AUDIT COMMITTEE AGENDA

HARTLEPOOL
BOROUGH COUNCIL

9 November 2012

at 9.00 am

in Committee Room A

MEMBERS: AUDIT COMMITTEE:

Councillors Ainslie, C Akers-Belcher, Dawkins, Hall, Shields and Wells.

1. **APOLOGIES FOR ABSENCE**

2. **TO RECEIVE ANY DECLARATIONS OF INTEREST BY MEMBERS**

3. **MINUTES**

   3.1 To confirm the minutes of the meeting held on 21 September 2012

4. **MINUTES OF THE AUDIT SUB-COMMMITTEE**

   4.1 To receive the minutes of the Sub-Committee meeting held on 10 September 2012
   4.2 To receive the minutes of the Sub-Committee meeting held on 24 September 2012
   4.3 To receive the minutes of the Sub-Committee meeting held on 8 October 2012
   4.4 To receive the minutes of the Sub-Committee meeting held on 22 October 2012

5. **ITEMS FOR DISCUSSION/DECISION**

   5.1 Treasury Management Outturn 2011-12 – *Chief Finance Officer*
   5.2 Treasury Management Strategy Review – *Chief Finance Officer*

6. **ANY OTHER ITEMS WHICH THE CHAIR CONSIDERS ARE URGENT**

AUDIT COMMITTEE

MINUTES AND DECISION RECORD

21 September 2012

The meeting commenced at 9.00 a.m. in the Civic Centre, Hartlepool

Present:

Councillor Christopher Akers-Belcher (In the Chair)

Councillors Ainslie, Dawkins, Hall, Shields and Wells

Officers: Chris Little, Chief Finance Officer
Noel Adamson, Head of Audit and Governance
Sandra Shears, Head of Finance – Corporate
Antony Steinberg, Economic Regeneration Manager
Denise Wimpenny, Principal Democratic Services Officer

Audit Commission Representative: Mark Kirkham and Diane Harold

12. Apologies for Absence

None

13. Declarations of interest by members

None

14. Confirmation of the minutes of the meeting held on 20 July 2012

Confirmed

15. Matters Arising from the Minutes of the meeting held on 20 July 2012

Minute11 – Mill House Master Plan – Verbal Update

The Chair indicated that this issue would be revisited in due course upon receipt of an update report.

16. Minutes of the Audit Sub-Committees

(i) The minutes of the Sub-Committee held on 2 July 2012 were received.

(ii) The minutes of the Sub-Committee held on 30 July 2012 were received.

(iii) The minutes of the Sub-Committee held on 13 August 2012 were received.

(iv) The minutes of the Sub-Committee held on 31 August 2012 were received.

17. Matters Arising from the Minutes of the Audit Sub-Committee held on 13 August 2012

Minute18 – Tenders for Sale of Former Henry Smith School Site King Oswy Drive Ref: 631

In response to a request for clarification, Members were advised of the next stage of the procurement process following the opening of tenders in this regard. A Member requested further information relating to the tender to which the Chief Finance Officer agreed to explore with the relevant officer and provide feedback following the meeting.

18. Governance and Finance Arrangements Tees Valley Unlimited/Local Enterprise Partnership *(Assistant Director, Regeneration and Planning)*

The Economic Regeneration Manager presented the report which provided details on the existing governance and financial arrangements for Tees Valley Unlimited (TVU) host of the Tees Valley Local Enterprise Partnership (LEP).

The report included background information relating to the establishment of TVU. The current governance arrangements had taken into account the need for each Local Authority area to represent its key priorities to progress overarching sub regional issues but also to ensure that the private sector was properly represented. The role of the private sector in these arrangements was critical given the Government's emphasis on the importance of LEP's being business led. However, there was strong public sector representation within the governance structure and the main local authority representation was within the Leader's and Mayor's Panel as well as the Chief Executive Panel.

Members were referred to the governance structure attached at Appendix 1 together with details of the functions of each group and supporting groups, as set out in the report. Key to the delivery of the strategies and action plans was the work of the Task and Finish Groups, details of which were included in the report.

The report included the risk implications and financial considerations. Details of the overall funding provided by the five Tees Valley local authorities together with Hartlepool's contribution, which comprised part of the Economic Regeneration Team budget, was provided as set out in the report.

The Chair welcomed the report noting the benefits for the town and expressed his thanks on behalf of the Committee to the officers involved in progressing this issue.

Decision

That the contents of the report, be noted.

19. Draft Local Audit Bill *(Chief Finance Officer)*

The Chief Finance Officer presented the report which updated Members on proposals for new local audit arrangements published by the Department for Communities and Local Government (DCLG) and the Audit Commission.

The report included background information to the Government's announcement in August 2010 of its intention to disband the Audit Commission, transfer the work of the Audit Commission's in-house practice to the private sector and put in place a new local audit framework.

The draft Local Audit Bill set out the Government's proposals for the new local audit arrangements and asked a number of questions to which the Government had indicated it would welcome responses from any interested parties during the process of pre-legislative scrutiny.

Given the short timescale for response it was not possible to provide a report to the Audit Committee in advance of the deadline for response from the Government. It had therefore been agreed, following consultation with the Chair of this Committee, that a response would be sent and subsequently reported to the Audit Committee for information purposes. A copy of the response was attached at Appendix A

Decision

That the contents of the letter, attached at Appendix A, be noted and Members be kept fully appraised of any future developments in relation to the provision of local audit arrangements.

20. Internal Audit Plan 2013/14 Update *(Head of Audit and Governance)*

The Head of Audit and Governance provided an update of progress made to date completing the internal audit plan for 2012/13.

Members were advised that Table 1 of the report detailed the pieces of work that had been completed. In order to continually improve the Internal Audit Service a review of the current process of reporting had been carried out. In order to address areas for improvements, a number of changes to current reporting arrangements had been undertaken, details of which were set out in the report together with the benefits of the new arrangements.

All audits for 2012/13, other than schools, had been undertaken using the new process with management embracing the changes and compiling their own action plans to mitigate risks identified. The report included a summary of the assurance placed on those audits completed using the new process, further details of which were attached at Appendix A.

The report detailed audits currently ongoing. It was noted that work completed and currently ongoing was in line with expectations at this time of year.

Decision

That the contents of the report be noted.

21. Approval of 2011/2012 Statement of Accounts (*Chief Finance Officer*)

The Chief Finance Officer introduced the report and indicated that arrangements had been made for representatives from the Audit Commission to present the Audit Commission's Annual Governance Report and enable Members to approve the final 2011/2012 statement of accounts.

The Chief Finance Officer commented that the key positive issues reported in the Annual Governance Report included the audit opinion on the financial statements and an unqualified Value for Money conclusion stating that the Council had again managed the significant financial challenges it had faced and had successfully delivered planned savings and efficiencies.

In relation to the final 2011/12 Statement of Accounts, a small number of errors had been identified by the Auditor and the Chief Finance Officer had agreed to amend the accounts to reflect the issues detailed in Appendix 3 of the Annual Governance Report. These errors had been amended in the disclosure notes and did not impact on the primary statements. Members were referred to additional information in relation to reserves, a copy of which was tabled at the meeting. Following agreement by the Committee it was agreed that the 2010/11 Statement of Accounts (Appendix C) be approved subject to the inclusion of additional information on page 67 relating to reserves.

The Auditor had also identified a number of other proposed changes which the Chief Finance Officer had recommended were not implemented as these issues were not material and did not impact on the position reported in the accounts or the level of general fund balances. The reasons for the recommendations were provided as set out in the report and included in the

Letter of Representation, attached at Appendix B. Members' views were sought in relation to the recommendation.

The Auditor presented the Annual Governance Report and detailed the key positive issues reported therein including an unqualified opinion on the accounts and unqualified conclusion that the Council had adequate arrangements in place to secure economy, efficiency and effectiveness in the use of resources. The Council had again managed the significant financial challenges it had faced and had successfully delivered planned savings and efficiencies with some savings achieved ahead of target. The Auditor commended the Finance Team their hard working in achieving a balanced cash flow statement and a positive audit.

