
**TREASURY MANAGEMENT ANNUAL REPORT AND OUTTURN PRUDENTIAL
INDICATORS 2006/07**

**Responsible Cabinet Member – Councillor Stephen Harker,
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 2006/07. The report also seeks approval of the outturn Prudential Indicators for 2006/07 in accordance with the requirement of the Prudential Code.

Information and Analysis

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 2006/07);
 - (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 to Council in March each year); and
 - (b) Review actual activity for the proceeding year (this report).
5. This report summarises:
 - (a) the Council's capital expenditure and financing 2006/07;
 - (b) the Council's overall borrowing need;
 - (c) the Council's treasury position at 31st March 2007;
 - (d) the Council's prudential indicators and compliance issues;
 - (e) the economic background for 2006/07
 - (f) summary of the Treasury Management Strategy agreed for 2006/07
 - (g) Treasury Management activity during 2006/07;
 - (h) performance and risk.

The Council's Capital Expenditure and Financing 2006/07

6. The Council undertakes capital expenditure on long term assets. These activities may be either:
 - (a) Financed immediately through capital receipts, capital grants etc.; or
 - (b) If insufficient financing is available the expenditure will give rise to a borrowing need.
7. Part of the Council's treasury activities is to address this 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 cashflow, its previous borrowing activities and the investment of surplus funds. These activities are structured to manage risk foremost and then optimise performance.
8. The actual Capital Expenditure forms one of the required prudential indicators. The table below shows total expenditure and how this was financed against what was expected to be spent and how this would have been financed. Actual expenditure was £8.523m less than expected resulting in £2.129m less borrowing required.

Table 1

	2005/06 Actual £m	2006/07 Estimate £m	2006/07 Actual £m
Non-HRA Capital Expenditure	26.770	34.947	29.173
HRA Capital Expenditure	10.254	14.779	12.030
Total Capital Expenditure	37.024	49.726	41.203
Resourced by:			
Capital Receipts	5.806	4.365	4.377
Capital Grants	16.930	21.629	16.675
Capital Contributions	0.993	1.806	0.602
Revenue	3.100	3.523	3.275
Unfinanced capital expenditure (borrowing needed to finance 2006/07 expenditure)	10.195	18.403	16.274

The Council's Overall Borrowing Need

9. The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). The figure is a gauge for the Council's debt position. It represents 2006/07 and prior years net capital expenditure which has not yet been paid for by revenue or other resources.
10. The Non- HRA element of the CFR is reduced each year by a statutory revenue charge (called the Minimum Revenue Provision – MRP). The total CFR can also be reduced by a charge more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP). The VRP's in Darlington Borough Council's accounts are made by departments as part of their annual charge for Departmental Unsupported Borrowing.
11. The Council's CFR for the year is shown below, and represents a key prudential indicator.

Table 2

Capital Financing Requirement	2005/06 Actual £m	2006/07 2007 Approved Indicator £m	31 st March Actual £m
Opening Balance	71.184	79.852	79.915
+ Unfinanced Capital Expenditure	11.111	18.403	16.274
- MRP / VRP	2.380	2.533	2.699
Closing balance	79.915	95.722	93.490

Treasury Position at 31st March 2007

12. Whilst the Council's gauge of its underlying need to borrow is the CFR, the Director of Corporate Services can manage the Council's actual borrowing position by either:-
 - (a) borrowing to the CFR level; or
 - (b) choosing to utilise some temporary cash flows instead of borrowing ("under borrowing"); or
 - (c) borrowing for future increases in CFR (borrowing in advance of need, the "over borrowed" amount can be invested).

13. The Council's total debt outstanding at 31st March 2007 was £95.242m. The aim was to manage it to the Council's revised CFR position £95.722m. . This meant when compared to our actual CFR that the Council was "over borrowed" by £1.752m, this "over borrowed" amount was in turn invested at a higher rate of interest than our debt interest rate. The treasury position at the 31st March 2007, including investments compared with the previous year was:

Table 3

Treasury Position	31 st March 2006		31 st March 2007	
	Principal £m	Average Rate %	Principal £m	Average Rate %
Fixed Rate Debt Market and Public Works Loan Board (PWLB)	86.603	4.69	95.242	4.40
Total Debt	86.603	4.69	95.242	4.40
Cashflow Investments	21.490	4.66	20.716	4.82
Capital Investments	24.900	4.86	22.750	4.92
Total Investments	46.390		43.466	
Net borrowing position	40.213		51.776	

Prudential Indicators and Compliance Issues

14. Some of the prudential indicators provide either an overview or specific limits on treasury activity. These are shown below:
15. **Net Borrowing and the CFR** – Over the medium term the Council's external borrowing, net of investments, must only be for capital purposes. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2006/07 plus the expected changes to the CFR over 2007/08 and 2008/09. The table below highlights the Council's net borrowing position against CFR. The Council has complied with this prudential indicator.

