CABINET
13 JULY 2010

ITEM NO. ....

TREASURY MANAGEMENT ANNUAL REPORT AND OUTTURN PRUDENTIAL INDICATORS 2009/10

Responsible Cabinet Member – Councillor Chris McEwan, Efficiency and Resources Portfolio

Responsible Director - Paul Wildsmith, Director of Corporate Services

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SUMMARY REPORT

Purpose of the Report

1. This report provides important information regarding the regulation and management of the Council's borrowing, investments and cash-flow. It is a requirement of the Council's reporting procedures and covers treasury activity for 2009/10. The report also seeks approval of the Prudential Indicators results for 2009/10 in accordance with the Prudential Code.

Summary

2. The financial year 2009/10 again presented exceptional circumstances with regard to treasury management. The stabilising in the economy, coupled with increased counterparty credit risk (the institutions that we invest with) presented the Council with continued issues not normally encountered. For Darlington Council the main implications of these exceptional circumstances have been :-

   (a) Deteriorating investment returns, resulting in reduced investment income from that originally budgeted.
   (b) Increase in counterparty risk led to a reduced number of institutions that the Council could use to invest with.

3. In response to the above issues in the early part of 2009/10 the Council reduced its overall external debt by using investments to repay debt. External debt and investments were both reduced by £23.400M during May and June of 2009. External debt has not increased since that time. The effect of this action was a net reduction in financing costs with significant saving to the revenue budget.

4. During 2009/10 the Council complied with its legislative and regulatory requirements. `The Director of Corporate services also confirms that borrowing was only undertaken for capital purposes.

5. At 31 March 2010, the Council's external debt was £80.860M (compared with £104.242M at 31 March 2009) with an average interest rate of 3.44%. Investments totalled £15.290M (£39.90M at 31 March 2008) earning interest of 2.17% on short term investments and 3.29% on long term.

6. Financing costs have been reduced during the year and a saving of £1.091M achieved from the original MTFP as reported elsewhere on this agenda as a result of a number of actions taken throughout the year to manage the financing costs in the changing economic climate.

7. This report was considered by Audit Committee at its meeting on 25th June 2010 under their responsibilities for ensuring effective scrutiny of the treasury management and its policy.

Recommendation

8. It is recommended that :-

   (a) The outturn 2009/10 Prudential Indicators within this report and those in Appendix 1 be noted.

   (b) The Treasury Management Annual Report for 2009/10 be noted.

   (c) This report be forwarded to Council, in order for the Prudential Indicators for 2009/10 to be approved.

Reasons

9. 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
(i) Accounting Records
(ii) Annual Investment Strategy 2009/10
(iii) Prudential Indicators and Treasury Management Strategy Report 2009/10

Elaine Hufford : Extension 2447

S17 Crime and Disorder	This report has no implications for crime and disorder
Health and Well Being	There are no issues relating to health and wellbeing which this report needs to address
Sustainability	There are no issues relating to environmental impact
Diversity	There are no specific implications for diversity
Wards Affected	The proposals affect all wards
Groups Affected	The proposals do not affect any specific
Budget and Policy Framework	The report does not change the Council's budget or Policy framework but needs to be considered by Council
Key Decision	This is a key decision and as such has been reported on the forward plan
Urgent Decision	For the purpose of 'call-in' procedure this does not represent an urgent matter
One Darlington: Perfectly Placed	The proposals in the report support delivery of the Sustainable Community Strategy through appropriate and effective deployment of the Councils Resources
Efficiency	The report outlines movements in the national economic outlook that has enabled officers to take advantage of changing interest rates to benefit the Revenue MTFP. Proposals to amend the counterparty list and increase limits for money Market Funds are made to increase efficiency, consistent with managing risks.

MAIN REPORT

Information and Analysis

10. This report summarises:

    (a) Capital expenditure and financing for 2009/10;
    (b) Overall borrowing need;
    (c) Treasury position at 31 March 2010;
    (d) Prudential indicators and compliance issues;
    (e) The economic background for 2009/10
    (f) The Treasury Management Strategy agreed for 2009/10;
    (g) Treasury Management activity during 2009/10;
    (h) Performance and risk.
    (i) Revised Investment Strategy 2009/10

11. Throughout this report a number of technical terms are used an glossary of terms can be found at the end of this report.