In response to a query as to whether the sale of Council assets such as paintings had been considered to assist with the budget savings required, the Chief Finance Officer outlined the work that had been undertaken by the Museum and Art Gallery Working Group in relation to this issue and indicated that there were various covenants which prevented any such sale.

The Chair expressed his thanks on behalf of the Committee to the Finance Team for their hard work in implementing the changes to the finance accounting arrangements and achieving a positive audit outcome.

Decision

i. That the matters raised in the Audit Commission's Annual Governance Report (Appendix A) be noted

ii. That the adjustments to the financial statements set out in Appendix 2 of the Audit Commission's Annual Governance Statement be noted

iii. That the reasons detailed for not amending the Statement of Accounts to reflect the unadjusted misstatements in the accounts (Appendix B) be approved

iv. That the Letter of Representation (Appendix B) be signed by the Chair

v. That the final 2010/11 Statement of Accounts (Appendix C) be approved subject to a minor amendment on Page 67 which included additional information in relation to reserves.

The meeting concluded at 10.00 am.

CHAIR

AUDIT SUB-COMMITTEE

MINUTES AND DECISION RECORD

10 September 2012

The meeting commenced at 3.00 p.m. in the Civic Centre, Hartlepool

PRESENT: Councillor Jim Ainslie (Chair);
Councillors Keith Dawkins and Linda Shields

OFFICERS: Sally Scott, Procurement Officer
Kate McCusker, Commercial Solicitor
Stephen Telford, Senior Engineer
Scott Parkes, Engineering Technician
Angela Armstrong, Principal Democratic Services Officer
Rachael White, Democratic Services Officer

27. Apologies for Absence

None.

28. Declarations of Interest

None.

29. Minutes of the meeting held on 31 August 2012

Confirmed.

30. Any Other Items which the Chairman Considers are Urgent

None.

31. Local Government (Access to Information)

The Chairman ruled that the following items of business should be considered by the Committee as a matter of urgency in accordance with the provisions of Section 100(B) (4)(b) of the Local Government Act 1972 in order that the matter could be dealt with without delay.

Minute 32 Demolition of Brierton School, Top Site. Ref: 638 - This item contains exempt information under Schedule 12A Local Government Act 1972 as amended by the Local Government (Access to Information)

(Variation) Order 2006 namely information relating to the financial or business affairs of any particular person (including the authority holding that information) – Para 3.

32. Demolition of Brierton School, Top Site. Ref: 638 – *(Senior Engineer – Environmental Issues)*

This item contains exempt information under Schedule 12A Local Government Act 1972 as amended by the Local Government (Access to Information) (Variation) Order 2006 namely information relating to the financial or business affairs of any particular person (including the authority holding that information) – Para 3.

Three tenders had been received in respect of this contract, which were opened in the presence of the Committee. Details are contained in the exempt section of the minutes.

Decision

That the opening of the tenders be noted.

33. Any Other Confidential Items which the Chairman Considers are Urgent

None.

The meeting concluded at 3.06pm

CHAIR

AUDIT SUB-COMMITTEE

MINUTES AND DECISION RECORD

24 September 2012

The meeting commenced at 3.00 p.m. in the Civic Centre, Hartlepool

PRESENT: Councillor Jim Ainslie (Chair);
Councillors Keith Dawkins and Linda Shields

OFFICERS: Karen Burke, Procurement Officer
Alyson Carman, Legal Services Manager
Brendon Colarossi, Senior Engineer (Construction)
Denise Wimpenny, Principal Democratic Services Officer
Rachael White, Democratic Services Officer

34. Apologies for Absence

None.

35. Declarations of Interest

None.

36. Minutes of the meeting held on 10 September 2012

Confirmed.

37. Any Other Items which the Chairman Considers are Urgent

None.

38. Local Government (Access to Information)

The Chairman ruled that the following items of business should be considered by the Committee as a matter of urgency in accordance with the provisions of Section 100(B) (4)(b) of the Local Government Act 1972 in order that the matter could be dealt with without delay.

Minute 39 Burn Valley Roundabout Improvements. Ref: 642 - This item contains exempt information under Schedule 12A Local Government

Act 1972 as amended by the Local Government (Access to Information) (Variation) Order 2006 namely information relating to the financial or business affairs of any particular person (including the authority holding that information) – Para 3.

39. Burn Valley Roundabout Improvements. Ref: 642 – *(Senior Engineer – Construction)*

This item contains exempt information under Schedule 12A Local Government Act 1972 as amended by the Local Government (Access to Information) (Variation) Order 2006 namely information relating to the financial or business affairs of any particular person (including the authority holding that information) – Para 3.

Three tenders had been received in respect of this contract, which were opened in the presence of the Committee. Details are contained in the exempt section of the minutes.

Decision

That the opening of the tenders be noted.

40. Any Other Confidential Items which the Chairman Considers are Urgent

None.

The meeting concluded at 3.12pm

CHAIR

AUDIT SUB-COMMITTEE

MINUTES AND DECISION RECORD

8 October 2012

The meeting commenced at 3.00 p.m. in the Civic Centre, Hartlepool

PRESENT: Councillor Jim Ainslie (Chair);
Councillors Keith Dawkins and Linda Shields

OFFICERS: Sally Scott, Procurement Officer
Fiona Srogi, Waste Management Team Leader
Craig Thelwell, Waste & Environmental Services Manager
Rachael White, Democratic Services Officer

41. Apologies for Absence

None.

42. Declarations of Interest

None.

43. Minutes of the meeting held on 24 September 2012

Confirmed.

44. Any Other Items which the Chairman Considers are Urgent

None.

45. Local Government (Access to Information)

The Chairman ruled that the following items of business should be considered by the Committee as a matter of urgency in accordance with the provisions of Section 100(B) (4)(b) of the Local Government Act 1972 in order that the matter could be dealt with without delay.

Minute 46 Kerbside Dry Recycling Collection Service. Ref: 154 - This item contains exempt information under Schedule 12A Local Government Act 1972 as amended by the Local Government (Access to

Information) (Variation) Order 2006 namely information relating to the financial or business affairs of any particular person (including the authority holding that information) – Para 3.

46. Kerbside Dry Recycling Collection Service. Ref: 154 – *(Waste & Environmental Services Manager and Waste Management Team Leader)*

This item contains exempt information under Schedule 12A Local Government Act 1972 as amended by the Local Government (Access to Information) (Variation) Order 2006 namely information relating to the financial or business affairs of any particular person (including the authority holding that information) – Para 3.

Four tenders had been received in respect of this contract, which were opened in the presence of the Committee. Details are contained in the exempt section of the minutes.

Decision

That the opening of the tenders be noted.

47. Any Other Confidential Items which the Chairman Considers are Urgent

None.

The meeting concluded at 3.13pm

CHAIR

AUDIT SUB-COMMITTEE

MINUTES AND DECISION RECORD

22 October 2012

The meeting commenced at 3.00 p.m. in the Civic Centre, Hartlepool

PRESENT: Councillor Jim Ainslie (Chair);
Councillors Keith Dawkins and Linda Shields

OFFICERS: David Hart, Procurement Manager
Scott Parkes, Engineering Technician
Paul Robson, Integrated Transport Manager
Sally Scott, Procurement Officer
Stephen Telford, Senior Engineer (Environmental Issues)
Kate McCusker, Commercial Solicitor
Rachael White, Democratic Services Officer

48. Apologies for Absence

None.

49. Declarations of Interest

None.

50. Minutes of the meeting held on 8 October 2012

Confirmed.

51. Items for Information

The Integrated Transport Manager informed Members of the outcome regarding the recent Passenger Transport Tender 2012.

52. Any Other Items which the Chairman Considers are Urgent

The Chair reported on the outcome of the Demolition of Brierton School, Top Site tender. The report was noted and Members agreed that the contract should be awarded to Contractor B.

53. Local Government (Access to Information)

The Chairman ruled that the following items of business should be considered by the Committee as a matter of urgency in accordance with the provisions of Section 100(B) (4)(b) of the Local Government Act 1972 in order that the matter could be dealt with without delay.