Table 4

	31 st March 2006 Actual £m	31 st March 2007 Approved Indicator £m	31 st March 2007 Actual £m
Net Borrowing Position	40.213	49.751	51.776
CFR	79.915	95.722	93.490

16. **The Authorised Limit** – The Authorised Limit is the "Affordable Borrowing Limit" required by section 3 of the Local Government Act 2003. The Council does not have power to borrow above this level. The table below demonstrates that during 2006/07 the Council has maintained gross borrowing within its Authorised Limit.
17. **The Operation Boundary** – The Operational Boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the Boundary are both acceptable, subject to the Authorised Limit not being breached.

18. **Actual financing costs as a proportion of net revenue expenditure** - 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 expenditure.

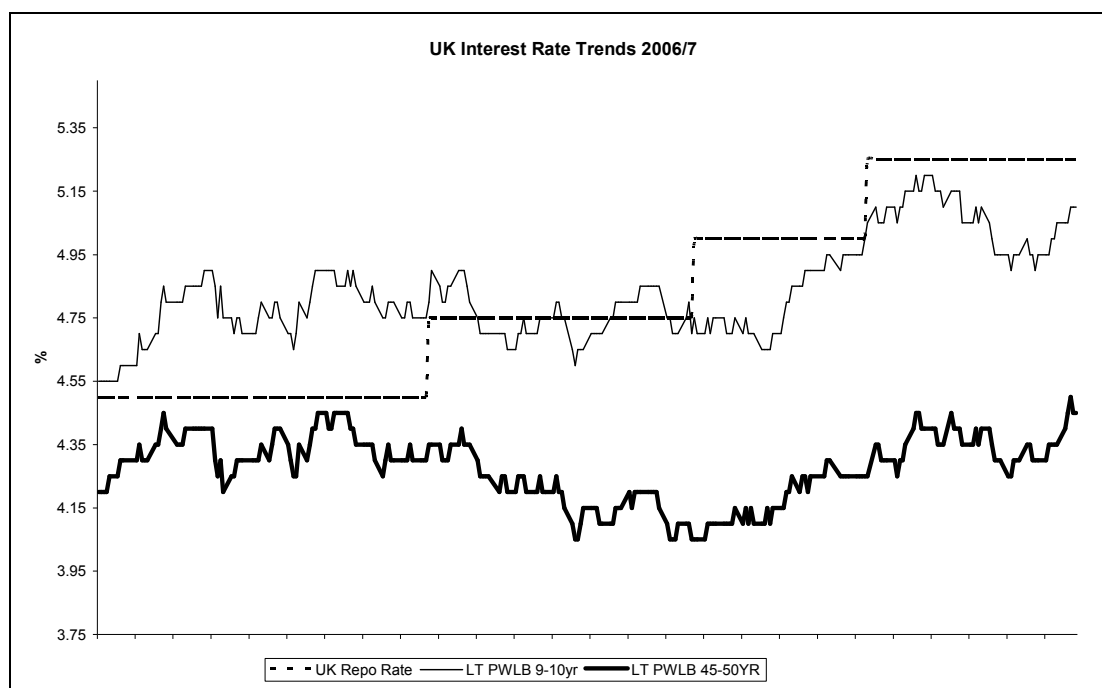
Table 5

	Actual 2005/06 £m	Approved Estimate 2006/07 £m	Actual 2006/07 £m
Approved Indicator – Authorised Limit	108.414	112.380	112.380
Maximum gross borrowing position	86.847	95.722	95.242
Approved Indicator – Operational Boundary	94.273	97.722	97.722
Average gross borrowing position	80.698	91.284	89.367
Minimum gross borrowing position	72.802	86.603	86.603
Financing costs as a percentage of net revenue expenditure	1.19%	2.29%	2.04%

Economic Background for 2006/07

19. All treasury activity is directed by both the current market interest rates and expectations of future movements, for instance longer term investment rates for one and two years will reflect anticipated movements in the Bank of England Monetary Policy Committee Bank Rate (UK Repo Rate). Longer term borrowing rates are influenced by inflation and demand and supply considerations.

Table 6



20. Strengthening economic activity and increasing inflation caused a rising trend in short term interest rates during 2006/07.