The Council's Capital Expenditure and Financing 2009/10

12. The Council undertakes capital expenditure on long term assets, which is financed either:

    (a) immediately through capital receipts, capital grants, contributions and from revenue.; or
    (b) by borrowing .

13. 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.

14. Capital Expenditure forms one of the prudential indicators that are used to regulate treasury activity. Table 1 shows total expenditure and how this was financed, compared with what was expected to be spent and how this would have been financed. Actual expenditure was £5.159M less than planned, resulting in £1.873M less borrowing being required.

Table 1 – Capital Expenditure and Financing

	2008/09	2009/10		
	Outturn £m	**Revised Estimate £m**	**Outturn £m**	**Variance £m**
General Fund Capital Expenditure	39.516	30.104	28.095	-2.009
HRA Capital Expenditure	9.718	14.455	11.305	-3.150
Total Capital Expenditure	**49.234**	**44.559**	**39.400**	**-5.159**
Resourced by:				
Capital Receipts	0.895	0.360	0.630	0.270
Capital Grants	32.466	27.453	24.256	-3.197
Capital Contributions	1.861	1.620	0.791	-0.829
Revenue	3.220	2.868	3.338	0.470
Borrowing needed to finance 2009/10 expenditure	**10.792**	**12.258**	**10.385**	**-1.873**

The Council's Underlying Borrowing Need

15. 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 2009/10 and prior years net capital expenditure which has not yet been paid for by revenue or other resources.

16. The General Fund element of the CFR is reduced each year by a statutory charge to the revenue accounts called the Minimum Revenue Provision (MRP). The total CFR can also be reduced each year through a Voluntary Revenue Provision (VRP).

17. It was not possible to make a VRP in 2009/10 as the level of Capital Receipts received by the Council was prohibitive. The MTFP still allows for a VRP in future years and this may be possible if capital receipts are received in future years.

18. The Council's CFR for the year is shown below, and represents a key prudential indicator. A key accounting change for 2009/10 was the inclusion of some PFI schemes on the balance sheet, which increase the Council's borrowing need, the CFR. No borrowing is actually required against these schemes as a borrowing facility is included in the contract. The CFR outturn for 2009/10 is £4.465M below the approved indicator, which is satisfactory.

Table 2 - Capital Financing Requirement

	2008/09	2009/10		
	Outturn £m	Approved Indicator £m	31 March Actual £m	Variance £m
Opening Balance	98.126	105.086	105.086	0.00
Add Capital Expenditure financed by borrowing	10.792	12.258	10.385	-1.873
Add adjustment for the inclusion of on balance sheet PFI Schemes	0.0	28.056	25.515	-2.541
Less MRP / VRP	-3.832	-3.278	-3.479	-0.201
Less PFI & finance lease repayments		-1.577	-1.427	0.150
Closing balance	**105.086**	**140.545**	**136.080**	**-4.465**

Treasury Position at 31 March 2010

19. Whilst the measure of the Council's underlying need to borrow is the CFR, the Director of Corporate Services can manage the Council's actual borrowing position by: -

    (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).

20. The financial reporting practice that the Council is required to follow (the Statement of Recommended Practice (SORP)), changed in 2007/08. Financial instruments (borrowing and investments etc.) must now be reported in the Statement of Accounts in accordance with national Financial Reporting Standards. The figures in this report are based on actual amounts borrowed and invested and so will differ from those in the Statement of Accounts.

21. The Council's total debt outstanding at 31 March 2010 was £80.860M plus the outstanding liability relating to the PFI scheme of £24.088M totalling £104.948M The aim was to manage it to the Council's revised CFR position £140.545M. This meant when compared to our actual CFR £136.080M that the Council was "under borrowed" by £31.132M, this "under borrowed" amount was financed by internal borrowing ie the amount invested externally was reduced to cover this. The treasury position at the 31 March 2010, including investments compared with the previous year was:

Table 3 – Summary of Borrowing and Investments

Treasury Position	31 March 2009		31 March 2010	
	Principal £m	Average Rate %	Principal £m	Average Rate %
Fixed Rate Debt Market and Public Works Loan Board (PWLB)	104.242	4.27	£80.860	3.44
Total Debt	**104.242**	**4.27**	**£80.860**	**3.44**
Cashflow Investments	24.150	5.25	7.000	2.17
Capital Investments	15.750	5.72	6.290	3.29
Total Investments	**39.900**		**15.290**	
Net borrowing position	**64.342**		**65.570**	

Prudential Indicators and Compliance Issues

22. Some prudential indicators provide an overview while others are specific limits on treasury activity. These indicators are shown below:

23. **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 2009/10 plus the expected changes to the CFR over 2010/11 and 2011/12. Table 4 highlights the Council's net borrowing position against CFR. The Council has complied with this prudential indicator.

Table 4 – Net Borrowing Compared with CFR

	31 March 2009 Actual £m	31 March 2010 Approved Indicator £m	31 March 2010 Actual £m
Net Borrowing Position	**64.342**	**65.860**	**65.570**
CFR Excluding PFI			**111.992**
CFR	**105.086**	**140.545**	**136.080**

24. **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.

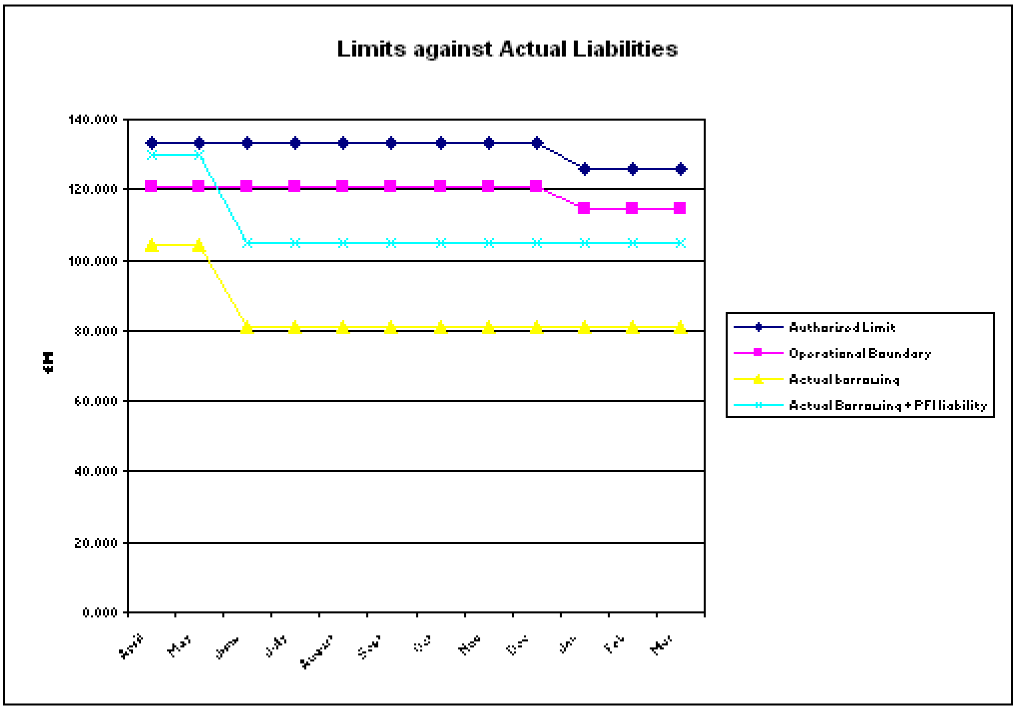
25. **The Operation Boundary –** The Operational Boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the Boundary are both acceptable, subject to the Authorised Limit not being breached.

26. **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 – Key Prudential Indicators

	Actual 2008/09 £M	Original Approved Limits 2009/10 £M	Revised Approved Limits 2009/10 £M	Actual Total Liabilities Borrowing + PFI 2009/10 £M
Approved Indicator – Authorised Limit	**124.638**	**133.010**	**125.772**	
Approved Indicator – Operational Boundary	**113.360**	**120.918**	**114.339**	**104.948**
Financing costs as a percentage of net revenue expenditure	**1.50%**	**3.11%**	**4.62%**	**4.04%**

Table 6 Limits against Actual Liabilities



27. Table 6 above shows the actual liabilities for Darlington Borough Council as outlined in paragraph 21 including the PFI liability of £24.008 which is now shown on the balance sheet under IFRS reporting. At 31st March 2010 the total liabilities of £104.948M were below both the Authorised Limit and the Operational Boundary.