Minute 54 – Provision of a Supported Housing Service for Young People in Hartlepool. Ref: 632 - This item contains exempt information under Schedule 12A Local Government Act 1972 as amended by the Local Government (Access to Information) (Variation) Order 2006 namely information relating to the financial or business affairs of any particular person (including the authority holding that information) – Para 3.

54. Provision of a Supported Housing Service for Young People in Hartlepool. Ref:632 – *(Strategic Procurement Manager)*

This item contains exempt information under Schedule 12A Local Government Act 1972 as amended by the Local Government (Access to Information) (Variation) Order 2006 namely information relating to the financial or business affairs of any particular person (including the authority holding that information) – Para 3.

Three tenders had been received in respect of this contract, which were opened in the presence of the Committee. Details are contained in the exempt section of the minutes.

Decision

That the opening of the tenders be noted.

55. Any Other Confidential Items which the Chairman Considers are Urgent

None.

The meeting concluded at 3.13pm

CHAIR

AUDIT COMMITTEE

9TH November, 2012

Report of: Chief Finance Officer

Subject: TREASURY MANAGEMENT OUTTURN 2011/2012

---

1. PURPOSE OF REPORT

1.1 This report provides a review of the Treasury Management activity for 2011/2012 and the outturn Prudential Indicators for this period.

2. BACKGROUND

2.1 As part of the annual Budget and Policy Framework process Authority approved the 2011/12 Treasury Management Strategy and associated Prudential Indicators on the 10th February, 2011.

2.2 The submission of the outturn report to Council is a requirement of the CIPFA Code of Practice on Treasury Management, DCLG (Department for Communities and Local Government) Investment Guidance and the CIPFA Prudential Code for Capital Finance in Local Authorities, as it allows Members to review progress against the approved strategy. This report is being submitted to the Audit Committee to enable members to scrutinise it prior to it being presented to the Council on the 6th December 2012.

2.3 The 2011/12 financial year continued the challenging economic environment of the previous year with weak signs of recovery. The implications have been the continuation of low investment returns and continued counterparty risk, albeit less severe than in previous years.

2.4 The focus of this report is events relating to the financial year 2011/2012 and summarises:

- the economic background for 2011/2012;
- the Council's capital expenditure and financing in 2011/2012;
- the Council's treasury position at 31st March 2012;
- the regulatory framework, risk and performance;

2.5 This report is being submitted to finalise the reporting of 2011/12 Treasury Management issues.

3. ECONOMIC BACKGROUND FOR 2011/2012

3.1 During 2011/12 was there was continued uncertainty in financial markets arising from problems with the Greek and other Euro zone economies. The European Central Bank (ECB) eventually calmed market concerns of a liquidity crisis among European Union (EU) banks by making available two huge three year credit lines, totalling close to €1 trillion at 1%.

3.2 A secondary benefit of this initiative was the bringing down of sovereign debt yields, for Italy and Spain, below panic levels. The final pieces in the calming of the EU sovereign debt crisis were agreements by the Greek Government of another major austerity package and by private Greek creditors accepting a major reduction in the total outstanding level of Greek debt. These agreements were a prerequisite for a second EU / IMF bailout package for Greece which was signed off in March.

3.3 Despite this second bailout, major concerns remain that these measures were merely a postponement of the debt crisis, rather than a solution, as they did not address the problem of low growth and loss of competitiveness in not only Greece, but also in other EU countries with major debt imbalances. These problems will, in turn, also affect the financial strength of many already weakened EU banks during the expected economic downturn in the EU. There are also major questions as to whether the Greek Government will be able to deliver on its promises of cuts in expenditure and increasing tax collection rates, given the hostility of much of the population.

3.4 The UK coalition Government maintained its fiscal policy stance and deficit reduction plan. Two credit rating agencies indicated that the UK could lose its AAA rating. Key to retaining this rating will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within the austerity plan timeframe. The USA and France lost their AAA ratings from one rating agency during the year.

3.5 UK growth proved mixed over the year. In quarter 2, growth was zero, but then quarter 3 surprised with a return to growth of 0.6% before moving back into negative territory (-0.2%) in quarter 4. The year finished with prospects for the UK economy being decidedly downbeat due to a return to negative growth in the EU in quarter 4, our largest trading partner, and a sharp increase in world oil prices caused by Middle East concerns. However, there was also a return of some economic optimism for growth outside the EU.

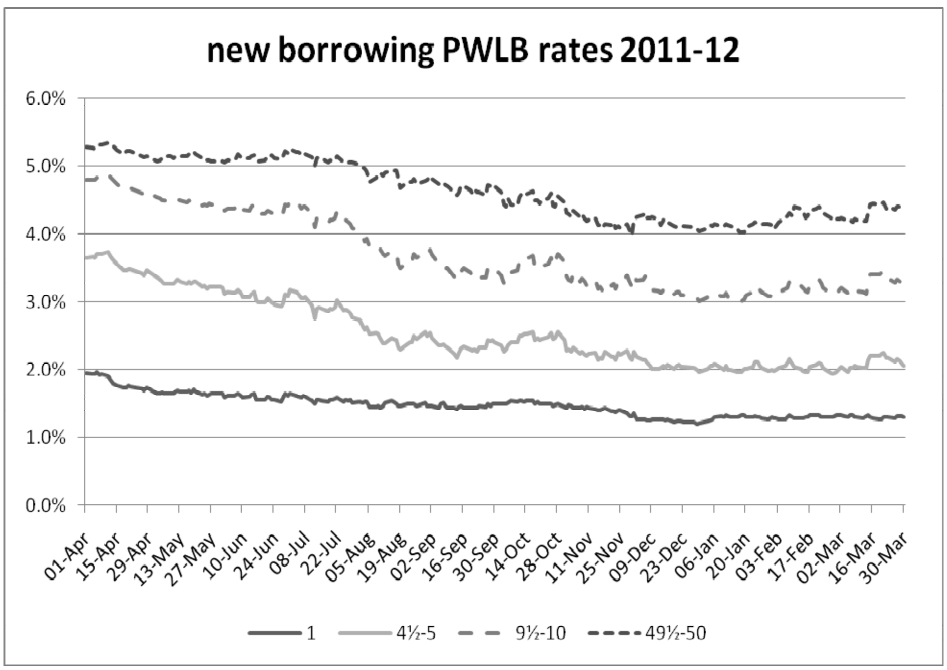
3.6 UK CPI inflation started the year at 4.5% and peaked at 5.2% in September. The January 2011 VAT hike dropped out of the annual CPI figure in January 2012 which helped to bring inflation down to 3.6%, falling further to 3.4% in February. Inflation is forecast by the

Bank of England to be on a downward trend to below 2% over 2012/13.

3.7 The Monetary Policy Committee agreed an increase in quantitative easing (QE) of £75bn in October on concerns of a downturn in growth and a forecast for inflation to fall below the 2% target. The MPC then agreed another round of £50bn of QE in February 2012 to counter the negative impact of the EU debt and growth crisis on the UK.

3.8 Gilt yields fell (i.e. interest paid on Government debt) for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of QE during the year, combined to depress PWLB rates to historically low levels.

3.9 Bank Rate was unchanged at 0.5% throughout the year while expectations of when the first increase would occur were steadily pushed back until the second half of 2013 at the earliest. Deposit rates picked up slightly in the second half of the year as competition for cash increased among banks.



4. THE COUNCIL'S CAPITAL EXPENDITURE AND FINANCING 2011/2012

4.1 The Council's approved capital programme is funded from a combination of capital receipts, capital grants, revenue contributions and prudential borrowing.

4.2 Part of the Council's treasury management activities is to address the prudential borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council. The wider treasury activity also includes managing the Council's day to day cash flows, its previous borrowing activities and the investment of surplus funds. These activities are structured to manage risk foremost, and then optimise performance.

4.3 Actual capital expenditure forms one of the required prudential indicators. As shown at Appendix A, the total amount of capital expenditure for the year was £34.848m, of which £3.967m was funded by Prudential Borrowing. Capital expenditure of £22.481m was rephased into 2012/2013 and matched by rephased resources.

