ITEM **4(b)(iv)**

MILTON KEYNES COUNCIL

27 FEBRUARY 2007

Report considered by Cabinet – 20 February 2007

Key Decision	**Yes**
Listed on Forward Plan	**Yes**
Within Policy	**Yes**
Policy Document	**Prudential Indicators for Capital Finance 2007-08 to 2009-10**

PRUDENTIAL INDICATORS FOR CAPITAL FINANCE 2007-08 TO 2009-10

Accountable Cabinet Member: Councillor Crooks

Author: Rebecca Thomas, Finance Manager – Capital and Treasury (Tel: 254244)

1 Purpose

1.1 The CIPFA Prudential Code for Capital Finance in Local Authorities requires the Council to set a range of prudential indicators for 2007-08 and the two following years. This must be done formally as part of the budget setting process each year and this report fulfils that obligation.

1.2 This report sets out:

- The background to the prudential indicators
- Updated prudential indicators for 2006-07 where applicable
- Proposed prudential indicators for 2007-08 and the following two years

2 Recommendations

2.1 That the Council be recommended to approve the prudential indicators required under the CIPFA Prudential Code for Capital Finance in Local Authorities as set out in the attached **Annex** to this report as part of setting the Council's budget for 2007-08 to 2010-11.

2.2 That in line with CIPFA's Guidance Notes to the Prudential Code the Council be recommended to confirm the existing delegated authority to the S.151 Officer to make adjustments between the "borrowing" and "other long term liabilities" categories within the overall total of these indicators as shown in the attached **Annex** paragraphs 3.1 and 3.2. This will allow movements between borrowing and finance leases.

3 Issues and Choices

Background

3.1 The Local Government Act 2003 introduced a new system of Local Government Capital Finance from 1 April 2004. Under the prudential regime each local authority must decide its own borrowing limits, taking account of its financial situation, medium term plans and in particular affordability.

3.2 CIPFA has developed the Prudential Code of Capital Finance in Local Authorities, which requires the Council to set a range of prudential indicators for the forthcoming and the two following years. The guidance to the Code requires the current year's indicators to be reviewed as part of the process.

Risk assessment

3.3 Officers have considered whether there are any significant risks that could potentially prevent the Council from achieving its plans at the desired levels of affordability and prudence. These are considered in the body of the report at individual indicator level.

Prudential Indicators

3.4 The prudential indicators are listed below:

a. Capital Expenditure
   i) Estimate of total capital expenditure to be incurred in 2007-08, 2008-09 and 2009-10 (para. 3.5)
   ii) Estimate of capital financing requirement as at the end of years 2007-08, 2008-09 and 2009-10 (para. 3.6)

b. Affordability
   i) Estimate of ratio of financing costs to net revenue stream (para. 3.7)
   ii) Estimate of the incremental impact of new capital investment decisions on council tax (para. 3.8)
   iii) Estimate of the incremental impact of new capital investment decisions on average weekly housing rents (para. 3.9)

c. External Debt
   i) Authorised limit for external debt for 2007-08, 2008-09 and 2009-10 (para. 3.10)
   ii) Operational boundary for external debt for 2007-08, 2008-09 and 2009-10 (para. 3.11)

d. Prudence
   i) Net external borrowing compared with adjusted capital financing requirement (para 3.12).

e. Treasury Management
   i) Adoption of CIPFA Code of Practice for Treasury Management (para. 3.13)
   ii) Upper limits on variable interest rate exposure (para. 3.14)
   iii) Upper limits on fixed interest rate exposure (para. 3.15)
   iv) Maturity structure of borrowing (para. 3.16)
   v) Investments exceeding 364 days (para. 3.17)

Capital Expenditure Prudential Indicators

3.5 Estimate of total capital expenditure to be incurred in years 1, 2 and 3

This indicator requires reasonable estimates of the total of capital expenditure to be incurred during the forthcoming financial year and at least the following two financial years.

The draft Capital Programme for 2007-08 to 2011-12 is included elsewhere on this agenda and the figures below are taken from that report. The 2006-07 figures, which are included for completeness, are taken from the Capital Monitoring – Position as at 31 December 2006 report, which is also included on this agenda. If any changes are made to these reports these indicators will need to be amended prior to their consideration by Council.

Estimates for 2008-09 and 2009-10 are based on continuation schemes from previous years and outline proposals for new bids. The programme will be adjusted as necessary in line with the actual bids submitted and the resources available when the annual programmes for the two years are agreed.

