
**TREASURY MANAGEMENT ANNUAL REPORT AND ACTUAL PRUDENTIAL
INDICATORS 2004/05**

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

Responsible Director(s) – 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 2004/05. The report also covers the actual Prudential Indicators for 2004/05 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 2004/05);
 - (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 Office of the Deputy Prime Minister (ODPM) 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. These require that the prime objective of the treasury management activity is the effective management of risk, and that its 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 2004/05;
 - (b) The Council's treasury position at 31 March 2005;
 - (c) Prudential Indicators and compliance with limits;
 - (d) A summary of the economic background affecting the strategy over 2004/05;
 - (e) Treasury Management activity during 2004/05;
 - (f) Performance and Risk.

The Treasury Management Strategy Agreed for 2004/05

6. The strategy anticipated that during 2004/05 the Council will need to borrow an additional c£10.500m 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 was included in the report on the Prudential Indicators approved by the Council on 10th March 2004 and the following estimates for long term investments were included for the three years 2004/05 £16.9m, 2005/06 £15.7m and 2006/07 £16.2m

Treasury Position at 31 March 2005

9. The treasury position at the 31 March 2005 compared with the previous year was:

Table 1

	31 March 2005		31 March 2004	
	Principal	Average Rate	Principal	Average Rate
PWLB and Money Market Debt	£72.228m	4.80%	£62.443m	4.755%
Total Debt	£72.228m		£62.443m	
Cashflow Investments	£15.400m	4.66%	£9.670m	3.63%
Capital Investments	£19.900m	4.67%	£19.900m	3.74%
Total Investments	£35.300m		£29.570m	

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 2004/05. The rise in the rate of return on investments relates directly to increases in the Bank of England Base rate since 2003/04.

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 2005 Actual	31 March 2005 Original Indicator
Net borrowing position	£37.214m	£42.342m
Capital Financing Requirement	£70.862m	£76.742m

- 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 2004/05 plus the expected changes to the CFR over 2005/06 and 2006/07. The table above highlights that the Council has complied with this requirement.

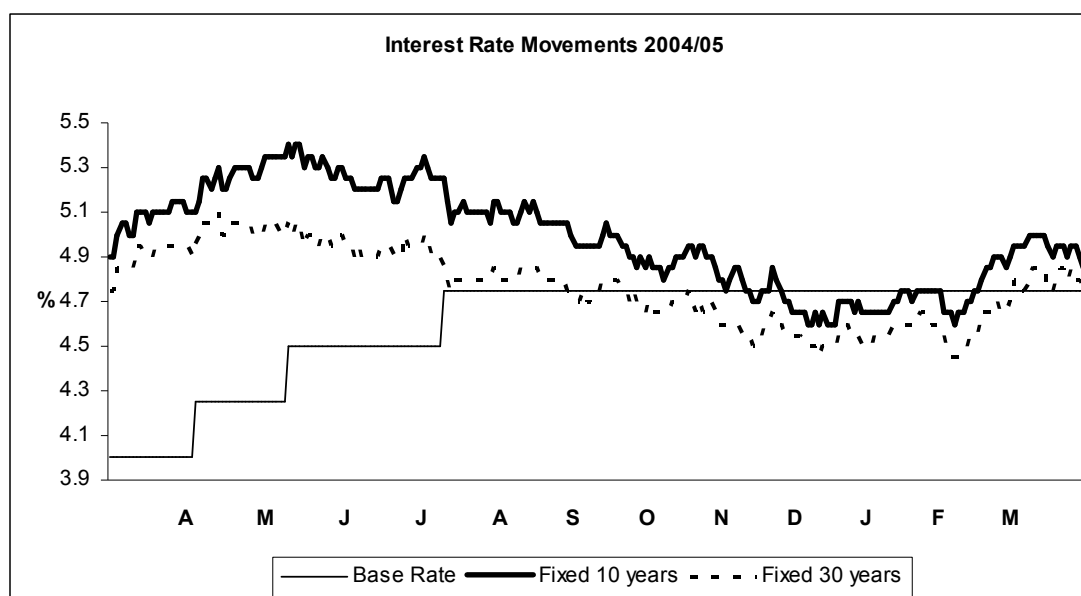
Table 3

	2004/05
Original Indicator - Authorised Limit	£97.035m
Original Indicator - Operational Boundary	£84.379m
Maximum gross borrowing position during the year	£72.324m
Minimum gross borrowing position during the year	£62.443m

- 15. The Authorised Limit is the “Affordable Borrowing Limit” required by Section 3 of the Local Government Act 2003. The table demonstrates that during 2004/05 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 over the Boundary is acceptable subject to the Authorised Limit not being breached.