4.4 The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This figure is the accumulated value of capital expenditure which has been financed from Prudential Borrowing. Each year the Council is required to apply revenue resources to reduce this outstanding balance.

4.5 Whilst the Council's CFR sets a limit on underlying need to borrow, the Council can manage the actual borrowing position by either;

- borrowing externally to the level of the CFR; or
- choosing to use temporary internal cash flow funds instead of borrowing; or
- a combination of the two.

4.6 The Council can also borrow for future planned increases in the CFR up to 3 years in advance, when this is deemed to be appropriate. This was not the case in 2011/2012.

4.7 The Council's CFR for the year was £91.097m as shown at Appendix A. This is lower than the approved estimate owing to the rephasing of capital expenditure until 2012/2013. As reported in the 2012/13 Strategy the Council took out an additional £4.233m of long term borrowing in 2011/12 in order to manage specific risks in relation to the business cases of two self funded schemes i.e. the Social Housing Scheme and the Photo-Voltaic (PV) Cells scheme.

4.8 The Council's total long term external borrowing as at 31st March, 2012 was £51.049m. This is currently less than the CFR as a result of being able to use the Council's balances to internalise the funding of capital expenditure. This strategy was approved in February 2011 and enabled the council to significantly reduce counterparty risk by reducing the level of external investments. This strategy was also the most cost effective strategy in 2011/2012 and contributed to the overall favourable 2011/2012 outturn reported to Cabinet in June 2012.

4.9 As reported when the Treasury Management Strategy was approved the Council will need to fund the CFR from external borrowing at some stage. The timing of new long term borrowing will need to be carefully managed to ensure the annual repayment and interest costs relating to the CFR do not exceed the available budget and become a budget pressure. This risk will continue to be managed closely to protect the Council's medium term financial position and a strategy for achieving this is covered in a separate report on your agenda.

5. THE COUNCIL'S TREASURY POSITION AT 31ST MARCH, 2012

5.1 The table below shows the treasury position for the Council as at the 31st March, 2012 compared with the previous year:

Treasury position	31st March 2011		31st March 2012	
	Principal	Average Rate	Principal	Average Rate
Fixed Interest Rate Debt				
- PWLB	£1.8m	4.12%	£6.0m	4.87%
- Market Loans	£45.0m	4.00%	£45.0m	4.00%
Total Long Term Debt	**£46.8m**	**4.00%**	**£51.0m**	**4.10%**
Variable Interest Rate Debt				
- Temporary loans	£4.0m	0.45%	£0.0m	0.00%
Total Debt	**£50.8m**	**3.24%**	**£51.0m**	**4.10%**
Total Investments	**£29.4m**	**2.68%**	**£33.4m**	**0.65%**
Net borrowing Position	**£21.4m**		**£17.6m**	

5.2 A key performance indicator shown in the above table is the very low average rate of external debt of 4.10% for debt held as at 31st March, 2012. This is a historically low rate for long term debt.

5.3 The Council's investment policy is governed by Department of Communities and Local Government (DCLG) guidance, which has been implemented in the annual investment strategy approved by Council on 10th February, 2011.

5.4 The original criteria approved by Members provided a starting point which was then restricted further to produce an operational list which is reviewed on a regular basis. Following the increased risk and uncertainty arising from the unprecedented recent economic crisis the Chief Finance Officer continued to adopt an even more vigilant approach resulting in what is effectively a 'named' list. This consists of a very select number of counterparties that are considered to be the lowest risk. This has involved the Council temporarily suspending making new deposits with all building societies.

5.5 The Council's approach of suspending building societies from the counterparty list has proven prudent as the ratings for all building societies were downgraded during 2010/2011 and ratings did not improve through 2011/12 owing to continuing concerns about their financial stability and exposure to property loans.

5.6 The Council also continued to exclude all foreign banks, including Irish banks from the list following the downgrading of the countries sovereign rating.

5.7 By not relying solely on credit ratings the Council sought to take a more pragmatic and broad based view of the factors that impact on counterparty risk. The downside of this prudent approach is that the Council achieved lower investment returns than would have been possible if deals were placed with organisations with a lesser financial standing. In the current climate the risk associated with these higher returns would not have been prudent.

5.8 As part of the approach to maximising investment security the Council has also kept investment periods short (i.e. in most cases up to 3 months but a maximum of 6 months). This has also resulted in lower investment returns.

5.9 A prudent approach will continue to be adopted in order to safeguard the Council's resources.

6. REGULATORY FRAMEWORK, RISK AND PERFORMANCE

6.1 The Council's treasury management activities are regulated by a variety of professional codes, 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 (although no restrictions were made in 2010/2011);
- 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;
- 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.

6.2 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.

6.3 The Council is aware of the risks of passive management of the Treasury Portfolio and with the support of Sector, the Council's advisers, has proactively managed its treasury position. A proactive approach will continue to be adopted.

6.4 **Prudential Indicators and Compliance Issues**

6.5 Details of each Prudential Indicator are shown at Appendix A. Some of the prudential indicators provide either an overview or specific limits on treasury activity. The key Prudential Indicators to report at outturn are described below.

6.6 The **Authorised Limit** is the "Affordable Borrowing Limit" required by Section 3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. Appendix A demonstrates that during 2011/2012 the Council has maintained gross borrowing within its Authorised Limit.

6.7 **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 have exceed the CFR for 2011/2012 plus the expected changes to the CFR over 2012/2013 and 2013/2014. The Council has complied with this Prudential Indicator.

8 CONCLUSION

8.1 The report provides members with an overview of the Treasury Management activities for 2011/2012, as required by legislation. The report demonstrates that these activities have been undertaken in accordance with relevant legislation, regulations and the Council's approved Treasury Management Strategy. Therefore, there are no specific issues to bring to Members attention.

9. RECOMMENDATION

9.1 It is recommended that Members approve that the report be referred to Council.

10. APPENDICES AVAILABLE ON REQUEST, IN THE MEMBERS LIBRARY AND ON-LINE

Appendix A Prudential Indicator 2011/12 Outturn attached.

11. BACKGROUND PAPERS

None

12. CONTACT OFFICER

Chris Little
Chief Finance Officer
Tel: 01429 523003
Email: chris.little@hartlepool.gov.uk

Appendix A

Prudential Indicators 2011/12 Outturn

1. Ratio of Financing Costs to Net Revenue Stream

This indicator shows the proportion of the total annual revenue budget that is funded by the local tax payer and Central Government, which is spent on servicing debt. The outturn is lower than the estimate, mainly as a result of savings achieved from long term borrowing repayment and the very low rates of interest on short term loans.

2011/12 Estimate		2011/12 Outturn
7.10%	Ratio of Financing costs to net revenue stream	5.25%

2. Capital Expenditure

This indicator shows the total capital expenditure for the year.

2011/12 Estimate £'000		2011/12 Outtum £'000
21,025	Capital Expenditure	34,848

The actual is higher than the estimate as a result of rephasing of capital expenditure from the previous year.

3. Capital Expenditure Financed from Borrowing

This shows the borrowing required to finance the capital expenditure programme.

2011/12 Estimate £'000		2011/12 Outtum £'000
8,652	Capital Expenditure Financed by Borrowing	3,967

The actual is lower than the estimate owing to expenditure funded by prudential borrowing rephased into future years.

4. Capital Financing Requirement

CFR is used to determine the minimum annual revenue charge for capital expenditure repayments (net of interest). It is calculated from the Authority's Balance Sheet and is shown below. Forecasts for future years are directly influenced by the capital expenditure decisions taken and the actual amount of revenue that is set aside to repay debt.

2011/12 Estimate £'000		2011/12 Outtum £'000
96,358	Capital Financing Requirement	91,097

The actual is lower than the estimate as a result of capital expenditure included within the estimate which as been rephased into 2012/2013.

5. Authorised Limit for External Debt

The authorised limit determines the maximum amount the Authority may borrow at any one time. The authorised limit covers both long term borrowing for capital purposes and borrowing for short term cash flow requirements. The authorised limit is set above the operational boundary to provide sufficient headroom for operational management and unusual cash movements. In line with the Prudential Code, the level has been set to give the authority flexibility to borrow up to three years in advance of need if more favourable interest rates can be obtained.

