42745	4.42510	4.42235	4.42373	4.42706	4.42980	4.43255	4.44039
High	4.87000	4.80000	4.80000	4.80000	4.80000	4.85000	4.85000	4.85000	4.85000	4.85000
Low	4.15000	4.15000	4.15000	4.15000	4.15000	4.20000	4.20000	4.20000	4.20000	4.20000
	6 to 7yrs	7 to 8yrs	8 to 9yrs	9 to 10yrs	10 to 15yrs	15 to 20yrs	20 to 25yrs	25 to 30yrs	30 to 35yrs	35 to 40yrs
Average	4.44196	4.44392	4.44255	4.44471	4.45898	4.43802	4.40098	4.35490	4.33157	4.05185
High	4.85000	4.85000	4.85000	4.85000	4.90000	4.90000	4.85000	4.80000	4.75000	4.25000
Low	4.20000	4.20000	4.15000	4.15000	4.10000	4.05000	3.95000	3.85000	3.80000	3.75000
	40 to 45yrs	45 to 50yrs								
Average	4.01481	3.99753								
High	4.20000	4.20000								
Low	3.70000	3.70000								

Glossary of Terms

Specified investments	Investments in Banks or Building Societies with a high credit rating for periods of less than 1 year
Non- Specified investments	Investments in unrated Building Societies and any investments in Banks or Building Societies for more than 1 year
Operational liquidity	Working cashflow
Instruments	Investments
Capital Financing Requirement	The authority's underlying need to borrow for capital purposes
Authorised Limit	Maximum amount of borrowing that could be taken in total
Operational Boundary	The expected amount of borrowing assumed in total
PWLB	Public Works Loans Board. The Governments lending body for Local Authorities
Stepped Loans	Loans taken that are not at a constant fixed rate of interest typically at a lower rate for the first four years then with a step up to a higher rate for the remaining period of the loan.