Capital Expenditure				
	2006-07 Latest Estimate £000	2007-08 Estimate £000	2008-09 Estimate £000	2009-10 Estimate £000
General Fund	109,017	117,483	87,532	62,664
HRA	14,269	12,319	12,329	12,274
Total	123,286	129,802	99,861	74,938

Risk - The risks of cost variations to planned expenditure against the capital programme are significant, and can arise for a variety of reasons, including tenders coming in over budget, changes to specifications, and slippage or acceleration of project phasing. There is also the possibility of needing to provide for urgent and unplanned capital works. The risks are managed by officers on an ongoing basis, by means of active financial monitoring, with monthly reports to Cabinet. Each project is defined as high, medium or low risk, and this will be reviewed monthly. A capital reserve, made up of unbudgeted capital receipts, provides a safety net to deal with otherwise unbudgeted urgent items that cannot be accommodated by any other means.

The availability of financing from capital receipts, grants and external contributions also carries risk, and this is managed by officers on an ongoing basis. Projects are not authorised to proceed unless or until the associated funding has been identified and secured.

3.6 Estimate of capital financing requirement (CFR) as at the end of years 1, 2 and 3

External borrowing arises as a consequence of all the financial transactions of the authority and not simply those arising from capital spending. The CFR can be understood as the Council's underlying need to borrow money long term for a capital purpose – that is, after allowing for capital funding from capital receipts, grants, third party contributions and revenue.

The Council is required to make reasonable estimates of the total CFR at the end of the forthcoming financial year and the following two years thereafter. A local authority that has an HRA must identify separately estimates of the HRA and General Fund CFR.

The CFR has been calculated in line with the methodology required by the relevant statutory instrument and the guidance to the Prudential Code. It incorporates the borrowing impacts of the Council's proposed capital programme. The current year's estimated closing CFR is also shown for completeness.

Capital Financing Requirement (Closing CFR)				
	2006-07	2007-08	2008-09	2009-10
	31 March 2007 Estimate	31 March 2008 Estimate	31 March 2009 Estimate	31 March 2010 Estimate
	£000	£000	£000	£000
Non-HRA	178,341	214,513	254,676	288,561
HRA	77,774	78,523	79,271	80,020
Total	256,115	293,036	333,947	368,581

Prudential Indicators of Affordability

3.7 Estimates of ratio of financing costs to net revenue stream

The indicator has been calculated as estimated debt interest costs for the year divided by the net budget requirement for the non-HRA element and total HRA income for the HRA element. The objective is to enable trends to be identified.

The Code requires separate indicators for the HRA and non-HRA element.

The figures used for General Fund net revenue stream are dependent upon the revenue budget to be agreed by Council and are therefore subject to change. If applicable, updated figures will be provided to Cabinet and Council at the earliest opportunity.

Ratio of financing costs to net revenue stream				
	2006-07 Latest Estimate %	2007-08 Estimate %	2008-09 Estimate %	2009-10 Estimate %
Non-HRA	9.67	11.34	13.51	14.70
HRA	24.45	23.88	23.49	23.18

Risk – Debt financing costs relating to past and current capital programmes have been estimated in accordance with proper practices, and with an inclination to prudence. The upward trend reflects the ongoing costs of the Council's investment in its capital programme to support population growth.

3.8 Estimates of the incremental impact of new capital investment decisions on the Council Tax

This indicator represents an estimate of the incremental impact of new capital investment decisions on the annual Council Tax (Band D). It is intended to show the effect on the Council Tax of approving more capital expenditure.

It is estimated that new borrowing of £36m in 2007-08, £40m in 2008-09 and £34m in 2009-10 will support the draft General Fund capital expenditure figures, shown at paragraph 3.5. The large part of this borrowing is supported borrowing, the cost of which is met by revenue support grant. The costs shown below represent the incremental impact on Council Tax of the unsupported borrowing that is being met directly from revenue budgets.

Estimates of incremental impact of new capital investment decisions on the Council Tax	
	General Fund
	£ p
Year 1 2007-08	4.62
Year 2 2008-09	11.50
Year 3 2009-10	12.55

3.9 Estimate of the incremental impact of new capital investment decisions on average weekly housing rent.

This represents an estimate of the incremental impact of new capital investment decisions on average weekly housing rents.

It is estimated that new borrowing of £0.8m in each of the years 2007-08, 2008-09 and 2009-10 will support the draft HRA capital expenditure figures, shown at paragraph 3.5. As the amount of borrowing assumed is within the government allocations for supported borrowing, which is funded through housing subsidy, there will be nil impact on housing rents.

Estimates of incremental impact of new capital investment decisions on the Council Housing Rents	
	HRA £ p
Year 1 2007-08	0.00
Year 2 2008-09	0.00
Year 3 2009-10	0.00

External Debt Prudential Indicators

3.10 Authorised limit for external debt for years 1, 2 and 3

For the purposes of this indicator the authorised limit for external debt is defined as the authorised limit for borrowing plus the authorised limit for other long term liabilities for years 1, 2 and 3.

