

To: Finance and Resources Committee
From: Treasurer
Date: 20th January 2010

PRUDENTIAL INDICATORS, TREASURY MANAGEMENT AND MINIMUM REVENUE PROVISION 2010/11

1. Purpose

- 1.1 This report seeks approval for the prudential indicators for capital expenditure and external debt as required by the Chartered Institute of Public Finance and Accountancy's (CIPFA) Prudential Code for Capital Finance (the Code).
- 1.2 The Code also requires the Authority to set and monitor a number of Treasury Management indicators within the Treasury Management Code of Practice (TM code) and set its Treasury Management strategy for the forthcoming year.
- 1.3 Additionally, this report also seeks approval for the annual policy statement on the making of the Minimum Revenue Provision (MRP) for the repayment of debt as required by the guidance issued under section 21(A) of the Local Government Act 2003 as inserted by section 238(2) of the Local Government and Public Involvement in Health Act 2007.
- 1.4 CIPFA has recently revised its Treasury Management Code of Practice requiring the Authority to formally nominate a Committee to assume responsibility for effective monitoring and scrutiny of treasury management strategy and policies. It is proposed that Finance and Resources Committee is so nominated. The full policy statement is attached at Appendix B for reference, clause 4.4 giving effect to the new requirement.

2. Background

2.1 Prudential Indicators and Treasury Management

- 2.1.1 The Code came into effect on 1st April 2004 and was fully revised in November 2009 following the review of Treasury Management in local authorities triggered by the Icelandic banking crisis. The Local Government Act 2003 states that the principles of the Code must be taken into account when assessing the Authority's budget proposals for 2010/11.

2.1.2 The Code requires the Authority to agree a range of indicators to take account of a number of relevant issues, namely:

- affordability (implications for the Council Tax)
- prudence and sustainability (e.g. implications for external borrowing)
- value for money (e.g. option appraisal)
- stewardship of assets (e.g. asset management planning)
- service objectives (e.g. strategic planning)
- practicality (e.g. achievability of the policing plan).

2.2 Minimum Revenue Provision (MRP)

2.2.1 Local Authorities are required by statute to set aside some of their revenues as minimum revenue provision for the repayment of debt in respect of capital expenditure financed by borrowing or credit arrangements.

2.2.2 The method of calculating MRP has been radically revised by the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008. Previously, the calculation of MRP was governed by detailed, formulaic rules which have been replaced by a simple duty to make prudent provision. In making prudent provision a Local Authority must have regard to the guidance issued by the Department for Communities and Local Government issued under section 238(2) of the Local Government and Public Involvement in Health Act 2007.

2.2.3 The Committee is asked to note that the basis for calculating MRP chargeable to revenue in any given year is the Capital Financing Requirement (CFR) at the start of that financial year. CFR is a balance sheet derived measure of an Authority's underlying need to borrow, reflecting capital transactions in the previous financial year.

2.2.4 The guidance outlines four ready made options for the calculation of MRP but does not rule out alternative approaches provided they are consistent with the statutory duty to make prudent revenue provision. This report contains no proposal for stepping outside the options outlined in the guidance since the capital transactions of Cambridgeshire Police Authority are relatively straight forward.

2.2.5 The four ready made options are:

- 1 Regulatory Method – this method is a hangover from the MRP regime in force prior to the introduction of the Prudential System in 2004. This Authority first incurred debt after 2004 and has only used the CFR method (see below) from that date. Consequently the Regulatory Method is not considered further;
- 2 The CFR method – this is the method used by Cambridgeshire Police Authority. MRP is calculated at 4% of CFR at the start of the financial year, on a reducing balance basis;

- 3 Asset Life Method – under this method provision is made over the estimated life of the asset(s) for which the borrowing is undertaken; and
- 4 Depreciation Method – provision for MRP is made equal to the depreciation charged in respect of the asset financed by borrowing or credit arrangements.

2.2.6 For 2010/11 and subsequent financial years options 1 and 2 above can only be used for Supported Capital Expenditure (SCE). SCE is the amount of borrowing assumed in the Revenue Support Grant settlement. SCE has remained constant at £834k throughout the period under consideration. Permissible methods for the balance of self-financed expenditure include options 3 and 4 above.