Economic Background for 2004/05

Table 4



17. The rising trend in UK interest rates which commenced in mid-2003 continued during the 2004/05 financial year as the Monetary Policy Committee (MPC) tightened policy to combat the effects rising economic activity might have upon inflation. These concerns were most in evidence during the early stages of the year and Base Rates were raised in quarter-point steps in May and June to 4.5%. Market pessimism was fuelled by this comparatively aggressive stance and longer-dated money rates rose to in excess of 5% to reflect this.
18. Official rates were raised again in August to 4.75%, the peak for the year. Thereafter, the MPC adopted a comparatively neutral stance. A steep rise in world oil prices (to in excess of \$50 per barrel) triggered a slowdown in economic activity in industrialised economies, notably the US. This, together with the low domestic inflation environment, caused the Bank of England to adopt a more optimistic view of medium-term inflation prospects, a tack that was seen as a hint that the rate cycle may have peaked. Money market rates adjusted to accommodate this assessment and longer fixed interest rates slipped lower.
19. Base Rates remained unaltered for the balance of the year but confidence that the rate cycle had peaked was undermined in the last few months of the period. Quoting stronger activity, tighter labour market conditions and rising raw material prices, the Bank of England February 2005 Inflation Report cast some doubt upon the ability of inflation to maintain a subdued performance over the medium term. Money rates rose in reaction to the view that a further tightening of monetary policy was not out of the question.
20. Long term interest rates (Public Works Loan Board (PWLB) rates) tended to track the movements in the money market. A rise in the early part of the year, in response to market interest rate pessimism, was reversed in the autumn and winter of 2004 as weaker economic activity placed downward pressure upon fixed interest rates across the globe. Rates returned to a rising trend in the closing months as the lacklustre performance of key international bond markets combined with a more pessimistic view on rates to drive yields modestly higher.

Treasury Management Activity During 2004/05

Debt Position

21. **Borrowing** - Capital expenditure for the year was £29.864m, 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 2004/05
PWLB	£10m	Fixed interest rate	4.875%	Average 28 years	4.818% from Appendix 2

22. This compares with a budget assumption of borrowing at an interest rate of 5%.

23. The table below shows the actual activity for interest charges and repayment of debt against budget for 2004/05.

Table 6

	Original Budget 2004/05	Revised Budget 2004/05	Actual 2004/05
Interest charges and repayment of debt	£3.601m	£3.154m	£3.272m
Average rate	4.70%	4.70%	4.80%

24. **Rescheduling** – No loans were rescheduled during 2004/05.

25. **Repayment** – During 2004/05 the Council repaid £0.214m of maturing PWLB debt.

26. **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 2004/05 the accounting treatment of such loans changed and an average interest is to be used. This has increased the amount of interest charged into 2004/05. This additional interest has been transferred to a provision, which will be used in future years to offset any increased interest rate charges.

27. **Summary of Debt Transactions** – Because of the new accounting treatment for Stepped Market loans and new loans taken out during 2004/05, which have interest rates above the previous years average rate, the new average rate for 2004/05 has increased from 4.75% to 4.80%.

Investment Position

28. **Investment Policy** – The Council's investment policy is governed by ODPM Guidance, which is implemented in the annual investment strategy approved by Council on 22nd July 2004. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

29. 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 2004/05.

Table 7

	Original Budget 2004/05	Revised Budget 2004/05	Actual 2004/05
Average monthly investment	£7.000m	£12.000m	£17.900m
Average rate of return on investment	3.80%	4.00%	4.66%
Interest earned	£0.266m	£0.480	£0.839m

(b) Capital Receipts and Funds

The table below shows actual activity against budget for 2004/05.

Table 8

	Original Budget 2004/05	Revised Budget 2004/05	Actual 2004/05
Average monthly investment	£16.900m	£19.900	£19.900m
Average rate of return on investment	3.80%	4.75%	4.67%
Interest earned	£0.642m	£0.945	£0.928m

30. 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. £0.125m was received in dividends on shares held, these dividends relate to 2003/04 and 2004/05 and a further £0.080m was received in interest from loan notes issued by NIAL again for 2003/04 and 2004/05.

Performance and Risk

Performance Indicators set for 2004/05

31. This service has set the following performance indicators. 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 2003/04 4.75%, Actual 2004/05 4.80%.
 - (b) Investments – Short term – Cashflow investment rate returned against comparative average rates. For actual performance see paragraph 32 below.
 - (c) Investments – Longer term- capital investment rates returned against comparative average rates. For actual performance see paragraph 32 below.