This requires the setting for the forthcoming financial year and the following two financial years of an authorised limit for total external debt (including temporary borrowing for cash flow purposes), gross of investments, separately identifying borrowing from other long term liabilities.

The authorised limit represents the maximum amount the Council may borrow at any point in time in the year. It has to be set at a level the Council considers is “prudent” and be consistent with plans for capital expenditure and financing. It contains a provision for forward funding of future years capital programmes which may be utilised if current interest rates reduce significantly but are predicted to rise in the following year.

This limit is based on the estimate of the most likely but not worst case scenario, with in addition sufficient headroom over and above this to allow for operational management, for example unusual cash movements.

The Council is asked to approve these limits and to confirm the existing delegated authority to the S.151 Officer, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long-term liabilities, in accordance with option appraisal and best value for money for the Council. Any such changes would be reported to the Council at its next meeting following the change.

Authorised limit for external debt				
	2006-07 Limit £000	2007-08 Limit £000	2008-09 Limit £000	2009-10 Limit £000
Borrowing	323,250	392,250	453,000	495,000
Other long term liabilities	750	750	1,000	1,000
TOTAL	324,000	393,000	454,000	496,000

Other long term liabilities, shown above, relate to outstanding finance lease obligations for items including IT equipment and office furniture and include a contingency for new leases.

Risk - Risk analysis and risk management strategies have been taken into account in setting this indicator, as have plans for capital expenditure, estimates of the capital financing requirement and estimates of cash flow requirements for all purposes. The upward trend again reflects the level of borrowing required to finance the Council's investment in its capital programme to support population growth.

3.11 Operational Boundary for total external debt for years 1, 2 and 3

The proposed operational boundary is based on the same estimates as the authorised limit. However it excludes the additional headroom included within the authorised limit to allow for unusual cash movements. It equates to the maximum of projected external debt.

The operational boundary represents a key management tool for in year monitoring by the S.151 Officer. Within the operational boundary, figures for borrowing and other long term liabilities are separately identified.

The Council is also asked to confirm the existing delegated authority to the S.151 Officer, within the same operational boundary for any individual year, to effect movement between the separately agreed figures for borrowing and other long term liabilities, in a similar fashion to the authorised limit. Any such changes will be reported to the Council at the next meeting following the change.

Operational boundary for external debt				
	2006-07 Boundary £000	2007-08 Boundary £000	2008-09 Boundary £000	2009-10 Boundary £000
Borrowing	303,250	372,250	433,000	475,000
Other long term liabilities	750	750	1,000	1,000
TOTAL	304,000	373,000	434,000	476,000

Risk - Risk analysis and risk management strategies have been taken into account in setting this indicator, as have plans for capital expenditure, estimates of the capital financing requirement and estimates of cash flow requirements for all purposes. As in paragraph 3.10 above the upward trend reflects the level of borrowing required to finance the Council's investment in its capital programme to support population growth.

Prudence

3.12 Net borrowing and capital financing requirement

This is the key indicator of prudence. It is intended to show that net external borrowing does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital requirement for the current and new two financial years.

Net external debt less than CFR	
	2007-08 £000
Borrowing	281,204
Less investments	(65,803)
Net external debt	215,401
Previous year CFR	256,115
Additional CFR -	
Current year	36,921
Next year	40,911
Following year	34,634
Adjusted CFR	368,581
Net external debt less than adjusted CFR	Yes

Treasury Management Prudential Indicators

3.13 Adoption of the CIPFA Code of Practice for Treasury Management

The Council adopted the CIPFA Code of Practice for Treasury Management in the Public Services at its meeting in March 2002. Treasury Management Practices' schedules (TMPs), setting out detailed procedures, have been established by the Head of Finance and are regularly reviewed. The first prudential indicator in respect of treasury management that the local authority has adopted the CIPFA Code is therefore met.

3.14 Upper limits on variable interest rate exposures

This indicator sets the upper limits to which the Council is exposed to the effects of changes in variable interest rates.

It refers to the Council's variable rate interest risk and relates to borrowing that is at variable rates less investments that are variable rate investments and is expressed as a principal sum.

This limit has been calculated on the basis that a reasonable limit will equate to approximately 25% of total borrowing. In practice it would be unusual for the exposure to exceed 15%.

Upper limits on variable interest rate exposures	
	Upper Limit £000
Latest 2006-07	88,000
Estimate 2007-08	108,000
Estimate 2008-09	123,000
Estimate 2009-10	128,000

3.15 Upper limits on fixed interest rate exposures

This indicator sets the upper limits to which the Council is exposed to the effects of changes in fixed interest rates.