3. Prudential Indicators – Capital Expenditure and External Debt

- 3.1 The Prudential Indicators that the Authority is required to take into account in assessing the affordability, prudence and sustainability of its proposed capital expenditure are set out at Appendix A, para. 1.
- 3.2 The Committee is asked to note that there is a continuing requirement to borrow in support of the proposed capital programme. As a consequence, the Committee is asked recommend the Authority to set the Authorised limit for external debt for 2010/11 at £60m (Appendix A, 1.8) and the Operational boundary for external debt at £50.856m (Appendix A, 1.10).

4. Prudential Indicators – Treasury Management

- 4.1 The Prudential Indicators that the Authority is required by the Code to set and monitor in order to manage the risks inherent in the Treasury Management function are set out at Appendix A, para. 2.
- 4.2 In addition, the Authority is required to set its Treasury Management strategy for the forthcoming year. The strategy to be adopted, which is summarised below, is consistent with the Authority's Treasury Management Policy statement and associated Treasury Management Practices.

5. Treasury Management Strategy

5.1 Investments

- 5.1.1 On 13th January 2009 the Police Authority approved and reaffirmed a number of tactical changes to the Treasury Management Policy in the face of unprecedented turbulence, uncertainty and volatility in the banking sector.

5.1.2 The key changes were:

- (i) to reaffirm the policy of placing security of investments ahead of any consideration of return and requiring all investments to be specified, (defined as; of high credit quality, in sterling and mature within 364 days).
- (ii) to keep the Authority's investments as short term as possible given volatility in credit ratings in the banking sector;
- (iii) to reduce the maximum investment with any one counterparty from £10m to £5m, excepting a Debt Management Account Deposit Facility (DMADF) and Northern Rock (see (viii) below);
- (iv) to tighten the credit rating requirement for counterparties from Fitch F1 (or equivalent) to the highest rating of each of the three main credit rating agencies i.e. Fitch F1+; Moody's P-1 and Standard and Poor's A-1+;
- (v) to permit investment in a DMADF (a flexible and secure facility provided by the Debt Management Office, an Executive Agency of HM Treasury);
- (vi) to permit, in extremis, investment of up to 100% of available funds in a DMADF;
- (vii) to permit investment in Northern Rock to a limit of 25% of available funds, within the government guaranteed term of 3 months,
- (viii) to limit investments not placed in a DMADF or Northern Rock to 25% of available funds for any one counterparty;
- (ix) to allow investment in UK banks falling outside the rating criteria at (iv) above where the UK Government holds a significant stake, to a limit of £5m or 25% of available funds;
- (x) to take account of sovereign ratings, rating outlooks and other appropriate market intelligence; and
- (xi) to authorise the Treasurer to take such decisions as may be required in a volatile investment climate subject to report back to the Police Authority.

Particular attention is drawn to point (iv) above which defines high credit quality (i.e. specified investments) for the Authority

5.1.3 In the event, the Authority has invested 100% of available cash with the DMADF because Northern Rock are not taking deposits for less than 3 months and interest rates are so low (currently around 0.25%) that the return on cash invested overnight is less than the transaction fees incurred in placing it with counterparties in the commercial sector.

5.1.4 Looking forward, it is proposed to reconfirm the changes to the Treasury Management Policy set out at para. 5.1.2 above because the banking sector, while not as fragile as a year ago, is still in recovery and the risk of liquidity problems remains. In addition, interest rates are likely to remain low in the short term making investment with many counterparties in the commercial sector unattractive for the reasons set out at para. 5.1.3 above.

- 5.1.5 However, it is also proposed to keep the Treasury Management policy under close review with a view to widening the list of available counterparties and / or seeking alternative investments (e.g. Money Market Funds) in order to benefit from increased rates of return with any changes being consistent with the Authority's appetite for risk and approved by the Authority in any event. Prior to any such review and approval, all investments will be specified (paragraph (5.1.2) above, and non specified investments will not be permitted. Should the Authority widen the list, security and liquidity benchmarking will then be undertaken.
- 5.1.6 The Authority uses Butlers as its treasury management consultants. The company provides a range of services which include:
- Technical support on treasury matters, capital finance issues and the drafting of members' reports.
 - Credit ratings, market information service, comprising the three main credit rating agencies.
 - Treasury Management Training has been offered by Butlers and this has been forwarded to the Treasurer (Section 151 Officer) for consideration.