28. A further six prudential indicators are detailed in **Appendix 1**.

Economic Background for 2009/10

29. A summary of the general economic conditions that have prevailed through 2009/10 provided by Butlers, the Council's treasury management advisors is attached at **Appendix 2.**

Summary of the Treasury Management Strategy agreed for 2009/10

30. The revised Prudential Indicators anticipated that during 2009/10 the Council would need to borrow £12.258M to finance part of its capital programme.

31. The Annual Investment Strategy stated that the use of Specified (usually less than 1 year) and non-specified (usually more than 1 year) investments would be carefully balanced to ensure that the Council has appropriate liquidity for its operational needs. In the normal course of the Council's business 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.

32. Longer term instruments (greater than one year from inception to repayment) will only be used where the Council's liquidity requirements are safeguarded. An estimate of long term investments (over 1 year) were included in the report on the Prudential Indicators update these were as follows £6M for 2009/10, £10M for 2010/11 and £15M for 2011/12.

Treasury Management Activity during 2009/10

Debt Position

33. **Borrowing –** 1 new loan of £13.500M was taken to replace a maturing variable rate loan. This fixed market loan (not with PWLB) has an interest rate of 2% for the next 3 years with a variable rate thereafter.

34. **Rescheduling –** Due to the continuing economic outlook throughout 2009/10 the profile of loan rates changed, short term loans continued to be considerably cheaper than longer term rates. These changes to the yield curve provided the Council with further opportunities to make savings over three years for the Revenue MTFP. In February 2010 three loans were rescheduled being replaced with 2 loans with variable rates of interest.

Table 10

	Loans repaid				Replacement Loans			
Date	**Amount £M**	**Duration of loans Years**	**Interest Rate**	**Discount received to General Fund £M**	**Amount £M**	**Duration of Loan Years**	**Interest Rate**	**Interest Savings to General Fund £M**
25/02/2010	2.000	25years	4.57%	0.016	3.500	3	0.70%	0.152
25/02/2010	3.500	24years	4.57%	0.044	3.500	4	0.70%	0.152
25/02/2010	1.500	22years	4.57%	0.018				
Total Savings				**0.078**				**0.304**

35. In the current year Officers have worked proactively in securing competitive borrowing from the market to ensure that as these new loans become repayable there will be further loans in place to protect these new borrowing rates achieved going forward.

36. **Repayment -** 1 loan of £13.474M was due for repayment during 2009/10. However in addition to that to achieve further savings and reduce counterparty risk further during 2009/10 the Council repaid debt of £23.408M. This reduced financing costs as the difference between average debt and investment returns was circa 3.5%, this produced savings of circa £68,250 per month as the Council was under borrowed. As interest rates rise this monthly saving will reduce over the coming year. Officers will work proactively to determine the correct time to enter the borrowing market again, taking into account both investment returns and prevailing borrowing rates. This timing cannot be predetermined although expectations are that these conditions will remain in place for the coming 9 to12 months.

37. **Summary of Debt Transactions –** The overall position of the debt activity resulted in an average interest rate of 3.44% compared with 4.27% for 2008/09.

Investment Position

38. **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 26 February 2009. This was reviewed in December 2009 but remained unchanged for the rest of 2009/10.

39. The repayment of debt as outlined above has resulted in the average money invested being reduced from the previous year.

40. The investment activity during the year conformed to the approved and revised Strategy and the Council had no liquidity difficulties.

