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OXFORD CITY COUNCIL

Report of: **Finance & Asset Management Business Manager**

To: **Executive Board**

Date: **5th November 2007** **Item No:**

Title of Report : **Treasury Management Annual Report 2006/07**

Summary and Recommendations

Purpose of report: The annual treasury report is a requirement of the Council's reporting procedures. It covers the treasury activity for 2006/07, and the actual Prudential Indicators for 2006/07.

Key decision: No

Portfolio Holder: Councillor Jim Campbell

Scrutiny Responsibility: Finance

Ward(s) affected: All

Report Approved by:
Mark Luntley, Strategic Director – Finance & Corporate Services
Sarah Fogden –Business Manager - Finance & Asset Management
Councillor Jim Campbell
Lindsay Cane – Legal and Democratic Services

Policy Framework: Sustaining Financial Stability

Recommendation(s): The Executive Board is asked to recommend Council

1. Approve the actual 2006/07 prudential indicators within the report
2. Note the treasury management annual report for 2006/07

Executive Summary

1. The Council had outstanding debt of £14,290,700 as at 31st March 2006. This is made up of £11,770,000 of fixed interest rate debt and £2,520,700 of other long term liabilities. The total interest paid on this debt in 2006/07 was £1,292,400.

2. The Council also had investments of £43,060,000 as at 31st March 2006, this was a combination of fixed term investments over varying periods. These periods ranged from overnight to 364 days. The total interest earned on these investments was £2,228,047.

3. In relation to investments the primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:
    - It has sufficient liquidity in its investments
    - It maintains a policy covering both the categories of investment types and criteria for choosing investment counterparties.

4. In relation to the Council's debt strategy the Strategic Director, Finance and Corporate Services will take the most appropriate form of borrowing depending on the prevailing interest rates at the time.

5. The Council adhered to its Treasury Strategies for both Debt management and Investment management for 2006/07.

6. The Prudential Indicators that the Council produces are used to determine the limits that the Council must operate within when carrying out its Treasury Management activities.

7. The Council has a statutory requirement to produce, monitor and report its Prudential Indicators, this is in line with the Prudential Code. The Prudential Indicators detailed in the body of this report are looking back at the results for 2006/07, and are designed to show the Council's position for each individual indicator, with an explanation of its relevance.

8. Key objectives of the Prudential Code are to ensure that the capital investment plans of local authorities are affordable, prudent and sustainable.

9. The Prudential system provides a flexible framework approach within which capital assets can be procured, managed, maintained and developed. At a strategic level it allows authorities to make their own decisions about the balance to be struck between revenue intensive or capital intensive methods of procuring services. It also allows capital investment to proceed where the authority can fund it within prudent and affordable limits. As a consequence these arrangements permit

‘spend to save’ schemes to proceed where they are not only affordable but also prudent and sustainable.

Background

10. The report meets the requirement of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

11. This report is a backward look at the treasury activities for 2006/07, and looks at how the Council has performed throughout the year. The strategy for the current year, 2007/08, was approved at Council in February 2007, and the strategy for 2008/09 will go through the approval process alongside the budget for 2008/09, and further reports will report the activities of each year within six months of the year end. This report summarises:
    - The capital activity for the year, and how this activity was financed
    - The impact on the Council’s indebtedness for capital purposes;
    - The Council’s overall treasury position;
    - The reporting of the required prudential indicators;
    - A summary of interest rate movements in the year;
    - Debt activity; and
    - Investment activity

12. The Council’s investment policy is governed by DCLG Guidance, which has been implemented in the annual investment strategy approved by Executive Board on 3rd April 2006, and Council on 26th June 2006. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

The Council’s Capital Expenditure and Financing 2006/07

13. The Council undertakes capital expenditure on long-term assets. These activities may either be:
    - Financed immediately through capital receipts, capital grants etc; or
    - If insufficient financing is available the expenditure will give rise to a borrowing need

14. 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 cash flow, its previous borrowing activities and the investment of surplus funds. These activities are structured to manage risk foremost, and then optimise performance. Wider information on the regulatory requirements is shown in paragraph 38.