2011/12 Limit £'000		2011/12 Peak £'000
115,000	Authorised limit for external debt	53,533

The above Authorised Limit was not exceeded during the year. The level of debt as per the Balance Sheet at the year end, excluding accrued interest was £51.050m. The peak level during the year was £53.533m.

6. Operational Boundary for External Debt

The operational boundary is the most likely prudent, but not worst case scenario, level of borrowing without the additional headroom included within the authorised limit. The level is set so that any sustained breaches serve as an early warning that the Authority is in danger of overspending or failing to achieve income targets and gives sufficient time to take appropriate corrective action.

2011/12 Limit £'000		2011/12 Peak £'000
102,000	Operational boundary for external debt	53,533

The operational limit was not exceeded in the year. The peak level of debt was £53.533m.

7. Interest Rate Exposures

This indicator is designed to reflect the risk associated with both fixed and variable rates of interest, but must be flexible enough to allow the Authority to make best use of any borrowing opportunities.

2011/12 Limit £'000	Upper limits on fixed and variable interest rate exposure	2011/12 Peak £'000
102,000	Fixed Rates	51,016
76,000	Variable Rates	6,712

The figures represent the peak values during the period.

8. Maturity Structure of Borrowing

This indicator is designed to reflect and minimise the situation whereby the Authority has a large repayment of debt needing to be replaced at a time of uncertainty over interest rates, but as with the indicator above, it must also be flexible enough to allow the Authority to take advantage of any borrowing opportunities.

	Upper Limit £000	Lower Limit £000	Actual £000
Less than one year	93,000	0	37
Between one and five years	102,000	0	265
Between five and ten years	102,000	0	332
Between ten and fifteen years	102,000	0	301
Between fifteen and twenty years	102,000	0	342
Between twenty and twenty-five years	102,000	0	402
Between twenty-five and thirty years	102,000	0	363
Between thirty and thirty-five years	102,000	0	443
Between thirty-five and forty years	102,000	0	541
Between forty and forty-five years	102,000	0	1,202
More than forty-five years	102,000	0	46,822

9. Investments over Maturing over One Year

This sets an upper limit for amounts invested for periods longer than 364 days. The limit was not exceeded as a prudent approach to investment has been taken owing to uncertainties in the economy this is in line with the Treasury Management Strategy. Consequently all investments made during the year were limited to less than one year.

	1 year £000	2 year £000	3 year £000
Maximum Limit	30,000	20,000	15,000
Actual	0	0	0

AUDIT COMMITTEE

9th November 2012

Report of: Chief Finance Officer

Subject: TREASURY MANAGEMENT STRATEGY REVIEW

---

1. PURPOSE OF REPORT

1.1 The purpose of the report is to review the existing Treasury Management Strategy and to recommend a strategy for 2013/14 and future years.

2. BACKGROUND

2.1 The objectives of the Treasury Management Strategy are to manage the Council's cash investments and the Capital Financing Requirement (CFR) which is the long term borrowing requirement at the lowest net cost, whilst effectively managing a range of potential risks. It is important that Treasury Management risks are managed effectively to avoid unbudgeted costs, which would be significant owing to the level of the Council's cash investments and long term borrowing requirement.

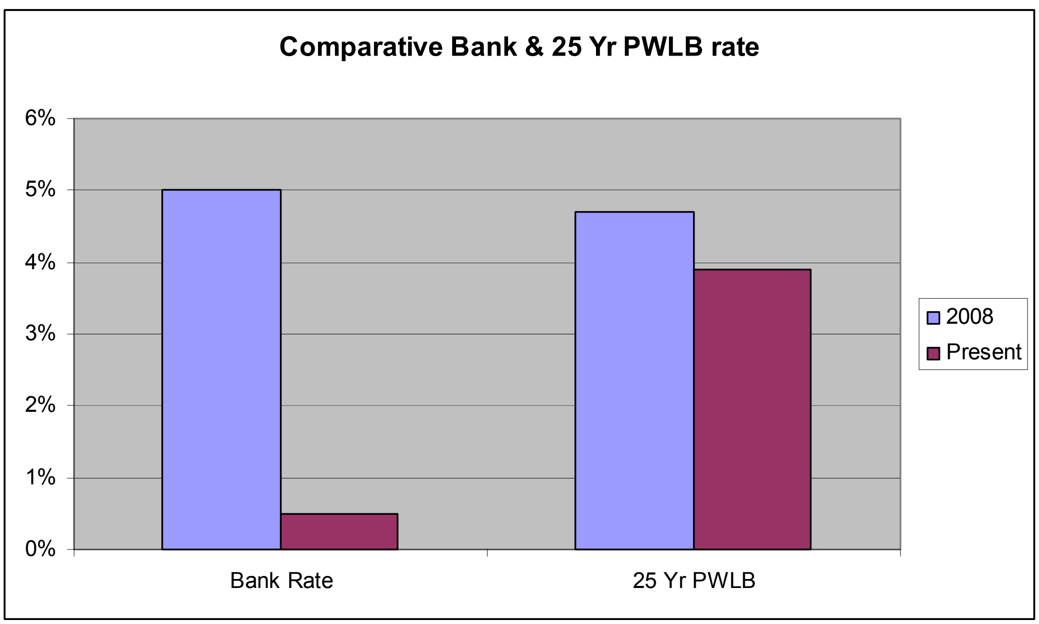
2.2 In order to manage these risks the Council has historically adopted a proactive Treasury Management Strategy and actively managed both cash investments and the CFR. This strategy has responded to external changes in the financial market and the economy, which has enabled the Council to minimise risk and the net cost of Treasury Management activity over a prolonged period.

2.3 In relation to managing cash investments the principal risk which needs to be managed is security of the money invested. The importance of this risk was clearly demonstrated by the problems some investors, including other Local Authorities, experienced with Icelandic banks. To mange this risk the Council has always operated robust criteria for determining the organisations it will invest surplus cash with.

2.4 With regard to the CFR the principle risk relates to securing sustainable low long term interest rates for the Council's borrowing requirement. This has historically been achieved by actively managing borrowing decisions and by using different funding sources, including the Public Works Loan Board (PWLB), market loans from banks and LOBO (Lender's Option Buyer's Option) loans.

2.5 This mixed approach to managing the Council's CFR has provided flexibility to manage unforeseen changes in circumstances. Most recently this approach has enabled the Council to net down investments and borrowings in response to the increase in investment counter party risk arising from the 2008 financial crisis and the unprecedented reduction in the bank base rate to the lowest level in modern economic times (i.e. the last 100 years and to a level not seen since records began in 1694). This approach has significantly reduced risk by reducing the level of the Council's cash investments at a time of continued uncertainty in the banking system and financial markets. It has also provided the lowest cost option for the Council's overall Treasury Management activity over the last few years.

2.6 As reported previously when the 2012/13 Treasury Management Strategy was considered the current strategy of netting down investments and borrowings is not sustainable on a permanent basis as the current historically low base rate is not sustainable and disconnected from longer term borrowing rates for periods of 25 years plus which are currently at 3.9%. These longer term rates are themselves at an historically low level as before the 2008 financial crisis interest rates for 25 year plus loans were 4.7%, compared to a base rate in 2008 of 5%, as summarised below:-



2.7 In addition the Council's available cash investments will reduce over the next few years as reserves are used to fund one-off commitments identified in the Medium Term Financial Strategy (MTFS), including housing market renewal commitments and redundancy/early retirement costs arising from the budget cuts required over for the next four years.

2.8 In view of the above factors the Treasury Management position will continue to require careful management for the next few years to assist the overall financial strategy. The following sections outline proposals for the continued proactive management of Treasury Management activity.

3. Future Capital Financial Requirement (CFR)

3.1 The CFR is the amount the Council needs to borrow to fund capital expenditure incurred in previous financial years and forecast capital expenditure in the next three years which is not funded from capital grants, capital receipts or directly from revenue budgets. Historically the majority of the authority's CFR related to capital expenditure supported by Government borrowing approvals.