41. Investments held by the Council consist of temporary surplus balances, capital receipts and other funds as detailed below: -

Table 11 - Temporary Surplus Cash Balances

	Approved Revised Budget 2009/10	Actual 2009/10
Monthly Average level of Investments	**£11.5M**	**£12.6M**
Average Rate of Return on Investment	**2.47%**	**2.17%**
Interest Earned	**£0.285M**	**£0.274M**

Table 12 - Capital Receipts and Funds

	Approved revised Budget 2009/10	Actual 2009/10
Monthly Average level of Investments	**£10M**	**£11.2M**
Average Rate of Return on Investment	**3.75%**	**3.29%**
Interest Earned	**£0.375M**	**£0.369M**

42. In addition to the above further investment income was due from Durham County Council relating to the Council's holding in Newcastle International Airport Ltd (NIAL), which was transferred from Durham County Council towards the end of 2003/04. NIAL has not declared a dividend for 2009 however £19,535 is due to Darlington Borough Council for interest on loans relating to 2009/10.

Performance and Risk

Performance Indicators set for 2009/10

43. Performance indicators relating to interest rates for borrowing and investments were set for this service. These are distinct historic performance indicators, as opposed to the Prudential Indicators, which are predominantly forward looking. For borrowing, the indicator is the average rate paid during the year compared with the previous year. Investment rates are compared with a representative set of comparative rates.

Table 13 – Performance Compared With Indicators

Borrowing	Average overall rate paid compared to previous years	**2008/09** 4.27%	**2009/10** 3.44%
Investments		**Average comparative rates**	**DBC**
Short term	Cash flow investment rate returned against comparative average rate	0.37%	2.17%
Long term	Capital investment rate returned against comparative average rates	0.88%	3.29%

Basket of comparative rates used to compare DBC performance: -	**Short Term Investments**	**Long Term Investments**
Comparative Rates		
Local Authority 2 day rate	0.34%	
Local Authority 7 day rate	0.34%	
Local Authority 6 month rate		0.92%
Local Authority 12 month rate		1.28%
London Inter Bank Bid (LIBID) 7 day rate	0.42%	0.42%
Average	**0.37%**	**0.88%**

44. As can be seen from the table, the actual investment rate achieved for short term investments exceeds the average of comparative rates for both short term and longer term investments. This is essentially because a number of our investments were placed when interest rates were higher.

45. Security and liquidity benchmarks are being developed and introduced for 2010/11 these will be reported in the mid-year monitoring and the annual reports in the future.

Risk

46. 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 2008/09);

    (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 CIFPA 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 Public Services;

(f) Under the Act the Department for Communities and Local Government has issued Investment Guidance to structure and regulate the Council's investment activities;

(g) Under section 238(2) of the Local Government and Public Involvement in Health Act 2007 the Secretary of State has taken powers to issue guidance on accounting practices. Guidance on Minimum Revenue Provision was issued under this section on 8th November 2007.

47. The Councils 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.

48. 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 taken advantage of the change in the yield curve on both borrowing and investing to secure reduced financing costs for the Revenue MTFP.

Conclusion

49. The Council's treasury management activity during 2009/10 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 £1.091M achieved from the original MTFP as reported elsewhere on this agenda as a result of a number of actions taken throughout the year to manage the financing costs in the changing economic climate.

Outcome of Consultation

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

APPENDIX 1

Additional Prudential Indicators not reported in the body of the report

		2008/09 Actual	2009/10 Approved Indicator	2009/10
1	**Incremental impact of capital investment decisions on the Band D Council tax**	**£2.44**	**£0.66**	**£0.28**
2	**Incremental impact of capital investment decisions on the housing rent levels**	**Nil**	**Nil**	**Nil**
3	**Upper limits on fixed interest rates (*against maximum position*)**	**100%**	**100%**	**100%**
4	**Upper limits on variable interest rates (*against maximum position*)**	**12.8%**	**40%**	**25%**
5	**Maturity structure of fixed rate borrowing (*against maximum position*)**			
	Under 12 months	**12.9%**	**25%**	**17%**
	12 months to 2 years	**13.2%**	**40%**	**8%**
	2 years to 5 years	**8.4%**	**60%**	**11%**
	5 years to 10 years	**0%**	**80%**	**0%**
	10 years and above	**65.5%**	**100%**	**64%**
6	**Maximum Principal funds invested greater than 364 days**	**£12.5M**	**£10M**	**£6.0M**

1. Economic Background for 2009/10

(a) Financial markets entered calmer waters in the early stages of the 2009/10 financial year as the worst fears of global depression and bank meltdown subsided. Nevertheless, while economies showed tentative signs of stabilising, a return to a positive growth path was still considered to be a long way off. Indeed, UK GDP data for the first half of 2009 registered its sharpest fall for over 20 years.