Summary of Average Investment Rates achieved

32. 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 2004/05 exceeds the average of comparative rates for short term, although the long term actual investment falls short of the average of comparative rates. This is because most of the investments were initially placed during 2003/04 when interest rates were lower.

Table 9

	Short Term Investments	Long Term Investments
	%	%
Actual	4.66	4.67
Comparative Rates		
Local Authority 2 day rate	4.47	
Local Authority 7 day rate	4.47	
Local Authority 6 month rate		4.77
Local Authority 12 month rate		4.92
London Inter Bank Bid Rate 7 Day	4.52	4.52
Average of comparative rates	4.49	4.74

Risk

33. 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.
34. 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 predominantly fixed, utilising long-term loans.
35. 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

36. Savings of £1.393m have been made against an original budget of £2.827m and £0.455 against a revised budget of £1.889m. The revised budget was included in the Half Yearly

Treasury Management Report approved by Council on 25th November 2004. The savings of £0.455m 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.

37. The consolidated rate of interest paid on borrowing has risen slightly from 4.755% to 4.8%, but this is still one of the lowest of all authorities in the country.
38. Investment interest performance compares reasonably well with general market interest rates.
39. The Authority has complied with the Council's procedures and external requirements.

Outcome of Consultation

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

Legal Implications

41. 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

42. 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

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

Decision Deadline

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

Recommendation

45. It is recommended that Cabinet:
 - (a) Approve the actual 2004/05 Prudential Indicators within the report and included in Appendix 1;
 - (b) Note the Treasury Management Annual Report for 2004/05.

Reasons

46. The recommendations are supported by the following reasons:

- (a) To comply with the Prudential Code for Capital Finance;
- (b) The recommendations are supported to comply with the Treasury Policy Statement adopted by this Council.

Paul Wildsmith
Director of Corporate Services

Background Papers

Accounting Records

Annual Investment Strategy 2004/05

Prudential Indicators and Treasury Management Strategy Report 2004/05

Elaine Hufford Extension 2447

Estimated and Actual Treasury Position and Prudential Indicators 2004/05

	Figures are for the financial year unless otherwise titled in italics	2004/05 Actual	2004/05 Original Indicator	2003/04 Actual
1	Capital Expenditure	£29.864m	£25.203m	
2	Capital Financing Requirement (CFR) at 31 March			
	Housing	£25.188m	£30.117m	
	Non Housing	£45.674m	£46.625m	
	Total	£70.862m	£76.742m	
3	Treasury Position at 31 March			
	Borrowing	£72.228m	£73.337m	£62.230m
	Other long term liabilities	£0.286m	£11.042m	£0.000m
	Total Debt	£72.514m	£84.379m	£62.230m
	Investments	£35.300m	£30.000m	£26.870m
	Net Borrowing	£37.214m	£54.379m	£35.360m
4	Authorised Limit (against maximum position)	£72.228m	£97.035m	
5	Operational Boundary	£72.228m	£84.379m	
6	Ratio of Financing costs to net revenue Stream	1.38%	2.67%	
7	Incremental impact of capital investment decisions on the Band D council tax	£2.58	£3.90	
8	Incremental impact of capital investment decisions on the housing rent levels	Nil	Nil	
9	Upper limits on fixed interest rates (against maximum position)	98.2%	100%	
10	Upper limits on variable interest rates (against maximum position)	1.8%	40%	
11	Maturity structure of fixed rate borrowing (against maximum position)			
	Under 12 months	0.3%		
	12 months to 2 years	1.5%	1%	
	2 years to 5 years	0%	2.8%	
	5 years to 10 years	8.0%	9.7%	
	10 years and above	90.2%	86.5%	
12	Maximum principal funds invested > 364 days (against maximum position)	£6.75m	16.900m	

Actual Average Fixed Maturity Interest Rates for the PWLB over 2004/05

Years	1	1 1/2	2	2 1/2	3	3 1/2	4	4 1/2	5	5 to 6
Average	4.720%	4.774%	4.825%	4.865%	4.893%	4.916%	4.936%	4.943%	4.956%	4.969%
High	5.100%	5.150%	5.250%	5.300%	5.350%	5.350%	5.400%	5.400%	5.400%	5.400%
Low	4.350%	4.400%	4.500%	4.500%	4.500%	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	Over 30	
Average	4.976%	4.984%	4.987%	4.988%	4.987%	4.952%	4.884%	4.818%	4.773%	
High	5.400%	5.400%	5.400%	5.400%	5.400%	5.300%	5.200%	5.100%	5.100%	
Low	4.600%	4.600%	4.600%	4.600%	4.600%	4.600%	4.550%	4.500%	4.450%	