5.2 Borrowing

- 5.2.1 The Authority is significantly underborrowed because it has used available internal cash to fund capital expenditure rather than borrow externally. This is a rational strategy when returns on balances and deposits are low and the rates on borrowing relatively high i.e. a low rate of return is forsaken in order to avoid a high cost of borrowing, bearing in mind the strategy of keeping investments as short-term as possible. The strategy is also rational where there is uncertainty in the banking sector i.e. cash is effectively tied up in capital investment rather than in a potentially risky financial investment. The Authority is not expecting to borrow in advance of need within the 2010/11 financial year.
- 5.2.2 Current rates of investment return are in the order of 0.25% in comparison with PWLB rates for 25 year loans which stand at 4.5%.
- 5.2.3 It is proposed to maintain the strategy of internal borrowing to the extent that internal cash resources allow. However, the Authority's capital plans are such that borrowing will be required in the short term.
- 5.2.4 It is envisaged that the Authority's borrowing requirements will be met by Public Works Loan Board ("PWLB") Loans. However, if interest rates are favourable, borrowing from money markets would be considered alongside PWLB loans.
- 5.2.5 The Authority's existing loans are on an annuity basis (i.e. interest and principal are repaid over the life of the loan). It is proposed that new borrowing is taken on a maturity basis (i.e. interest only is paid over the life of the loan with the principal repayable at term) on the grounds that a cash flow advantage is obtained and that borrowing will better match the requirement for finance as measured by the CFR.

- 5.2.6 **Rescheduling** - opportunities arise over the life of a loan or portfolio of loans to reschedule the debt to take advantage of lower interest rates going forward.
- 5.2.7 The Authority's portfolio of loans has been reviewed for such an opportunity which does not arise, particularly as PWLB rates are forecast to increase in the near future.

6. Basis for calculating MRP

6.1 Supported Capital Expenditure (SCE)

- 6.1.1 The Committee approved the use of the CFR method as described at para. 2.2.5 above for SCE in 2009/10 on the grounds that the MRP charge to revenue is thereby offset by the MRP element of the Revenue Support Grant which is calculated on the same basis.

6.2 Self-financed Capital Expenditure

- 6.2.1 The Committee approved the use of the asset life (equal instalment) method as described at para. 2.2.5 above for self-financed expenditure in 2009/10 on the grounds that the method is both straightforward to apply and best matches the MRP with the economic benefits expected to flow from the assets so financed.
- 6.3 The continued use of the CFR method for SCE and the asset life (equal instalment) method for self-financed expenditure for the 2010/11 financial year is proposed since the underlying rationales remain unchanged.

7. Recommendations

- 7.1 The Committee is asked to recommend the Authority:-
- a) to approve the Prudential Indicators in respect of capital expenditure and external debt having particular regard to the Authorised Limit for external debt and the Operational Boundary for external debt for 2010/11 (para. 3.2 above and Appendix A, 1.8 and 1.10);
 - b) to approve the Treasury Management Prudential Indicators set out at Appendix A, para. 2;
 - c) to approve the Treasury Management Strategy with immediate effect (para. 5 above);
 - d) to approve the use of the CFR method for calculating MRP in respect of supported capital expenditure and the asset life (equal instalment) method for self-financed capital expenditure for 2010/11 (para 6.3); and
 - e) to approve the revised Treasury Management Policy Statement (Appendix B).

BIBLIOGRAPHY

Source Document (s)	Contact Officer	Location
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<p>Originating Officer: Niki Howard, Director of Finance and John Hummersone, Treasurer</p> <p>Is it considered that this report contains 'exempt information' and should be considered in private? NO</p> <p>If the answer is "YES", please state the nature of the exempt information and the relevant clause (s) in Part 1 of Revised Schedule 12A to the Local Government Act 1972</p> <p>.....</p> <p>The attached report has been cleared with the undermentioned officers: (delete as appropriate)</p> <p>Chief Executive/Chief Constable/Treasurer</p> <p>Others</p> <p>Submitted on7th January 2010.....</p> <p>A report will not be sent to the Authority unless this box has been satisfactorily completed and all necessary consultation carried out - the responsibility for which rests with the originator (except for consultation with the Chairman and this will be undertaken by the Chief Executive).</p>		

