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OXFORD CITY COUNCIL

To: Finance Panel (Panel of the Scrutiny Committee)

Date: 8 September 2016

Report of: Head of Financial Services

Title of Report: The Implications of Brexit for Local Government

Summary

Purpose of report: To update the Finance Panel on the expected implications of Brexit (British exit from the European Union) for local government.

Key decision No

Executive lead member: Councillor Ed Turner, Board Member for Finance, Asset Management and Public Health

Report author: Nigel Kennedy, Head of Financial Services

Background

1. The Finance Panel requested a briefing from the Head of Financial Services on the expected financial impacts of Brexit on local government.

Investments and Borrowing

Credit Rating of UK

2. The UK's Sovereign credit rating has been downgraded by both Standard & Poor's and Fitch from AAA to AA and put on negative outlook. Standard and Poor's warned that further downgrades could follow in the coming months and that uncertainty following the Brexit vote would hurt growth, push up borrowing and could trigger a constitutional crisis if it led to a second Scottish referendum.

3. Moodys which use a slightly different rating system have also placed the UK's rating on negative outlook.

4. The UK is now deemed less credit worthy than the US and EU
5. Moodys have suggested they may put UK banks on negative watch but no changes yet; changes in the financial regulation of the banking sector have led to a separation of bank credit ratings from sovereign credit ratings.

6. Yields on 10-year Government bonds have fallen to historic low levels as investors seek safety from Bank of England base rate cuts.

7. The shareholders of the European Investment Bank (EIB) are the 28 Member States of the European Union and the UK has a 16.11% shareholding in the EIB. At present the UK shareholding in the EIB remains and the EIB's engagement in the UK is unchanged, however it is likely that the EIB's engagement in the UK will form part of the broader discussions to define the future relationship of the UK with Europe and European bodies.

Interest rates

8. The Bank of England's Monetary Policy Committee did not adjust the Base Rate when it met in July. However, the release of economic data showing that the Brexit implications were more significant that at first thought meant that the MPC Committee cut bank base rate by 0.25% to a record low of 0.25% at its meeting on the 4th August.

9. The Bank of England could also enact fresh policy measures in the near term, such as expanding the Quantitative Easing programme, in order to support the British economy. These measures including the cutting of interest rates means that banks will not be short of cheap funds, which means they don't need to offer competitive investment rates.

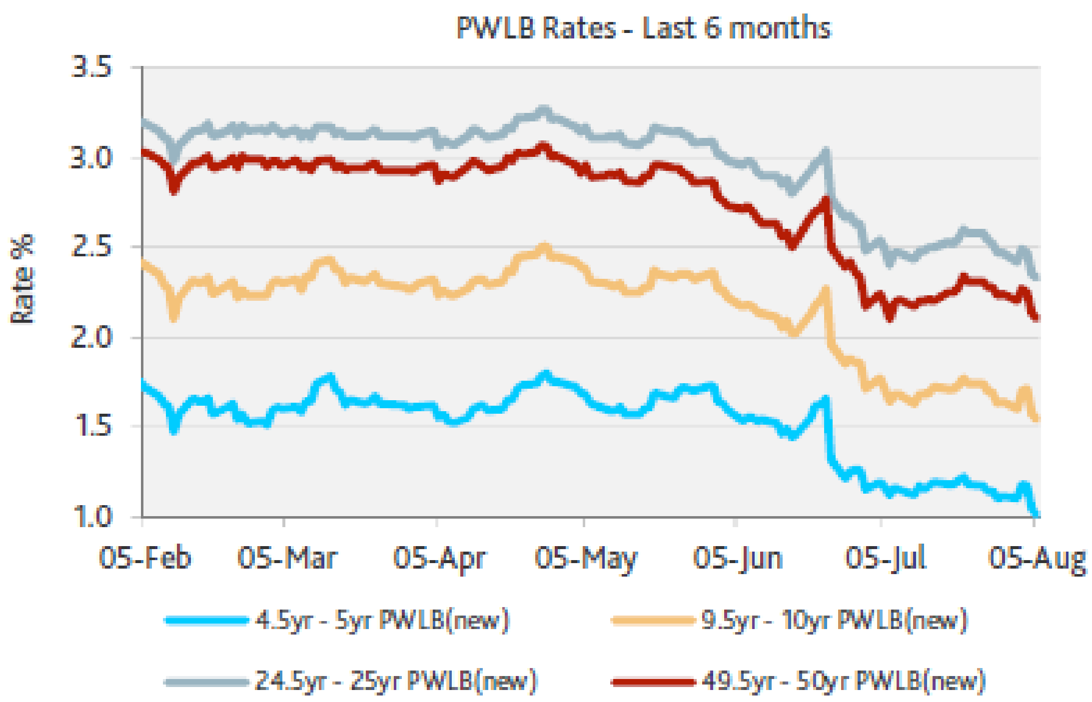
10. Capita; the Council's Treasury advisors have revised their interest rate forecasts and expect base rate to be cut further to 0.10% in December 2016. The forecast goes on to suggest no rise in base rate until quarter 2 of 2018. This is shown in Figure 1 below.