(b) It was not until the summer months that economic performances began to stage a welcome improvement. Fear of a collapse of another leading financial institution lessened markedly and this was reflected in the more ‘normal’ behaviour of money market rates. That said, banking sectors in most countries were far from trouble free; asset write downs persisted, minor US banks continued to fail and the troubles of a number of building societies continued to make the headlines.

(c) The UK economy continued to post a mixed performance and it was far from clear how far down the road to recovery it had travelled. The low point of the business cycle was passed during the third quarter of the year but the return to positive growth proved stubborn; for the UK this would not materialise until the fourth quarter of 2009.

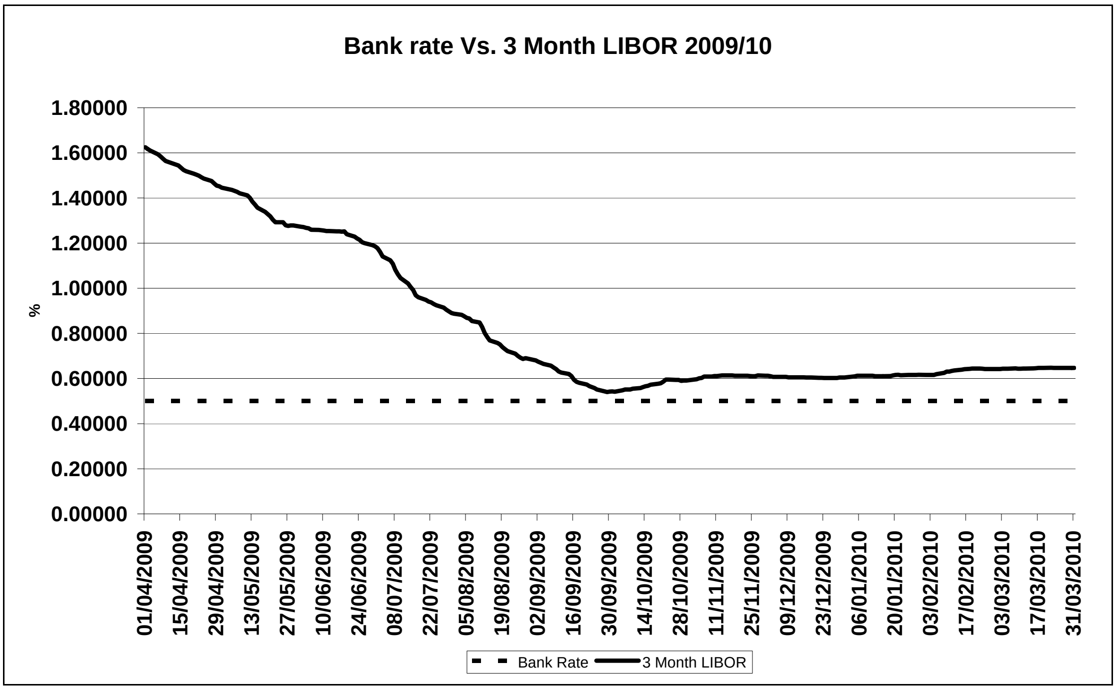
(d) Industrial production was one of the buoyant areas of the economy, although it was far from consistent. The main area of uncertainty remained consumer spending. This key driver of economic activity was hampered by the household sector’s striving to reduce its heavily indebted position. This, along with the continued deterioration in the employment situation and the weakness of earnings growth served as further deterrents to spending.