21. The growth in economic activity was greater than expected by the financial markets and external pressures on consumer price inflation continued to increase. During the early months of the year, short-term interest rates remained unchanged but there were growing expectations that official interest rates would eventually rise.
22. The first rise in the Bank Rate from 4.5% to 4.75% was announced in August 2006 as the Bank of England responded to the deteriorating inflation outlook. The economy's slow response to monetary policy tightening, a less than favourable international backdrop and concerns that domestic inflation expectations would drive prices higher prompted additional rate rises. Two quarter point increases in Bank Rate were announced in November 2006 to 5% and January 2007 to 5.25%. Further tightening measures were anticipated by the market, and attractive investment opportunities prevailed to year end.
23. Long-term interest (PWLB) rates varied during the year but the overall trend was towards higher levels (**Appendix 2** shows the average PWLB fixed maturity interest rates for 2006/07). Domestic and international inflation expectations in reaction to strong economic growth globally, were the main driving force. Strong demand for bonds was not sufficient to counter-act the upward trend. Occasional rallies in the gilt-edged market caused dips in rates that provided favourable borrowing opportunities but by the year end long term rates were close to the highest levels since early 2005.

Summary of the Treasury Management Strategy agreed for 2006/07

24. The revised strategy (agreed by Council on 18th January 2007) anticipated that during 2006/07 the Council would need to borrow £15.870m to cover part of its capital programme.
25. The Annual Investment Strategy stated that the Council will carefully balance the use of Specified (usually less than 1 year) and non-specified investments (usually more than 1 year) 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.
26. The use of longer term instruments (greater than one year from inception to repayment) will fall in the non-specified 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 Council on 18th January 2007 and estimated long term investments of £10m were included for the three years 2006/07, 2007/08 and 2007/08 .

Treasury Management Activity during 2006/07

Debt Position

27. **Borrowing** – Loans were taken out throughout the year to finance the expected net capital spend. The loans taken out were:

Table 7

Lender	Principal	Type	Interest Rate	Maturity	Average for 2006/07
PWLB	£3.528m	Fixed interest rate	4.30%	40-45yrs	4.46%
PWLB	£5.111m	Fixed Interest rate	4.12%	45-50yrs.	4.27%

28. This compares with a budget assumption of borrowing at an interest rate of 4.5%
29. **Resheduling** – Throughout the year a number of opportunities arose whereby loans could be repaid without any breakage costs. The Council repaid £35.768m of debt at an average rate of 4.81%. These loans were replaced with £35.765mm of debt at 4.35%. As a result annual savings of £0.110m will be made to the General Rate Fund after taking into account savings on the HRA.
30. **Repayment** - No loans were due for repayment during 2006/07.
31. **Summary of Debt Transactions** – The overall position of the debt activity resulted in a fall in the average interest rate payable from 4.69% to 4.40%.

Investment Position

32. **Investment Policy** – the Council’s investment policy is governed by the Department of Communities and Local Government Guidance which has been implemented in the annual investment strategy approved by Council on 9th March 2006. The investment activity during the year conformed to the approved strategy and the Council had no liquidity difficulties.
33. Investments held by the Council consist of temporary surplus balances, capital receipts and other funds as detailed below:
- (a) **Temporary Surplus Cash Balances** – the table below shows the activity against budget for 2006/07.

Table 8

	Approved Budget 2006/07	Actual 2006/07
Average Monthly Investment	£22.500m	£23.490m
Average Rate of Return on Investment	4.63%	4.82%
Interest Earned	£1.042m	£1.131m

(b) Capital Receipts and Funds

Table 9

	Approved Budget 2006/07	Actual 2006/07
Average Monthly Investment	£25.970m	£23.880m
Average Rate of Return on Investment	4.67%	4.92%
Interest Earned	£1.213m	£1.175m

34. 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. £0.077m was received for dividends on shares relating to 2006/07 and a further £0.034m was received in interest on loans issued by NIAL again for 2006/07.

Performance and Risk

Performance Indicators set for 2006/07

35. 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 2005/06 4.69%. Actual for 2006/07 4.4%.
- (b) **Investments – Short Term** – Cashflow investment rate returned against comparative average rate. For actual performance see paragraph 36 below.
- (c) **Investments – Longer Term** – Capital investment rate returned against comparative average rates For actual performance see paragraph 36 below.