Figure 1: Capita interest rates forecast

	NOW	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
BANK RATE	0.25	0.25	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.25	0.25	0.25	0.50
3 month LIBID	0.50	0.30	0.20	0.20	0.20	0.20	0.20	0.30	0.30	0.30	0.40	0.50	0.60
6 month LIBID	0.55	0.40	0.30	0.30	0.30	0.40	0.40	0.50	0.50	0.50	0.60	0.60	0.70
12 month LIBID	0.75	0.60	0.50	0.50	0.60	0.60	0.70	0.70	0.70	0.80	0.80	0.80	0.90
5 yr PWLB	1.00	1.00	1.00	1.00	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.20	1.30
10 yr PWLB	1.60	1.50	1.50	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80
25 yr PWLB	2.30	2.30	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.60
50 yr PWLB	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.40

11. Reaction to the Bank of England's comments around quantitative easing caused an immediate fall in gilt rates between 10 and 50 years of about 25-37 basis points. Capita have subsequently revised PWLB borrowing rate forecasts down to historically low levels. See Figure 2 below.

Figure 2: Public Works Loan Board Rates – Last 6 months



City Council Investments

12. As at the 31st July the Council held £77.8 million of Investments in the following institutions:

Figure 3: City Council investments

	Maturity Period			
	0-3 months	3-6 months	6-12 months	>12 months
	£millions	£millions	£millions	£millions
Banks	7.5	16.5	7.0	
Building Societies	7.0	10.0		
Money Market Funds	14.8			
Local Authorities	5.0			
Property Funds				10.0
Certificate of Deposits				
Total	**34.3**	**26.5**	**7.0**	**10.0**

13. Average investment returns in July was 0.68% for banks and building societies excluding property funds and 1.11% including property funds. For investments redeeming in August, the Council has been quoted in the range of 0.16% to 0.65%for new 6 months deals as opposed to the 0.62 to 0.80% achieved in the last month. The 6 month rates quoted now are often lower than current money

market funds (MMFs), which is a reverse of the pre-Brexit position despite MMF rates falling to a range of 0.37% to 0.45% from 0.45% to 0.52%.

14. Another impact of the UK credit rating downgrade is a reduction in investment duration limits.

15. Within the medium term financial plan an amount of £746k has been included for investment interest based on an average interest rate of 0.7% excluding property and 1.3% including property funds. A reduction in the average rate of investments to 0.44% would reduce investment interest by around £100k. With the base rate decrease and the potential for a further decrease it is likely that this financial pressure will increase.

16. The reduction in returns will also impact on the Council's Pension Fund although the impact will not be clear until the next actuarial review which is due this financial year; an early indication of the results will be needed to enable forward planning for pension costs.

Property Funds

17. The Council has invested in three property funds. The primary reason for the Council investing in the CCLA and Lothbury property funds was to achieve a revenue return. Since the vote for Brexit, the capital value of these funds has reduced; however it is still significantly above the purchase value. Investments in property funds are long term and it is expected that there will be fluctuations of the capital value over the period that the property fund investments are held. More detail on the property funds the Council holds are as follows:

CCLA

a) £3 million investment in the Local Authorities Property Fund held in two tranches. The total capital value as at the end of July 2016 was £3,611,964.
b) The Council has enjoyed growth since joining the Fund, however the recent Brexit result has had a considerable effect on the Fund as shown on the chart below. The fund has effectively fallen back to July 2015 net asset values. The CCLA fund managers took the decision to down value the fund by 3% from £636 million to £617 million as a result of uncertainty in the market due to the Brexit vote. Other property funds in the market have down valued further.
c) The Fund managers believe the portfolio of properties remain attractive with strong and robust long-term tenants, low void rates of 4.8%, no gearing and relatively low exposure to City of London and Central London properties.
d) The Fund still allows redemptions.