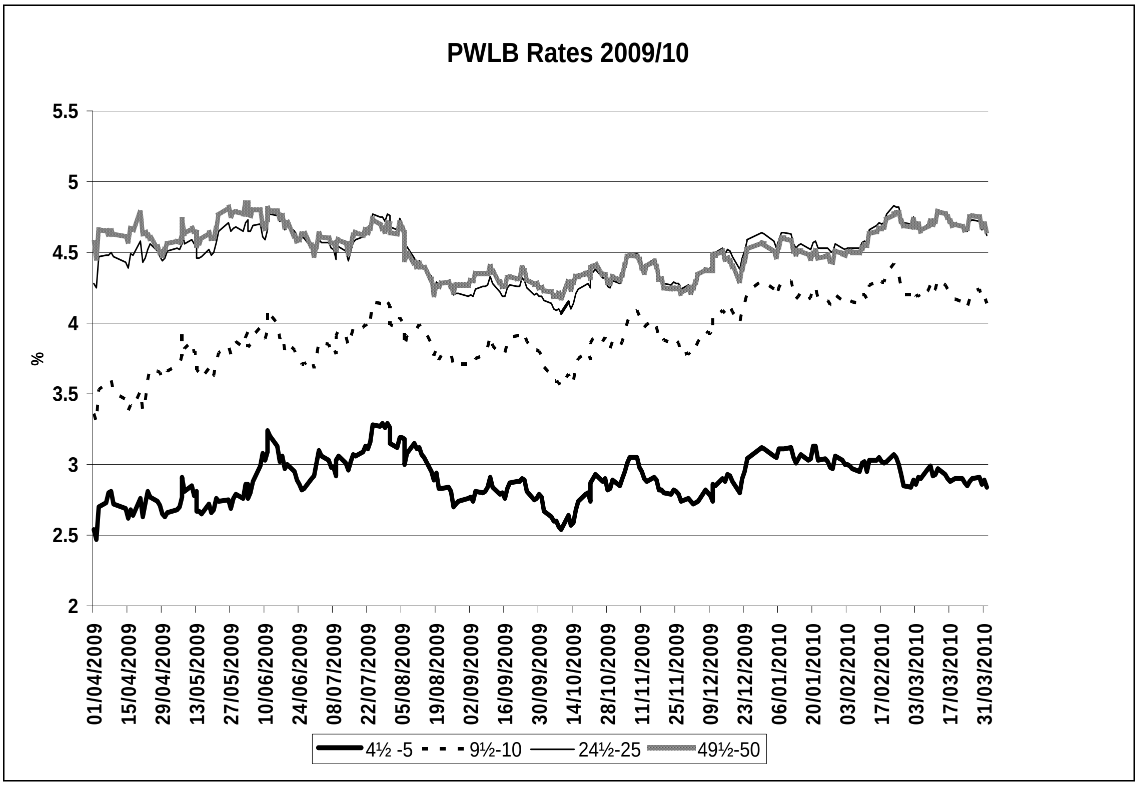
(e) The bias of MPC decisions remained directed towards policy ease throughout the year. As official interest rates had been reduced to near-zero (0.5% Bank Rate) in March 2009, monetary relaxation took the form of the extension of the Quantitative Easing programme. The £125bn tranche sanctioned in March was followed by two further boosts, £50bn in August and £25bn in November.

(f) The accommodative policy approach, coupled with dwindling fears of financial collapse, created an environment in which money market rates eased to yet lower levels. In addition to this, the margin between LIBOR and LIBID rates returned to a more normal position. This was a sign that banks were more comfortable about transacting business between each other but the availability of credit to a wider cross-section of the economy remained problematic through to year-end.

(g) Long-term interest rates did not suffer from the massive gilt funding requirement created by the surge in the public sector deficit. The Quantitative Easing programme was the principal source of market support. The large-scale purchasing of stock that this element of monetary policy required meant the Bank of England was to absorb virtually all of the year’s supply.

(h) Nevertheless, the programme was not sufficient to drive yields below the low point seen immediately after the inauguration of the QE programme in March 2009. Long-term rates remained generally erratic, (frequently registering large intra-day movements), but fluctuated within a comparatively narrow range. Investors were happy to take advantage of the support they were receiving from official activity but behaved in a manner that suggested most believed it is only a matter of time before the good fortunes of the market would come to an end. Indeed, yields returned to a rising trend once QE drew to a close in January 2010.





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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
Discount	Amount payable by the PWLB when loans are repaid if the current loan rate is less than the rate borne by the original debt
Yield Curve	Is a graph that shows the relationship between the interest rate paid and length of time to repayment of a loan.