3.2 Government borrowing approvals are authority to fund capital expenditure from loans. The Government then pay revenue grant to councils to partly fund the annual loan repayment and interest costs. The balance of these costs is then funded from the Council's General Fund budget. Prior to the introduction of the prudential borrowing system councils could only borrow for capital expenditure authorised by a Government borrowing approval.

3.3 Following the introduction of the prudential borrowing systems councils can determine their own borrowing levels, subject to revenue affordability. The Council has managed the new flexibility carefully owing to the ongoing revenue commitment of taking on new additional borrowing. The Council has only approved specific self funding business cases, for example affordable housing schemes and a limited amount of General Fund capital expenditure where the resulting loan repayment and interest costs have been funded as a revenue budget pressure.

3.4 Councils ultimately need to fund the CFR by borrowing money from the PWLB or banks. The CFR is then repaid over a number of years reflecting the long term benefits of capital expenditure. In simple terms the CFR represents the Councils outstanding mortgage, although the legislation and accounting requirements are significantly more complex.

3.5 In the short term the Council can fund the CFR by netting down investments and borrowings. This is only sustainable while the Council has temporary cash investments and in the medium term the CFR will need to be funded from external loans. This is the approach currently adopted by the Council and the position as at 31 March 2012, shows the Council has under-borrowing against the CFR of £36m.

31 March 2012	£m
CFR	83
Borrowing	47
Under-borrowing	36

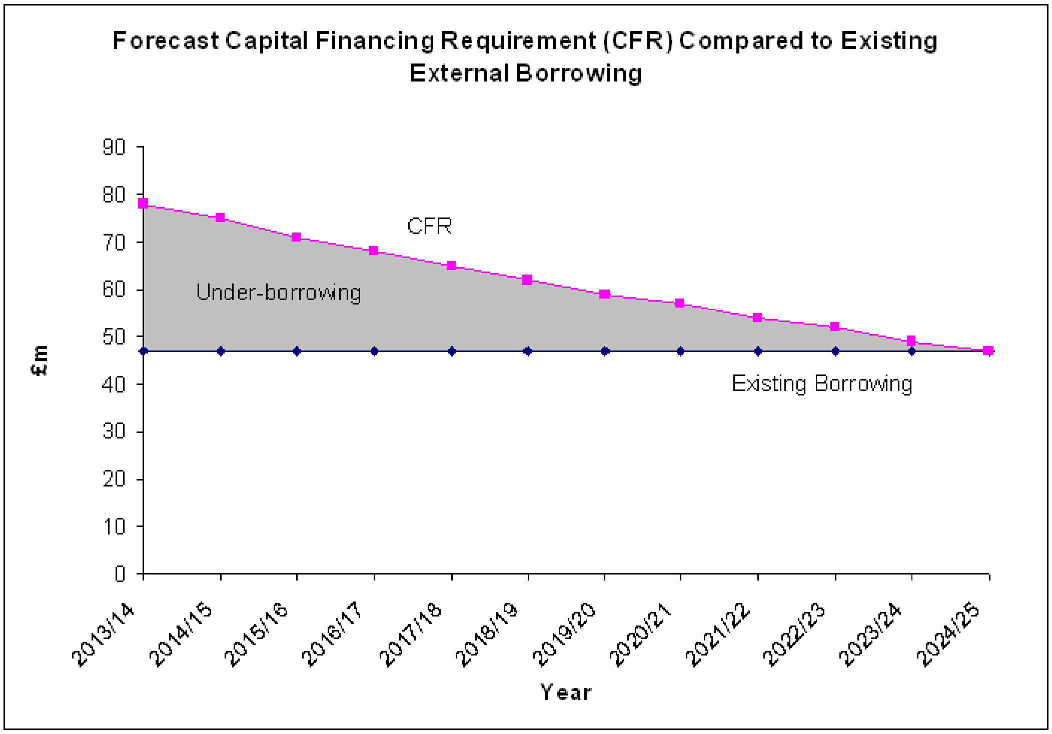
3.6 The previous treasury management strategy anticipated that the CFR would remain stable at around £83m for the foreseeable future. This position reflected the impact of the annual repayments costs and interest on new capital expenditure covered by Government borrowing matching savings arising from the repayment of previous year's borrowings. The MTFS included provision for the annual statutory repayment of the CFR, known as Minimum Revenue Provision (MRP), and forecast interest costs.

3.7 In 2011/12 the Government replaced borrowing approvals with capital grants. This position was not expected and was repeated in 2012/13 and is expected to continue in future years.

3.8 The replacement of borrowing approvals with capital grants is a fundamental change and beneficial for councils in revenue terms as Government support for capital expenditure is now being funded from a cash capital grant, therefore avoiding new borrowing. The downside to this change is a reduction in the overall level of Government capital support for councils, although this would have happened irrespective of the way council capital spending is supported owing to the impact of the 2010 spending review.

3.9 It is anticipated that this is a permanent change as from April 2013 the Government's new system for providing revenue grant to support the General Fund revenue budget will make it extremely complex for the Government to a support capital via borrowing approvals.

3.10 Against this background a revised forecast of the CFR for the next 15 years has been prepared. This forecast anticipates annual reductions in the level of under borrowing, i.e. the amount the CFR exceeds the level of external debt. This position also assumes no new borrowing is undertaken during this period, as summarised below.



4. Strategy for funding CFR

4.1 The fundamental change in the way the Government will support a reduced level of capital expenditure by Councils provides an opportunity to review the Treasury Management strategy and in particular the strategy for funding the ongoing forecast CFR.

4.2 Fundamentally this strategy is still about managing financial risk and essentially there are two components to risk:

- Managing new loans; and
- Managing existing outstanding loans and the underfunding of the CFR and links to investments.

Managing new loans will be based on specific business cases whereby the annual interest and MRP costs are funded from income, or as a specific budget pressure. Managing existing outstanding loans and the underfunding of the CFR will need to be done within the existing budget and details of how this will be achieved are set out in the following paragraphs.

4.3 As detailed in section 3 a 15 year forecast of the CFR has been prepared. This shows a year on year decrease in the outstanding CFR. Individually the annual reductions are relatively small figures. However, on a cumulative basis the annual reduction becomes more significant over the period covered by the MTFS.

4.4 This forecast enables the Council to review the existing Treasury Management strategy and should allow ongoing revenue savings to be achieved in annual loan repayment costs over the period of the MTFS.

4.5 There are two elements to the Councils annual loan repayment costs – the statutory Minimum Revenue Provision (MRP) and interest costs.

4.6 **Minimum Revenue Provision (MRP)**

4.7 The MRP is calculated on the basis of the CFR and based on the forecast reduction in the CFR it is anticipated there will be annual reductions in the MRP over the period of the MTFS (2013/14 to 2016/17), which can be taken as a revenue savings, as summarised below.

	2013/14 £'000	2014/15 £'000	2015/16 £'000	2016/17 £'000
Annual MRP Saving	70	210	90	140
Cummulative MRP Saving	70	280	370	510

4.8 **Interest costs**

4.9 The second element of the annual loan repayment cost is interest payments relating to the CFR and the underlying outstanding debt. This is more difficult to predict and will depend on the level of interest rates in future years and the timing of decisions to manage the necessary transition from the existing Treasury Management Strategy of netting down borrowings and investments, to a strategy which funds the underlying CFR from external borrowing.

4.10 The transition from the existing strategy will need careful management to minimise financial risk to the Council and the ongoing interest costs of funding the CFR. This is particularly challenging in the current economic climate and interest environment owing to the unpredictable circumstances which currently exist. The most visible factor is the historically low Bank of England base rate and the extent to which this is disconnected from longer term interest rates.

4.11 The Bank of England base rate has remained at 0.5% since March 2009, which is significantly longer than most economic forecasters predicted. It is now anticipated that the current base rate will continue for the foreseeable future. However, given the unpredictable economic conditions (by previous economic standards) it is unclear how long the base rate will be sustainable at this level, the factors which could lead to the rate increasing and the speed of future increases. There could be a major impact on the base rate if the UK ‘AAA’ credit rating is downgraded, which it is anticipated would significantly increase the Bank of England base rate.