Figure 4: Growth in value of CCLA Property Fund

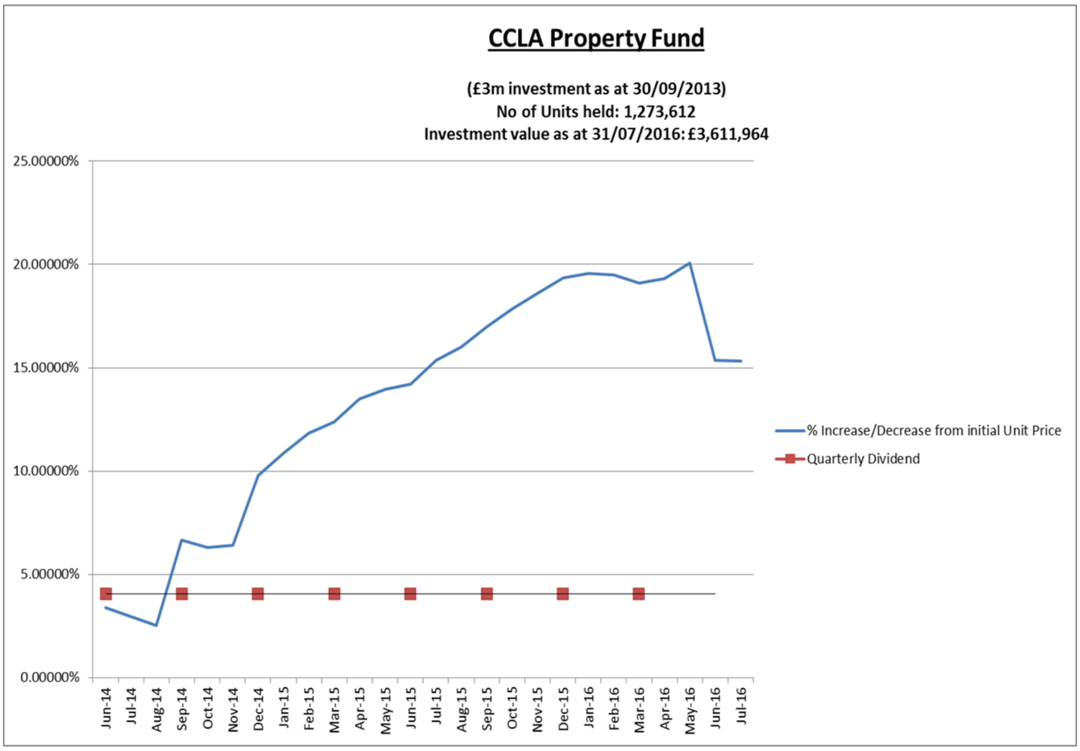
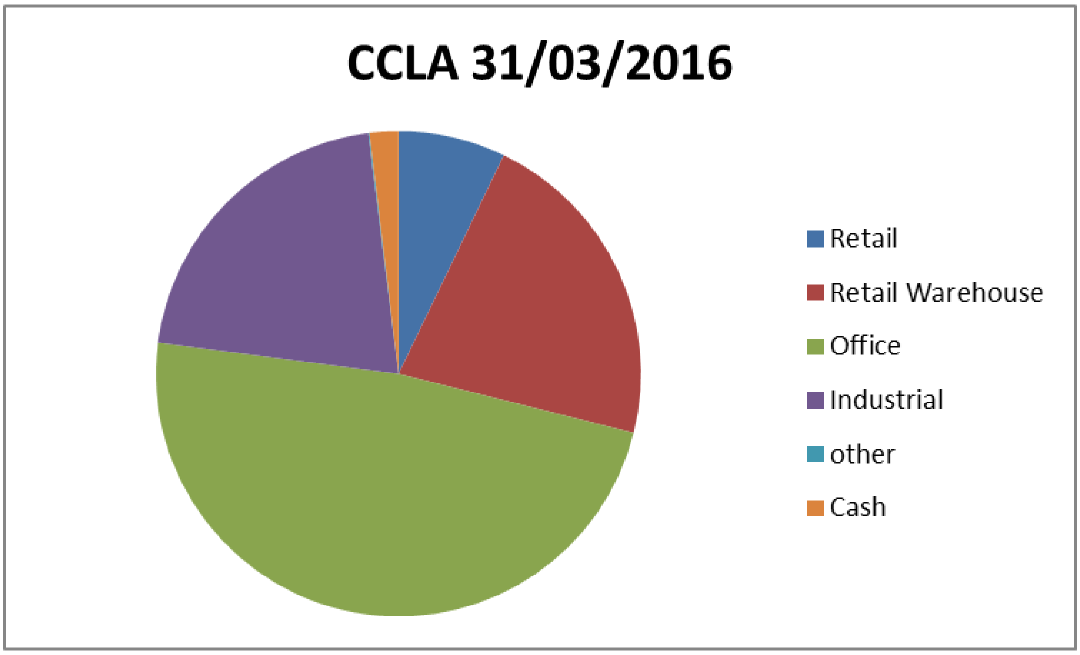