It refers to the Council's exposure to fixed rate risk and relates to borrowing that is at fixed rates less investments that are fixed rate investments. The indicator is expressed as a principal sum.

The limit has been set at the level of 100% of borrowing being at a fixed interest rate. This is to allow for the possibility that, subject to market conditions, it may be necessary or desirable for all borrowing at a point in time to be at a fixed rate.

Fixed rate risk	
	Upper Limit £000
Latest 2006-07	308,000
Estimate 2007-08	377,000
Estimate 2008-09	438,000
Estimate 2009-10	480,000

3.16 Prudential limits for the maturity structure of borrowing

This represents the amount of projected borrowing that is fixed rate maturing in each period expressed as a percentage of total projected borrowing that is fixed rate at the start of the period where the periods in question are:

- Under 12 months
- 12 months and within 24 months

- 24 months and within 5 years
- 5 years and within 10 years
- 10 years and above

This sets both upper and lower limits for 2007-08 with respect to the maturity structure of the Council's borrowing.

Maturity structure of borrowing		
	Lower Limit %	Upper Limit %
Under 12 months	0	15
1-2 years	0	15
2-5 years	0	40
5-10 years	0	40
Over 10 years	60	100

Risk – The debt maturity profile is actively managed to ensure that no more than 15% of total debt matures in any one year. This ensures that the Council is not exposed to unmanageable risks if interest rates become volatile.

3.17 Principal sums invested for periods longer than 364 days

Under the Local Government Act 2003 and Guidance on investments, all Councils are now permitted to invest for periods exceeding 1 year.

The Council is required to set a limit to the level of such investments it might wish to make. The limit has been set at a level that would allow for monies not anticipated to be spent in year e.g. capital receipts, to be invested for longer periods if interest rates are favourable.

Upper limit on investments for periods longer than 364 days	
	Upper Limit £000
Latest 2006-07	10,000
Estimate 2007-08	25,000
Estimate 2008-09	25,000
Estimate 2009-10	25,000

Risk – This upper limit has been set at a prudent level in order not to compromise cash flow liquidity.

3.18 Wider Financial Context

The prudential indicators will provide a framework in 2007-08 in which the Council conducts its treasury activities, consistent with good treasury risk management. They will be monitored throughout the year and reported to Cabinet on a regular basis.

The Code indicates that “in all cases, the process of setting prudential indicators for treasury management should be accompanied by a clear and integrated forward treasury management strategy, and a recognition of the pre-existing structure of the authority’s borrowing and investment portfolios.” The indicators proposed here have been proposed taking account of the existing structure of borrowing and all reasonable restructuring activity that might occur.

The Code requires the following matters to be taken into account when setting or revising prudential indicators

(a) Option appraisal for all projects, i.e. value for money
(b) Asset management planning, i.e. stewardship of asset
(c) Strategic planning for the authority, i.e. service objectives
(d) Achievability of the forward plan, i.e. its practicality
(e) Implications for external borrowing, i.e. prudence
(f) Implications for Council Tax and housing rents, i.e. affordability.

Items (a)-(c) are largely considered in the current arrangements as part of the asset management planning / corporate capital strategy processes. Items (d) and (f) in financial terms will be commented upon by the Council’s Section 151 Officer in presenting the budget, and item (e) is inherent to the prudential indicator setting process.

Implications

3.19 Policy - The Council’s prudential indicators are consistent with the Treasury Management Strategy which is included elsewhere on this agenda and will be brought to Council on 27 February.

3.20 Resources and Risk - Financial issues are dealt with in the main body of the report.

Yes	Capital	Yes	Revenue	No	Accommodation
No	IT	No	Medium Term Plan	No	Asset Management

3.21 Legal - Under the Local Government Act 2003 and the Local Authorities (Capital Finance and Accounting (England) Regulations 2003 the Council must set Prudential Limits as part of the overall budget setting process. CIPFA’s Prudential Code is regarded as mandatory guidance associated with the new Local Government Act 2003.

3.22 Other Implications

No	Equalities/Diversity	No	Sustainability	No	Human Rights
No	E-Government	No	Stakeholders	No	Crime & Disorder

Background Papers:

Legislative and regulatory framework:

Local Government Act 2003

Local Authorities (Capital Finance and Accounting) England Regulations 2003

Guidance on Local Government Investments 2004

CIPFA Prudential Code for Capital Finance in Local Authorities

CIPFA Guidance to the Prudential Code

CIPFA Code of Practice for Treasury Management

Reports to Cabinet & Council:

Adoption of the above CIPFA Code of Practice for Treasury Management - 12 March 2002

Reports included in this agenda -

Capital Programme 2007-08 to 2011-12

Council Wide Revenue Budget 2007-08 to 2010-11

Treasury Strategy 2007-08 to 2009-10