Prudential Indicators 2010/11 to 2012/13

1. Capital Expenditure and External Debt

- 1.1 The actual capital expenditure incurred in 2008/09 and the estimates of capital expenditure to be incurred for the current and future years that are recommended for approval are:

Prudential Indicator 1

Capital Expenditure					
	2008/09 £'000 Actual	2009/10 £'000 Forecast	2010/11 £'000 Estimate	2011/12 £'000 Estimate	2012/13 £'000 Estimate
Total	11,670	15,435	20,290	13,175	3,275

- 1.2 Estimates of the Ratio of Financing Costs to Net Revenue Stream for the current and future years, and the actual figures for 2008/09 are:

Prudential Indicator 2

Ratio of financing costs to net revenue stream					
	2008/09 Actual	2009/10 Forecast	2010/11 Estimate	2011/12 Estimate	2012/13 Estimate
Total	0.9%	1.0%	2.3%	2.9%	3.8%

- 1.3 The estimates of financing costs include current commitments and the proposals set out in the 2010/11 Budget Report.
- 1.4 Estimates of the end of the year Capital Financing Requirement for the Authority for the current and future years and the actual Capital Financing Requirement at 31st March 2009 are:

Prudential Indicator 3

Capital Financing requirements					
	31/03/09 £'000 Actual	31/03/10 £'000 Forecast	31/03/11 £'000 Estimate	31/03/12 £'000 Estimate	31/03/13 £'000 Estimate
Total	18,016	32,730	50,856	61,492	61,821

- 1.5 The Capital Financing Requirement measures the Authority's underlying need to borrow for a capital purpose. In accordance with best professional practice, Cambridgeshire Police Authority does not associate borrowing with particular items or types of expenditure. The Authority has an integrated treasury management strategy and has adopted the CIPFA *Code of Practice for Treasury Management in the Public Services*. Cambridgeshire Police Authority has, at any point in time, a number of cashflows both positive and negative, and manages its treasury position in terms of its borrowings and investments in accordance with its approved treasury management strategy and practices. In day to day cash management, no distinction can be made between revenue cash and capital cash. External borrowing arises as a consequence of all the financial transactions of the Authority and not simply those arising from capital spending. In contrast, the capital financing requirements reflects the Authority's underlying need to borrow for a capital purpose.
- 1.6 CIPFA's *Prudential Code for Capital Finance in Local Authorities* includes the following as a key indicator of prudence (**Prudential Indicator 4**):
- "In order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years."*
- 1.7 The Treasurer reports that the Authority had no difficulty meeting this requirement in 2008/09, nor are any difficulties envisaged for the current or future years. This view takes into account current commitments, existing plans, and the proposals in the 2010/11 Budget report.
- 1.8 In respect of its external debt, it is recommended that the Authority approves the following Authorised Limits (**Prudential Indicator 5**) for its total external debt gross of investments for the next three financial years. These limits separately identify borrowing from other long term liabilities such as finance leases. The Authority is asked to approve these limits.

Prudential Indicator 5

Authorised limit for external debt				
	2009/10 £'000	2010/11 £'000	2011/12 £'000	2012/13 £'000
Borrowing	40,000	60,000	70,000	70,000
Other long term liabilities	-	-	-	-
Total	40,000	60,000	70,000	70,000

- 1.9 The Treasurer reports that these Authorised Limits are consistent with the Authority's current commitments, existing plans and the proposals in the 2010/11 Budget report for capital expenditure and financing, and with its approved treasury management policy statement and practices. The Treasurer confirms that they are based on the estimate of most likely, prudent but not worse case scenario, with sufficient headroom to allow for operational management, for example, unusual cash payments. Risk analysis and risk management strategies have been taken into account; as have plans for capital expenditure, estimates of the Capital Financing Requirement and estimate of cashflow requirements for all purposes.
- 1.10 The Authority is also asked to approve the following Operational Boundary (Indicator 6) for external debt for the same period. The proposed Operational Boundary for external debt is based on the same estimates as the Authorised Limit, but reflects directly the Director of Finance's estimate of the most likely, prudent but not worse case scenario, without the additional headroom included within the Authorised Limit to allow, for example, for unusual cash movements, and equates to the maximum of external debt projected by this estimate. The Operational Boundary represents a key management tool for in-year monitoring by the Director of Finance. Within the Operational Boundary, figures for borrowing and other long-term liabilities are separately identified.