Figure 5: CCLA Property Fund asset allocation by type



Lothbury

e) £7 million is currently invested in the Lothbury Property Fund held in two tranches. The capital value as at the end of July 2016 was £7,745,209.

f) The Council has enjoyed growth since joining the Fund. The Council's investment has fallen since May 2016 as shown in the chart below.
g) The Fund still allows redemptions.

Figure 6: Growth in value of Lothbury Property Fund

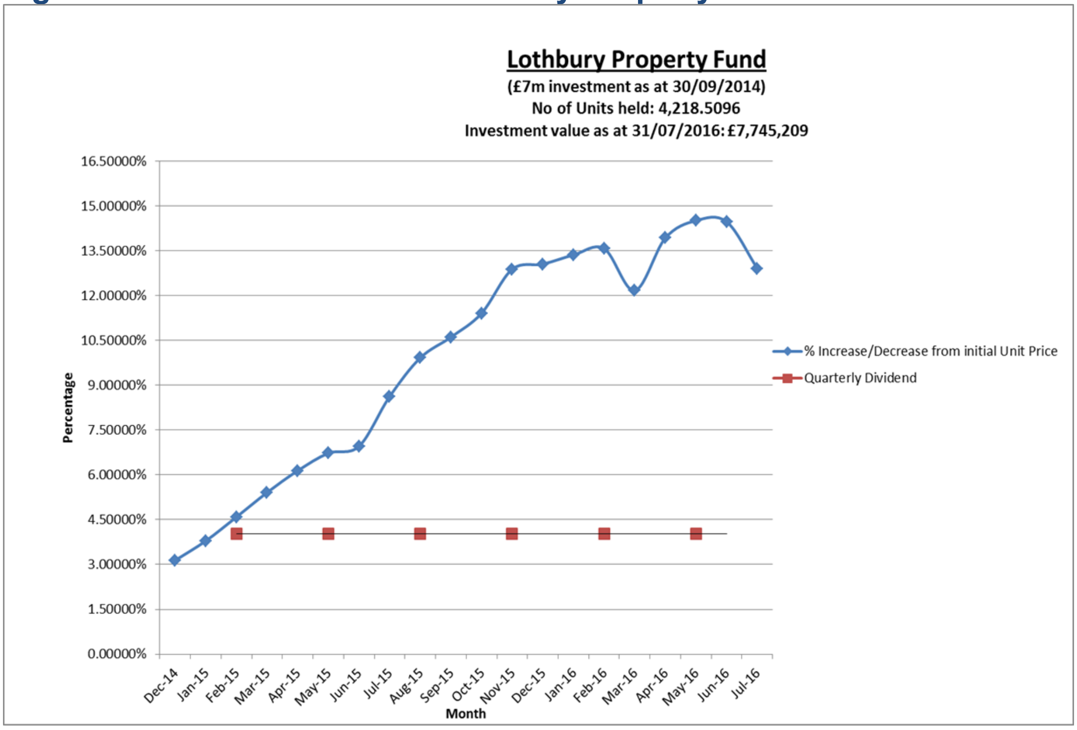
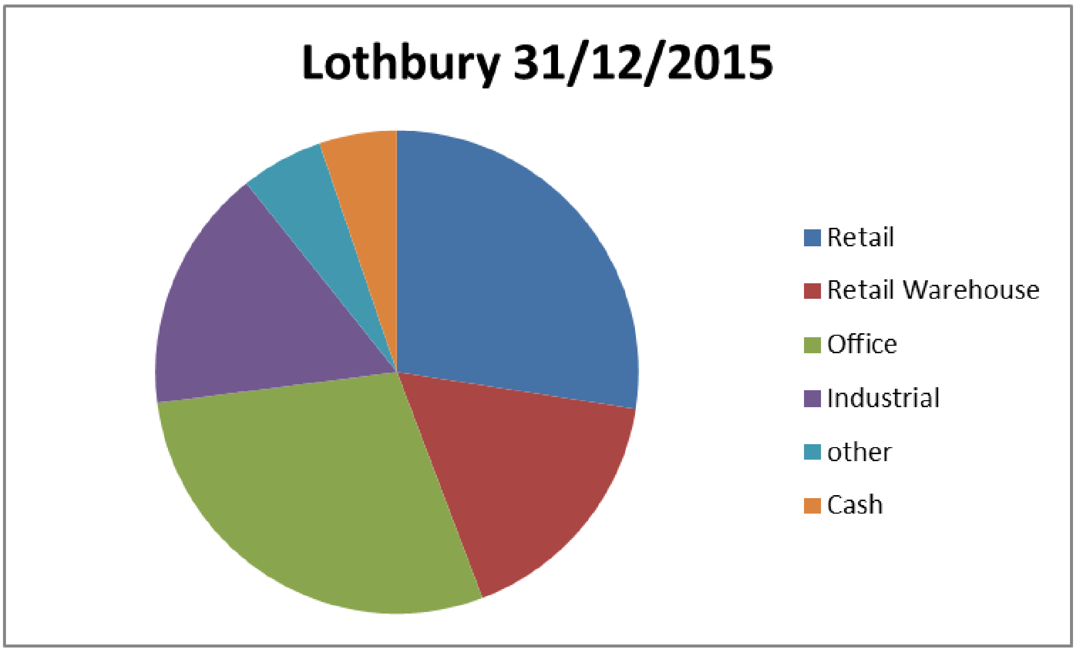