4.12 Against this uncertainly the Council needs to maintain a robust strategy for managing investments and borrowings to reflect the forecast reductions in the CFR. In relation to managing this interest rate risk there are essentially two options available to the Council.

4.13 Option 1 – Delay new long term borrowing until 2016/17

4.14 This strategy would continue the existing approach of netting down investments and borrowings in the short-term. As investments are used up the underfunding of the CFR (i.e. the difference between the CFR and actual external debt) would be funded from short-term loans. It is anticipated that the interest on these loans would be at (or near) to the current base rate.

4.15 This strategy assumes the base rate remains at 0.5% until March 2015. Based on available information from a range of forecasters (including the Council's own treasury management advisors) and recent statements by the Governor of the Bank of England this is not an unrealistic planning assumption.

4.16 This option therefore maximises the potential interest savings which should be achievable on the Council's borrowing from 2013/14.

4.17 However, the current economic environment is unprecedented and unforeseen circumstances could result in the base rate increasing earlier than currently anticipated and to a higher level, significantly above the historic current base rate which is not sustainable. If a permanent interest rate saving is built into the MTFS and the base rate increases the Council would face an unbudgeted pressure. The magnitude of this pressure would depend on the scale of the saving built into the MTFS and the level of increase in the base rate.

4.18 To manage this risk a careful assessment of the forecast interest rate saving which could be included in the MTFS has been undertaken. This assessment reflects the following factors:

- forecast reductions in the CFR over the period covered by the MTFS, as detailed in section 3, which will reduce the underlying level of the Council's forecast external debt;
- forecast interest rates over the period of the MTFS and the linkage between the base rate and longer term interest rates;
- a risk assessment of LOBO's being called over this period and the Council having to refinance these loans at a higher interest rate;
- a prudent assessment of when this saving can be included in the MTFS.

4.19 The final bullet point will be a key element of the strategy for managing financial risks relating to the Treasury Management Strategy over the period of the MTFS. The assessment of the various factors and risks underpinning this option indicates that any interest savings should be achievable from 2013/14 to supplement the MRP saving detailed earlier in the report. These savings could therefore potentially be built into the MTFS from 2013/14. However, this would increase financial risk over the remainder of the MTFS as the risk of an increase in the base rate increases over time, which would result in a budget pressure if the full savings is taken from 2013/14.

4.20 Therefore, to mitigate this risk the interest saving either needs to be phased over the period of the MTFS, or the risk managed by establishing a reserve from the savings in 2013/14. In my professional opinion and reflecting the statutory requirement to provide Council with advice on the robustness of the annual budget I would recommended that the forecast Treasury Management saving in 2013/14 is earmarked as a reserve to manage these risks over the period of the MTFS. This professional advice reflects the planned 2013/14 savings plan and my advice that this approach will provide the necessary funding to manage Treasury Management risks detailed in paragraph 4.18 over the next 4 years.

4.21 This proposal would then enable a permanent saving of £1m to be taken in 2014/15 and future years as detailed in the following table. This would significantly reduce the forecast unfunded deficit for 2014/15 from £1.4m (assuming the saving plan is achieved) to £0.4m. The table indicates that over the period of the MTFS the proportion of the overall saving arising from a reduction in MRP increases and the proportion from interest savings decreases, which makes the position more sustainable over time. This does not remove the risk from an increase in the base rate, however the recommended risk reserve should provide sufficient funding to offset an increase in the average interest rate on the Council's CFR to 4% over the period of 2014/15 to 2016/17.

	2013/14 £'000	**2014/15 £'000**	**2015/16 £'000**	**2016/17 £'000**
MRP Saving	70	280	370	510
Forecast interest savings	800	720	630	490
Total Forecast saving earmarked to manage Treasury Management risk over period of MTFS	870	0	0	0
Total forecast saving earmarked to reduce budget deficits	0	1,000	1,000	1,000

4.22 The risk strategy for Treasury Management activity also needs to address the risk that interest rates on the existing LOBO loans increase during the period of the MTFS, as detailed in section 5.

4.23 In summary the above strategy should address the risk of adopting this option from an increase in the interest rate on the existing CFR over the period of the current MTFS. This risk needs careful management to enable the Council to benefit from the advantages of this option, which are:

- maximising the savings which can be taken towards assisting the current MTFS; and
- avoid increasing external investments, which would occur if the current strategy of netting down investments and borrowings is unwound. This

option therefore avoids increasing the risk of the Council having higher temporary cash investments and the resulting increase in counterparty risk. It also avoids an increase in costs from interest earned on investments being significantly lower than interest paid on new borrowings.

4.24 **Option 2 – Fully fund forecast CFR in 2013/14**

4.25 The option would unwind the current strategy of netting down investments and borrowings and fully fund the forecast CFR from external loans. Under this option the Council could either fund the CFR on a short-term basis or lock into longer term interest rates. The advantage of this option is that the Council would have certainty over interest costs, although this would depend on the length of new loans.

4.26 The maximum financial certainty would be achieved by locking into longer term interest rates for the forecast CFR. However, the cost of this certainty would reduce the interest savings which could be taken towards the MTFS owing to higher interest rates paid on borrowings and the much lower interest earned on investments, which are linked to the base rate. This option would only guarantee the annual MRP savings identified in paragraph 4.21, which are significantly lower than the combined MRP and interest savings which can be achieved by adopting Option 1.

4.27 This option would also increase external investments and therefore counterparty risk. The current strategy has aimed to minimise these risks owing to the continued uncertainty in the financial markets and the primary Treasury Management objective of protecting the monies invested by the Council. In my professional opinion I would not recommend a strategy which increases investment risks and potentially puts Council funds at risk.

5. **Managing existing debt – LOBO Loans.**

5.1 As reported in previous Treasury Management Strategy reports the majority of the current external debt (96%) is funded from LOBO (Lenders Option, Borrowers Option) loans. These loans provide fixed interest rates for defined periods and also defined dates for reviewing interest rates, know as ‘call dates’.

5.2 The LOBO loans were all taken out before the current banking crisis, during the period December 2006 to January 2008. Interest rates on these loans are around 4%, which was lower than the PWLB fixed interest rates available at the time and therefore the LOBO loans have provided ongoing savings compared to the alternative of using the PWLB. By historic standards (excluding the period covered by the current banking and financial crisis) the interest rates on the LOBO loans are low compared to other forms of long term borrowing.

5.3 If the lender exercises the option to review the interest rate the Council can either accept the new interest rate, or repay the loan as if it was a maturity loan i.e. there is no penalty or cost of repaying the loan early. At that time the Council would need to refinance these loans. To manage this risk the original LOBO loans were arranged with different review dates to enable the Council to phase the impact over a number of financial years.

5.4 An annual assessment of the probability of lenders exercising the review option is undertaken with support from the Council's external Treasury Advisors. The latest review indicates that this is a low risk for 2013/14 and 2014/15, and a slightly increasing risk for 2015/16 and 2016/17. However, this position will change when the base rate increases and over the period of the MTFS there is potential risk that some of these loans may need refinancing. If this occurs this is anticipated to be at an interest rate above the current LOBO interest rate, as increases in base rates will trigger increases in longer term interest rates. The suggested reserve detailed in paragraph 4.20 would help to manage this risk over the period of the MTFS. Beyond 2016/17 it is anticipated that this potential risk can be managed from the additional MRP savings forecast from 2016/17. This position assumes these forecast additional MRP savings are achieved and future interest rate increases do not exceed current forecasts.

6. Managing the Capital Funding Reserve

6.1 The Capital Funding Reserve is earmarked to fund capital expenditure commitments approved by full Council. At the end of each financial year the value of the Capital Funding Reserve reflects contractual capital expenditure commitments which have not been paid owing to the longer lead time for capital projects which can be phased over more than one financial year.

6.2 At the end of 2011/12 the value of the Capital Funding Reserve was approximately £2.6m. The majority of this amount will be used to fund existing capital commitments in 2013/14, although some funding may be carried forward to fund existing capital commitments in 2014/15.