15. The actual capital expenditure forms one of the required prudential indicators. The table below shows how this was financed:

£m	2005/06 Actual	2006/07 Estimate	2006/07 Actual
Non- HRA capital expenditure	8,544.8	8,220.5	7,402.1
HRA capital expenditure	14,302.0	11,400.0	10,890.2
Total capital expenditure	**22,846.8**	**19,620.5**	**18,292.3**
Resource by:			
capital receipts	6,672.0	8,348.0	7,831.0
capital grants	9,431.0	7,715.0	7,715.0
revenue	3,917.0	1,237.0	1,237.0
Unfinanced capital expenditure (additional need to borrow)	**2,826.8**	**2,320.5**	**1,509.3**

16. The figures in this table can be seen in the Statement of Accounts for 2006/07 in the Balance Sheet Note 7.15.

The Council's Overall Borrowing Need

17. The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This 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

18. The total CFR can be reduced by:
    - The application of additional capital resources, for example unapplied capital receipts; or
    - Charge a voluntary revenue provision or depreciation against it

CFR (£m)	31st March 2006 Actual	31st March 2007 Estimate Indicator	31st March 2007 Actual
Opening balance	3,180.0	6,007.0	6,007.0
+ unfinanced capital expenditure	3,017.0	47.3	2,320.2
- MRP/VRP	-190.0		-810.2
Closing balance	6,007.0	6,054.3	7,517.0

19. The Council's CFR for the year is shown below, and represents a key prudential indicator.

20. The figures in this table can also be seen in the Statement of accounts for 2006/07 in the Balance Sheet Note 7.15.

Treasury Position at 31st March 2007

21. Whilst the Council's gauge of its underlying need to borrow is the CFR, the Section 151 Officer and the treasury function can manage the Council's actual borrowing position by either:
    - Borrowing to the CFR; or
    - Choosing to utilise some temporary cash flow funds, which will reduce our investment balance, instead of borrowing (under borrowing); or
    - Borrowing for future increases in the CFR (borrowing in advance of need)

22. During 2006/07 the Section 151 Officer managed the debt position to be stable. At the end of 2006/07 the Council had total debt of £14.3m. This debt belongs to the HRA and repayment of it is provided for in Housing Subsidy. This means there is no benefit to the Council to repay this debt as it will reduce our Housing Subsidy. The Council's treasury position as at the 31st March 2007 compared with the previous year was:

Treasury Position	**31st March 2006**		**31st March 2007**	
	Principal £000s	**Average Rate**	**Principal £000s**	**Average Rate**
Borrowing				
Fixed interest rate debt	11,770.0	10.21%	11,277.1	10.22%
Other long term liabilities	2,520.7	4.82%	2,320.3	4.52%
Variable interest rate debt	0.0	0.00%	0.0	0.00%
Total Debt	**14,290.7**	**9.26%**	**13,597.4**	**9.25%**
Investments				
Fixed interest investments	36,060.0	4.87%	32,615.0	4.94%
Variable interest investments	0.0	0.00%	0.0	0.00%
Total Investment	**36,060.0**	**4.87%**	**32,615.0**	**4.94%**
Net borrowing position	**-21,769.3**		**-19,017.6**	

23. The figures in this table can be seen in the Statement of Accounts in the following areas:
    - Fixed interest rate debt is shown in Note 7.27 plus the Balance Sheet line for Short Term investments
    - Other long term liabilities is shown in Note 7.29
    - Fixed interest investments is shown in the Balance Sheet line for investments

Prudential indicators and compliance issues

24. Some of the prudential indicators provide either an overview or specific limits on treasury activity. These are shown below:

25. **Net Borrowing and the CFR** – in order to ensure that borrowing levels are prudent, over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. 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 the CFR, and shows that it is well below. The Council has complied with this prudential indicator.

	31st March 2006 Actual £000s	31st March 2007 Estimated Indicator £000s	31st March 2007 Actual £000s
Total Debt	14,290.70	13,597.40	13,597.40
Total Investments	43,060.00	45,000.00	34,615.00
Net Borrowing Position	**-28,769.30**	**-31,402.60**	**-21,017.60**
CFR	**6,007.00**	**6,054.30**	**7,517.00**

26. **The Authorised Limit** – The authorised limit is the 'affordable borrowing limit' required by S3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrate that during 2006/07 the Council has maintained gross borrowing within its Authorised Limit.

27. **The Operational Boundary** – The operational boundary is the expected borrowing position of the Council during the year, and periods occurring where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

28. **Actual financing costs as a proportion of net revenue stream** – 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 stream.