Figure 7: Lothbury Property Fund asset allocation by type



Real Assets Lettings

h) The Council has recently invested an amount of £5million with match funding from the Big Society to purchase houses for homeless families. Although essentially this is a service requirement the Council does expect to make around 3% rate of return commencing next financial year plus a share in the uplift in the value of the 50 properties purchased.

Borrowing

18. Within the Council's Medium Term Financial Plan provision has been made for the following prudential borrowing:

Figure 8: Borrowing provision in the Council's Medium Term Financial Plan

	HRA	General Fund	Housing Company	Total
Year	**£000's**	**£000's**	**£000's**	**£000's**
2016/17	-			
2017/18	6,512	5,588	12,250	24,350
2018/19	6,254	3,260		9,514
2019/20	7,419	5,039		12,458
Total	20,185	13,887	12,250	46,322

19. The Council currently has around £20 million of internal borrowing and reserves and balances of around £60 million which potentially provide additional headroom dependant on the Council's expenditure profile. However, as highlighted earlier; borrowing rates are at historically low levels so officers are monitoring the situation carefully.

Britain's Contribution to the EU

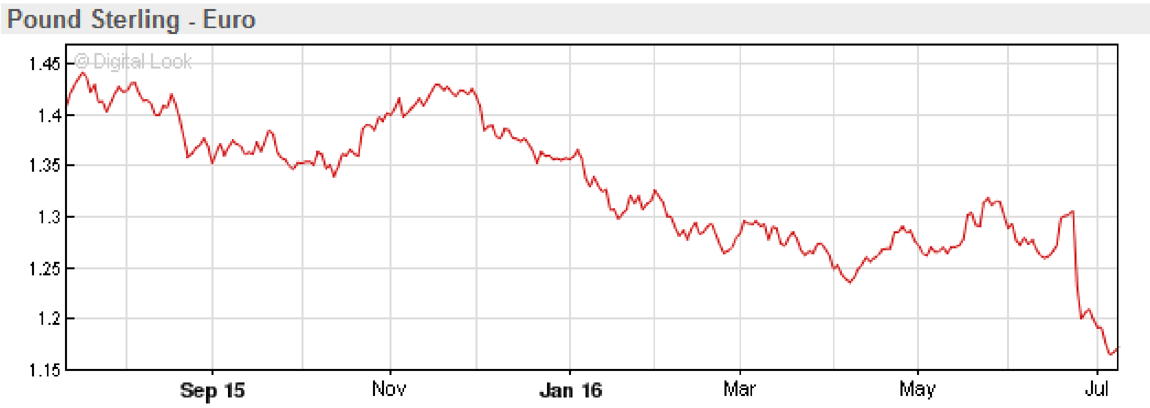
20. From 2010 to 2015, the UK's average annual gross contribution to the EU amounted to around £16.8 billion. However the UK also receives a rebate and funding from various EU initiatives. This means that the UK's average annual net contribution to the EU budget over these same years is estimated to be around £8.8 billion, or around 0.5% of GDP.