6.3 Whilst, the Capital Funding Reserve is committed to fund existing capital expenditure commitments, there is a potential opportunity to replace this funding with Prudential Borrowing. This would then enable this one-off funding to be reallocated to fund other one-off commitments, of either a revenue or capital nature, which may need to be funded in future years.

6.4 As Members will appreciate the use of Prudential Borrowing would result in an additional unfunded budget pressure and in normal circumstances I would not recommend that this approach should be adopted as it would simply increase the revenue budget deficit.

6.5 However, the Council faces unprecedented financial challenges/uncertainty and budget deficits over the next 4 years. Therefore, all potential opportunities and options for maximising future financial flexibility need to be assessed.

6.6 In relation to the Capital Funding Reserve this needs to consider whether it would be in the Councils medium term financial interest to release this funding by replacing it with prudential borrowing. This would then provide an uncommitted revenue reserve to fund future, and currently unidentified, expenditure commitments. As it is anticipated that the majority of the Capital Funding Reserve will be spent in the current year this issue needs to be considered in the current year otherwise the opportunity to increase future financial flexibility will be lost.

6.7 In considering this option a strategy for managing the resulting additional unfunded Prudential Borrowing costs, which would be in the order of £0.23m, would need to developed. This is a complex area. However, it would be possible to maximise future financial flexibility and avoid an immediate budget pressure in 2013/14 by adopting the following strategy:

- Step 1 - approve an increase in the 2012/13 Prudential Borrowing limits of £2.6m to release the Capital Funding Reserve;

- Step 2 – relocate the Capital Funding Reserve and create a Prudential Borrowing Repayment Reserve. This amount would be specifically invested to offset the interest payable on the increased Prudential Borrowing in 2013/14, thereby mitigating the resulting revenue budget pressure. From 2014/15 there would still be a residual budget pressure from the net interest and MRP costs, which it is anticipated can be funded from the existing capital financing budget in 2014/15 and future years.

- Step 3 – The Prudential Borrowing Repayment Reserve would be retained until such time as the Council needs to fund unforeseen one-off future expenditure commitments not yet identified through existing risk management arrangements. At the point such one-off commitments arise the Prudential Borrowing Repayment Reserve could then be reallocated to fund these issues. This would then result in a permanent revenue cost from the increased use of Prudential Borrowing. Alternatively, in the event that no unexpected additional one-off commitments arise over the next 4 years the Prudential Borrowing Repayment Reserve can be used to repay the additional Prudential Borrowing, arising from the implementation of this strategy, which would remove the potential revenue pressure.

6.8 In my professional opinion this proposal is an appropriate strategy to help manage the unprecedented financial challenges and uncertainty facing the Council over the next 4 years, such as the in-year impact of a reduction in business rates for the Power Station. Therefore, I recommend that these arrangements are implemented as this will provide financial flexibility to help manage the financial challenges facing the Council and help avoid significant in-year budget cuts if these risks occur. This position will need to be managed carefully and an annual update will be provided in the Treasury Management Strategy submitted to the Audit Committee and full Council.

7 PRUDENTIAL CODE MID-YEAR REVIEW 2012/13

7.1 The previous sections outlined the proposed Treasury Management Strategy for future years. These proposed changes will not impact on the prudential indicators approved by full Council for 2012/13. Compliance against the approved 2012/13 indicators is monitored on a regular basis and there are no breaches to report.

7.2 The CFR and Capital Expenditure Financed by Borrowing will vary from the original estimate approved by full Council in February 2012 owing to planned capital expenditure being rephased to 2013/14 and the approval of the strategy outlined in paragraph 6.7. An initial assessment indicates that there will be no net impact on the total borrowing forecast for the period of the MTFS although there may be timing differences around individual financial years.

8 CONCLUSION

8.1 The continued uncertainty in financial markets around the world, the uncertain economic outlook and future direction of interest rates make Treasury Management particularly challenging. These factors are unprecedented in modern economic terms (i.e. the last 100 years) which means it is extremely unclear which direction interest rates will take in future years.

8.2 Despite these uncertainties the Council still needs to develop a sustainable and robust Treasury Management Strategy for 2013/14. This strategy also needs to fit in with the MTFS owing to the impact of Treasury Management costs on the overall budget. The report therefore addresses the potential benefits and risks relating to Treasury Management activity.

8.3 In terms of a borrowing strategy the report outlines two options. In my professional view it is recommended that the Council adopts Option 1, which continues with the current strategy of netting down investments and borrowings and delays any new long term borrowing. This strategy is based on an assessment of the forecast borrowing requirement over a 15 year period.

8.4 This strategy should enable a significant revenue savings to be achieved. The strategy is not without financial risk and to manage this position I would recommend that a specific risk reserve is established from the forecast 2013/14 saving. If the risk reserve is not established I would not recommend that this option is adopted. This proposal will then enable a saving of £1m to be taken towards the 2014/15 budget deficit. This would significantly reduce the forecast underfunded deficit for 2014/15 from £1.4m (assuming the saving plan is achieved) to £0.4m.

8.5 Risk will also be managed by setting a trigger point of 3.5% for 10 year interest rates. When this trigger point is reached I will need to determine if it is appropriate at that time to lock into longer term interest rates.

8.6 The recommended strategy proposes allocating forecast MRP and interest savings towards reducing the 2014/15 budget deficit, rather than allocating to fund new capital expenditure. This recommendation reflects the overall budget deficits facing the Council over the next 4 years or £18m to £21m. The strategy is also based on the anticipation that the Government will continue to support local authority capital expenditure from capital grants, rather than borrowing approvals. If this position changes the Council would need to consider whether it can afford to take on any new borrowing, which would increase the forecast budget deficits over the next four years.

8.7 In relation to the Council's investment strategy the report reminds Members of the key issues which need to be considered and in order of importance these are:

- safeguarding the re-payment of the principal and interest of its investments on time;
- ensuring adequate liquidity;
- investment return.

8.8 In the current economic climate, the current investment strategy has one over-riding risk consideration which is safeguarding the principal invested. As a result of these underlying concerns the existing investment strategy will continue to net down investments and borrowings and maintain the tight controls already in place in the approved investment strategy. This strategy restricts both the institutions the authority will invest in and the period of Investment. The authority will continue to invest on a short term basis (i.e. up to 100 days) and restrict counterparties to the current investment list as detailed in the 2012/13 Treasury Management Strategy.

9. RECOMMENDATIONS

9.1 It is recommended that Members:

i) Note the report;

ii) Approve the adoption of Option 1 for the Council's borrowing strategy which will delay long term borrowing and continue the existing strategy of netting down investments and borrowings until there is a significant forecast change in current interest rates;

iii) Note and approve my professional advice that if recommendation (ii) is approved that a permanent interest and MRP saving of £1m can be built into the 2014/15 base budget forecast – as detailed in paragraph 4.21,

iv) Note that if recommendation (iii) is approved the current forecast 2014/15 net budget deficit of £1.4m (assuming the savings plan is achieved) will be reduced from £1m to £0.4m;

v) Note and approve my professional advice that the saving detailed in recommendation (iii) can only be achieved if the forecast 2013/14 Treasury Management saving of £0.870m is earmarked to establish a 'Treasury Management risk reserve' to manage the risk of interest rates increasing over the period of the MTFS and therefore costs exceeding the reduced ongoing revenue budget;

vi) Note that an annual review of the 'Treasury Management risk reserve' will be reported to Members as part of the annual Treasury Management review;

vii) Approve the continuation of the existing investment strategy and counterparty list;

viii) Approve the proposal for managing the Capital Funding Reserve detailed in paragraph 6.7, the resulting increase in Prudential Borrowing Limits and to note that an annual update will be reported to Members;

ix) Note the prudential code mid-year review in section 7; and,

x) Refer the above proposals to full Council for approval.

10. APPENDICES AVAILABLE ON REQUEST, IN THE MEMBERS LIBRARY AND ON-LINE

None

11. BACKGROUND PAPERS

None

12. CONTACT OFFICER

Chris Little
Chief Finance Officer
Tel: 01429 523003
Email: chris.little@hartlepool.gov.uk