	2006/07 £000s
Indicators	
Original Indicator - Authorised Limit	24,000.0
Original Indicator - Operational Boundary	20,500.0
Actuals	
Minimum gross borrowing position	13,597.4
Maximum gross borrowing position	14,290.7
Average gross borrowing position	13,944.0

Financing costs as a proportion of net revenue stream - General Fund	3.3%
Financing costs as a proportion of net revenue stream - HRA	8.0%

Economic Background for 2006/07

29. 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 MPC Bank Rate (UK Repo Rate). Longer term borrowing rates are influenced by inflation and demand and supply considerations.

30. The 2006/07 financial year featured a rising trend in short term interest rates as policy makers and financial markets responded to the twin effects of strengthening economic activity and rising inflation.

31. The optimism that prevailed in the first few months of 2006 had evaporated by the beginning of the new financial year. The rebound in economic activity since 2005 proved more robust than consensus expectations. In addition, external pressures on consumer price inflation had continued to escalate. While short-term interest rates remained steady in the first few months of the year, there were growing expectations that a rise in official interest rates would eventually materialise.

32. The first hike 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 economies slow response to monetary policy tightening, a less than favourable international backdrop and concerns that deteriorating inflation expectations at home would drive prices higher prompted additional rate hikes. Two, quarter point increases in Bank Rate were announced in November 2006 and January 2007. The market anticipated further tightening measures, and attractive investment opportunities prevailed to year-end.

33. Long-term interest (PWLB) rates charted an erratic course but the overall trend was towards higher levels. Deteriorating inflation expectations on the domestic and international fronts, in reaction to strong growth on a global basis, was the principal force driving yields higher. Strong technical demand for bonds, courtesy of the rebalancing of pension fund portfolios in favour of fixed income assets, was insufficiently strong to counter the rise in yields. Occasional rallies in the gilt-edged market caused dips in rates and presented favourable borrowing opportunities. But these were short-lived and by the close of the year, yields were trading close to the highest levels seen since early 2005.

The Strategy Agreed for 2006/07

34. In relation to investments the primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:
    - It has sufficient liquidity in its investments
    - It maintains a policy covering both the categories of investment types and criteria for choosing investment counterparties.

35. In relation to the Council's debt strategy the Strategic Director, Finance and Corporate Services will take the most appropriate form of borrowing depending on the prevailing interest rates at the time.

36. The Council adhered to its Treasury Strategy for 2006/07.

The Strategy Agreed for 2007/08

37. The Strategic Director, Finance and Corporate Services has delegated powers to determine the need for any future borrowing and the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks. It is likely that longer term fixed rates will be considered if borrowing levels remain relatively low. This strategy will be considered when looking at the use of Prudential Borrowing.

38. The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:
    - It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed.
    - It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security.

39. The strategy agreed in February 2007 stated that expectations on shorter-term interest rates, on which investment decisions are based, showed a likelihood of a peak at 5.25% in early 2007. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts. The actual rates have risen higher than this predicted rate, and the base rate is currently at 5.75%, which is now believed to be its peak. Although on many deals within the last six weeks we have been able to achieve rates above 6%.

40. The Strategic Director, Finance and Corporate services has delegated powers to undertake the most appropriate form of investments

depending on the prevailing interest rates at the time, taking into account the risks, and will maintain a counterparty list in compliance with the agreed criteria.

Actual Debt position

41. No new external borrowing was undertaken during 2006/07, although the Council did use unsupported borrowing to help finance the recycling scheme. This internal borrowing was funded from internal resources.

42. The total spend on the recycling scheme through the capital programme was £2,128,984. £354,831 of this was paid by City Works revenue budget, which relates to a sixth of the total spend as this was the agreed repayment terms of the internal borrowing. The remaining £1,774,153 was funded by internal resources and will be repaid through City Works over the next six years.

43. The Council will proactively seek to use prudential borrowing in ‘spend to save’ schemes. The Council’s prudential borrowing strategy will be reported to Executive Board in December alongside the Treasury Management Strategy.