21. Although in the near term budgetary contributions to the EU must still be made, and funding flows into the UK will continue, the longer term position is uncertain and is dependent on the exit negotiations between the UK and the EU. In addition it remains to be seen whether the new UK Government will redirect the money it may save from leaving the EU to similar areas as those benefiting from European funding, including local government.

Pound versus Euro

22. The pound has fallen against the euro since the Brexit vote to a low of 1.16 euros as opposed to a 52 week high of 1.44 euros and a level of 1.3 euros before the Brexit vote.

Figure 9: The value of the Pound against the Euro



EU Funding

23. The City Council has actively pursued European Funding for relevant projects in recent years. Additionally, the Local Enterprise Partnership (LEP) has secured funding from the European Structural Investment Funds (ESIF) (c£20million). The proposals can be most easily understood as being organised around two headline programmes:
    - £14.77m (+ match) Business Support Programme
    - £4.73million Labour Market and Community Development Programme

Oxfutures Programme

24. The Oxfutures Programme is run by the Low Carbon Hub on behalf of the City Council and County Council. The partnership received £1.2 million of EU grant on the basis that it leveraged 15 times this amount in schemes with local businesses. The target is 23 million euros or £19.658 million, an increase £1.8 million since the BREXIT decision on 23rd June and the fall in the exchange rate. In the event that the target is not achieved a proportion of grant is repayable to the EU.

25. Going forward access to EU funds may not be possible.

EU Obligations

26. There are a range of EU obligations affecting local authorities. Procurement, local economic development, waste and employment are all determined by EU regulations. It is probable that some of these regulations will remain enshrined within UK law, while others may be repealed or overturned in the fullness of time.

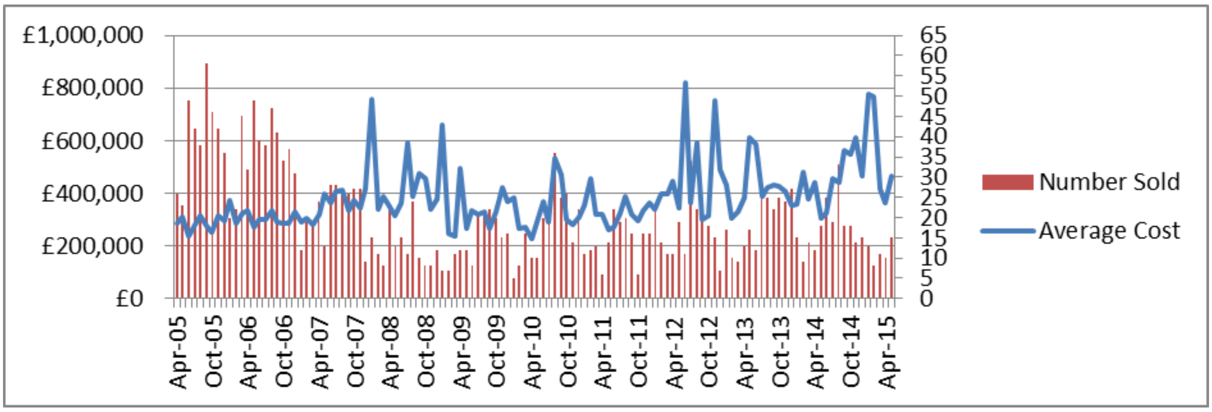
State Aid Rules

27. Potentially some EU state aid rules would be relaxed, which could mean it is easier in some circumstances to support companies with public funding when warranted, although we would still have to comply with restrictions that may be imposed as part of a negotiated European Free Trade Agreement.

House Prices

28. Many economists believe that house prices could go down because of a potential fall in inward investment which would not help those councils who are setting up development companies and building more properties to sell as part of the plan to find alternative sources of income, helped significantly by the present buoyant housing market. It is fair to say however that even with the recent financial markets fluctuations the average cost of dwellings in Oxford has been upwards.