Summary of Average Investment Rates achieved

36. 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 achieved for short term investments exceeds the average of comparative rates for the short term investments. However, the longer term investments have not achieved the target to be above the comparative rates, this was predicted in the half yearly report, the reason for this is interest rates are rising and some longer term investments were placed on a fixed rate when interest rates were generally lower.

Table 10

	Short Term Investments	Long Term Investments
	%	%
Darlington Borough Council Actual	4.82	4.92
Average of Comparative Rates	4.76	4.96
Comparative Rates		
Local Authority 2 day rate	4.72	
Local Authority 7 day rate	4.72	
Local Authority 6 month rate		4.96
Local Authority 12 month rate		5.10
London Inter Bank Bid (LIBID) 7 day rate	4.82	4.82

Risk

37. 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.
38. 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.
39. 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.

Conclusion

40. The Council's treasury management activity during 2006/07 has been carried out in accordance with Council Policy and within legal limits. Financing costs have been reduced during the year and a saving of £0.313m achieved from the approved budget as a result of reduced interest payments, increased cash-flow interest income and dividends from Newcastle Airport Shares.

Outcome of Consultation

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

Legal Implications

42. This report has been considered by the Borough Solicitor for legal implications in accordance with the Council's approved procedures. There are no issues which the Borough Solicitor 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

43. 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

44. The issues contained within this report are required to be approved by Council.

Decision Deadline

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

Recommendation

46. It is recommended that :-
- (a) The outturn 2006/07 Prudential Indicators within this report and those in Appendix 1 be noted;
 - (b) The Treasury Management Annual Report for 2006/07 be noted.
 - (c) This report be forwarded to Council, in order for the outturn Prudential Indicators for 2006/07 to be approved.

Reasons

47. The recommendations are supported by the following reasons :-
- (a) In order to comply with the Prudential Code for Capital finance in Local Authorities.
 - (b) To inform members of the Performance of the Treasury Management function.
 - (c) To comply with the requirements of the Local Government Act 2003

Paul Wildsmith
Director of Corporate Services

Background Papers

1. Accounting Records
2. Annual investment Strategy 2006/07
3. Prudential Indicators and Treasury Management strategy Report 2006/07

Elaine Hufford : Extension 2447

Additional Prudential Indicators not reported in the body of the report

	Figures are for the financial year unless otherwise italics	2006/07 Actual	2006/07 Approved Indicator	2005/06 Actual
1	Incremental impact of capital investment decisions on the Band D Council tax	£1.97	£2.15	£1.76
2	Incremental impact of capital investment decisions on the housing rent levels	Nil	Nil	Nil
3	Upper limits on fixed interest rates (<i>against maximum position</i>)	100%	100%	100%
4	Upper limits on variable interest rates (<i>against maximum position</i>)	0%	40%	1.8%
5	Maturity structure of fixed rate borrowing (<i>against maximum position</i>)			
	Under 12 months	0%	25%	0%
	12 months to 2 years	0%	40%	0%
	2 years to 5 years	0%	60%	0%
	5 years to 10 years	0%	80%	6%
	10 years and above	100%	100%	94%
6	Maximum Principal funds invested greater than 364 days (<i>against maximum position</i>)	£8m	£10m	£6.75m

Average Rates for the Comparison Borrowing Table

Average Fixed maturity Interest Rates for PWLB over 2006/07

Years	1	1.5	2	2.5	3	3.5	4	4.5	5	5 to 6
Average	5.134	5.144	5.129	5.115	5.097	5.077	5.055	5.030	5.010	4.985
High	5.700	5.700	5.700	5.650	5.600	5.600	5.550	5.500	5.500	5.450
Low	4.550	4.550	4.550	4.550	4.550	4.550	4.550	4.550	4.550	4.550
	6 to 7	7 to 8	8 to 9	9 to 10	10 to 15	15 to 20	20 to 25	25 to 30	30 to 35	35 to 40
Average	4.944	4.902	4.864	4.833	4.807	4.657	4.700	4.562	4.438	4.377
High	5.350	5.300	5.250	5.200	5.150	4.950	4.950	4.800	4.650	4.600
Low	4.550	4.550	4.55	4.55	4.550	4.450	4.450	4.350	4.200	4.150
	40 to 45	45 to 50								
Average	4.463	4.273								
High	4.500	4.500								
Low	4.100	4.050								

Glossary of Terms

Specified Investments	Investments in Banks and Building Societies with a high credit rating for periods of less than 1 year
Non-Specified Investments	Investments in un rated Building Societies and any investments in Banks and Building Societies for more than 1 year.
Operational Liquidity	Working Cashflow
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 Loan Board. The Governments lending body to Local Authorities