Prudential Indicator 6

Operational boundary for external debt				
	2009/10 £'000	2010/11 £'000	2011/12 £'000	2012/13 £'000
Borrowing	32,730	50,856	61,492	61,821
Other long term liabilities	-	-	-	-
Total	32,730	50,856	61,492	61,821

- 1.11 The Authority's actual external debt at 31st March 2009 was £8.4m, comprising borrowing only. It should be noted that actual external debt is not directly comparable to the Authorised Limit and Operational Boundary, since the actual external debt reflects the position at any one time and is largely dependent on the timing of payments against the approved Capital Programme.
- 1.12 In taking its decisions on the 2010/11 Budget report, the Authority is asked to note that the Authorised Limit determined for 2009/10 will be the statutory limit determined under decision 3(1) of the Local Government Act 2003.
- 1.13 The estimated incremental impact on Band D Council Tax of capital investment decisions proposed in the 2010/11 Budget report, over and above capital investment decisions that have previously been taken by the Authority, is:

Prudential Indicator 7

2010/11	2011/12	2012/13
£ 6.22	£ 3.33	£ 4.52

1.14 Consideration of options for the Capital Programme

1.14.1 In considering its programme for capital investment, the Authority is required within the Prudential Code to have regard to:

- ◆ affordability, e.g. implications for Council Tax
- ◆ prudence and sustainability, e.g. implications for external borrowing
- ◆ value for money, e.g. option appraisal
- ◆ stewardship of assets, e.g. asset management planning
- ◆ practicality, e.g. achievability for the forward plan

1.14.2 A key measure of affordability is the incremental impact on the Council Tax, and the Authority could consider different options for its capital investment programme in relation to their differential impact on the Council Tax.

2. Treasury Management

2.1 The Treasury Management function provides the link between the Authority's Capital Financing Requirement and the structure and management of its debt. The Prudential Code sets out a range of indicators designed to assist the Authority in managing the risks inherent in the Treasury Management function the first of which (**Prudential Indicator 8**) is that the Authority has formally adopted the CIPFA *Code of Practice for Treasury Management in Public Services*. The specific indicators required by the Treasury Management Code are set out in the following paragraphs.

2.2 It is recommended that the Authority set an upper limit on its fixed interest rate exposures for 2010/11, 2011/12 and 2012/13 of 100% of its net outstanding principal sums (**Treasury Management Indicator 1**).

2.3 It is recommended that the Authority set upper and lower limits for the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate as follows:

Treasury Management Indicator 2

	Upper Limit	Lower Limit
under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

2.4 It is recommended that the maximum principal sums invested for more than 364 days is as follows:

Treasury Indicator 3

Maximum principal sums invested > 364 days				
		2008/09	2009/10	2010/11
		£000	£000	£000
Total		-	-	-

Cambridgeshire Police Authority
Treasury Management Policy Statement
Amended January 2010

1. This organisation defines its treasury management activities as “The management of the organisation’s cash flows, its banking, money market and capital market transaction; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.”
2. This organisation regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury activities will focus on their risk implications for the organisation.
3. This organisation acknowledges that effective treasury management will provide support towards the achievement of its business and services objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.
4. The Authority adopts the key recommendations of CIPFA’s *Treasury Management in the Public Services: Code of Practice (the Code)*, as described in Section 5 of that Code.
 - 1 Accordingly the Authority will create and maintain, as the cornerstones for effective treasury management:
 - a treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities;
 - suitable treasury management practices (TMP’s), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities; and
 - the content of the policy statement and TMP’s will follow the recommendations contained in Sections 6 and 7 of the code, subject only to amendment where necessary to reflect the particular circumstances of this organisation. Such amendments will not result in the organisation materially deviating from the Code’s key principles.
 - 2 The Police Authority will receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMP’s

- 3 The Authority delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Treasurer (Section 151 Officer) and for the execution and administration of treasury management decisions to Director of Finance and Resources, who will act in accordance with the organisation's policy statement and TMP's and if he/she is a CIPFA member, CIPFA's Standard of Professional Practice on Treasury Management.
- 4 The Police Authority nominates the Finance and Resources Committee for effective scrutiny of the treasury management strategy and policies.