Figure 10: Average cost of dwellings in Oxford



Petrol prices

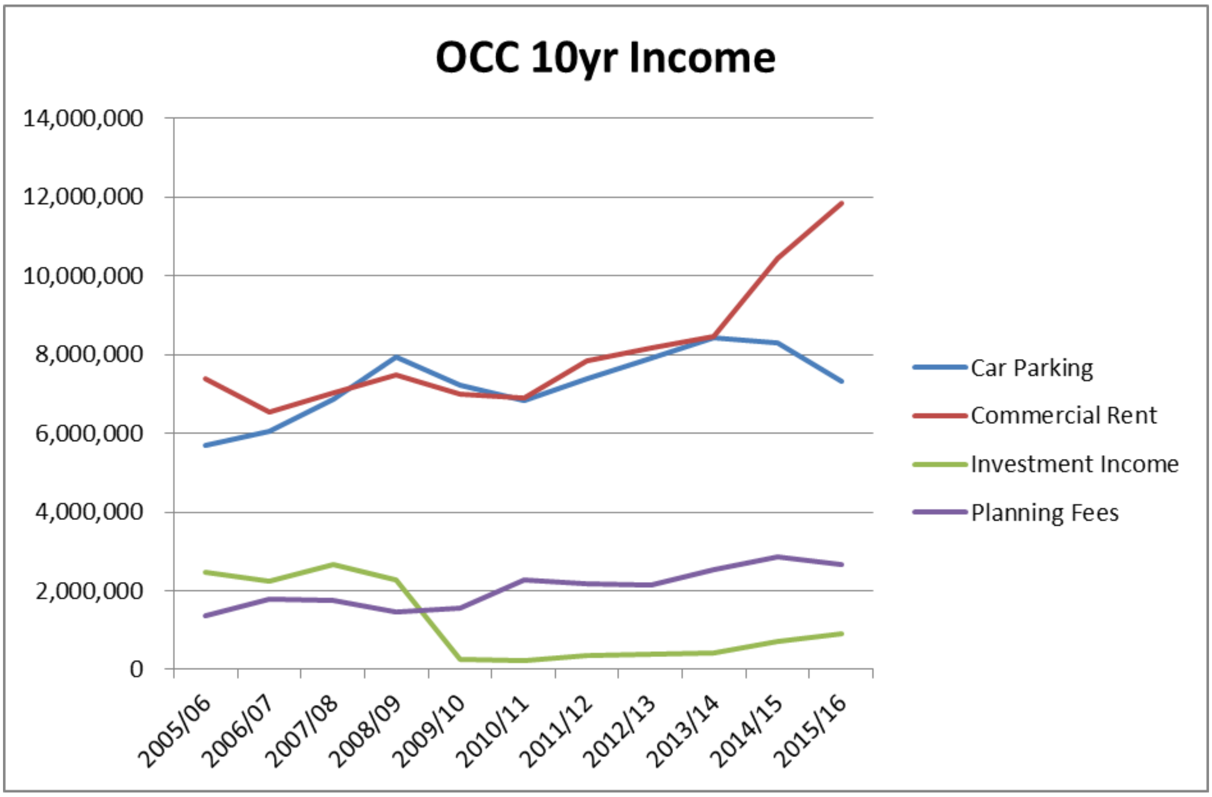
29. The Petrol Retailers Association and the AA motoring organisation have warned drivers that a 2p to 3p increase in the cost of a litre of fuel should be expected. The Council uses around £800k of fuel per annum, so this represents a £20k increase

The Council's Key Income Streams

30. For an indication of what the effect of BREXIT may have on the Councils own income streams it is worth looking at what happened in the last recession and the effect on some of the Council's main income streams, i.e. car parking, planning fees, investment income, commercial property income and Business Rates. It will appreciated that past history may not be reflective of the future.

31. Following 6 successive quarters of negative growth the UK finally moved out of recession in the final quarter of 2009. The graph below shows the Councils' main income streams between 2005/06 and 2015/16 which shows the trend before, during and after the recession.

Figure 11: The impact of the 2008/9 recession on Council income streams



32. The main observations include:
    - Investment income dropped significantly as base rates were cut to 0.5% and will drop further following the cut to 0.25%.
    - Some dip in car parking income in 2010/11 but equally this could be explained by the transfer of 2 park and ride sites to the County Council.
    - Planning fees show some plateauing in 2008/2009 but with steady growth thereafter.
    - Commercial rents have continued to climb over the period, more significantly in 2014/15 which arises due to the switch of car parking income from the Westgate in favour of a fixed rental from the Westgate Development Partnership.