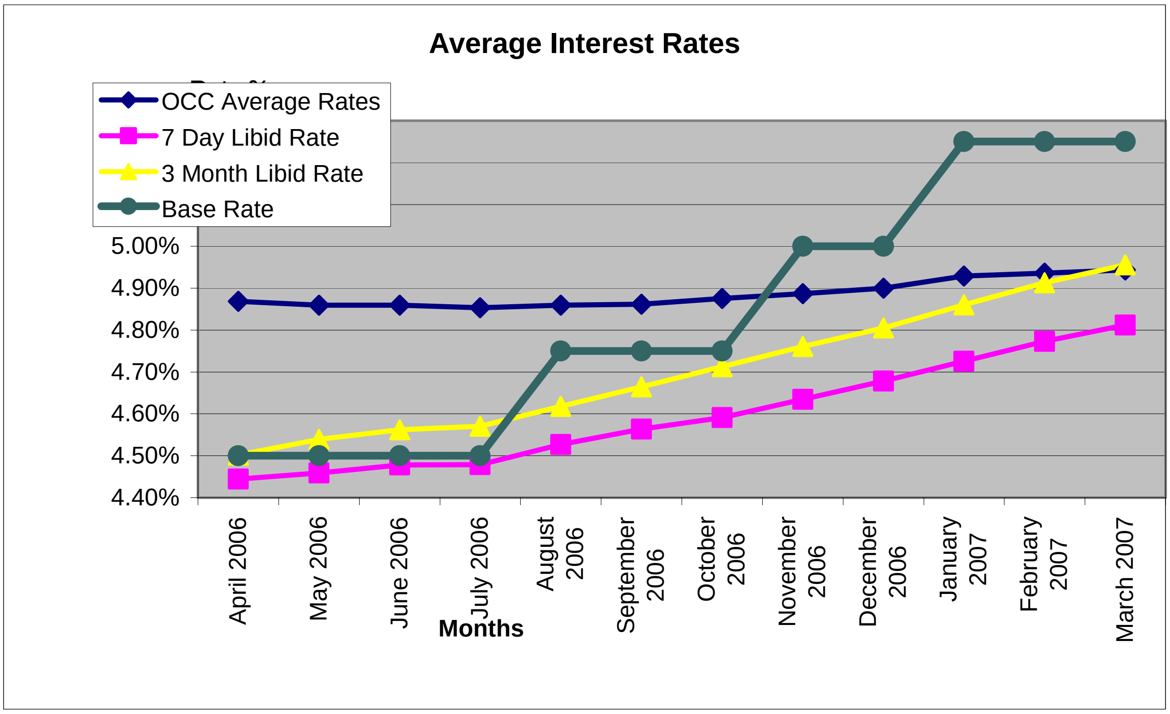
Actual Investment position

44. **Resources** – The Council’s longer-term cash balances comprise primarily revenue and capital resources, although these will be influenced by cash flow considerations.

45. **Investments held by the Council** – The Council invests in various banks and building societies, and always remains within the limits approved by Council and set out within our Counterparty list. During 2006/07 the Council maintained an average invested balance of £45,159,620 and received an average return of 4.94%. The comparable performance indicators shown on the graph are the average 7-day LIBID rate, which was 4.84%, and the average 3 Month LIBID rate, which was 4.96%.

46. The Council has now started to include the 7 day LIBID as a comparator along side the 3 month LIBID. This is because it has recently become apparent that the 7 day LIBID is a more prudent and realistic measure. The LIBID rate is the rate at which banks are willing to borrow money from other banks, this rate changes on a daily basis. The reason the 7 day LIBID is more realistic is because of the recent US sub-prime mortgage problems leading to the credit crunch situation, where banks had a lack of confidence in each other and were unwilling to lend to each other. This pushed the 3 month LIBID rate up to an unsustainable and unprecedented level.

47. The original budget for interest receivable in 2006/07 was £2.065m and was increased to £2.235m in year, the Council achieved £2.230m, which was slightly under the increased estimate for the year. This compares with a budget assumption of £46m investment balance at 4.50% interest rate



Regulatory Framework, Risk and Performance

48. The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:
    - 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;
    - 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, no restrictions were made in 2006/07;
    - Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;
    - The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;
    - 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;
    - Under the Act the DCLG has issued investment guidance to structure and regulate the Council's investment activities.

49. The Council has complied with all of the above 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.

50. The Council is aware of the risks of passive management of the treasury portfolio and, with the support of Butlers, our treasury advisors, has proactively managed its treasury position.

Recommendation(s): The Executive Board is asked to recommend Council to:

1. Approve the actual 2006/07 prudential indicators within the report
2. Note the treasury management annual report for 2006/07

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Background papers: None