Focus on Investment Property

33. The Council has a commercial portfolio that currently is estimated to deliver a rental stream of £11.5m in 2016/17. The table below identifies the potential lease renewals and annual uplifts expected over the next few years as per the approved MTFP.

Figure 12: Expected additional income from the Council's commercial portfolio

2016/17	£123,000	Will be achieved once rent review completed
2017/18	£ 50,000	
2018/19	£ 9,000	
2019/20	£150,000	
Total	**£332,000**	

Figure 13: Analysis of Commercial Property Rental Income by Type of Holding

Property Category	**Annual Rent**	**% Income**
Agricultural	£ 14,350	0.1%
Café/ Snack bar	£ 232,550	2.0%
Easement	£ 10,276	0.1%
Hotel/Guest House	£ 168,500	1.5%
Licence	£ 333,178	2.9%
Mooring	£ 47,643	0.4%
Residential	£ 1,148,843	10.0%
Restaurant	£ 1,496,079	13.0%
Retail	£ 5,636,660	48.8%
Offices	£ 1,806,336	15.6%
Light Industrial	£ 226,296	2.0%
Community Facility	£ 101,390	0.9%
Museum/Theatre	£ 320,000	2.8%
Total Budget	**£ 11,542,100**	

Retail Catergory includes Covered Market and all income expected from Westgate Development

34. In the short term (1-5 years) any negative impact on rental income is expected to be limited given the current profile of lease renewals. However, it could be impacted in the longer term dependant on the capital appreciation of the portfolio as leases come up for renewal. More concerning would be any loss of the anticipated rental streams from the Westgate Shopping Centre.

Business Rates

35. The business rates net collectable debit in Oxford City is shown as follows:

Figure 14: The business rates net collectable debit in Oxford City

Business Rates Net Collectable Debit		
		£000s
2005/06		62,244
2006/07		68,937
2007/08		72,460
2008/09		77,628
2009/10		80,422
2010/11		78,654
2011/12		81,537
2012/13		83,445
2013/14		85,581
2014/15		86,669
2015/16		88,488

36. Although some reduction in the business rates between 2009/10 and 2010/11, which could be attributed to a change in the rating list valuation, changes in exemption thresholds and a reduction in the multiplier, overall the net collectable debit and hence the number of businesses in the cities has remained buoyant over the period from 2005/06 to 2015/16.

37. Currently there are 19 properties with rateable values of over £1 million totalling £50 million (22% of total rateable value) out a total of 4,000 properties with a total rateable value of £230 million. Since the introduction of Business Rates retention in 2013/14 some of the risk in the volatility of business rates income is shouldered by the local authority. The authority could lose around £500k in income before a safety net payment from the Government is initiated. The loss of one of these top 19 properties alone could bring about this situation. There is a further review of the Business Rates system underway which may lead to the Council bearing even more of the risk in this area.

Conclusions

38. The Brexit event has produced some unrest in the financial markets. The Council's property investments especially with CCLA have been devalued downwards, although it must be remembered that capital fluctuations are to be expected within the property market; property funds are a long term investment with the aim of achieving a revenue return. CCLA advise that void rates are still low, current income yields are still good in comparison to benchmarks and exposure to leases of less than 5 years unexpired has fallen to 48% of the portfolio compared to 65% in 2014. As long as the fund continues to give a good yield then we should continue to hold as there will be difficulties in placing the funds should we withdraw.

39. Investment income in other areas is likely to decline due to cuts in the base rate and confidence in the market following the reduction in the UK sovereignty rating.

It is still early days to see the effect on the Councils income streams but past history, if deemed representative, would indicate limited effect in Oxford.

40. On the plus side borrowing rates are at an all-time low and with a base rate reduction a likelihood these will only go one way which bodes well for further borrowing which the Council are forecast to do in the future.

41. Further financial pressures are likely in other areas such as pensions and fuel.

42. Funding for large projects including infrastructure may reduce with the loss of European funding and this may have an effect on the Local Enterprise Partnership.

43. Overall there is a sense that Oxford City can in the short term weather any subsequent adverse Brexit impact. However, if the Brexit situation results in a national recession then we will not necessarily be able to continue to be immune from such an event and the impact of national chains going insolvent and closing stores would increase potentially affecting our property funds, direct property investments and our income streams and business rates. How much this would impact on Oxford is not known for sure but it is hoped, given our unique tourist pull factor and subsequent high demand, that any adverse aspects would be limited or certainly less than the national picture.

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