AGENDA ITEM: 12

NORTH WALES FIRE AND RESCUE AUTHORITY

19 March 2012

Prudential Indicators, Treasury Management Strategy, Investment Strategy and Minimum Revenue Provision Policy

Report by Ken Finch, Treasurer

PURPOSE OF REPORT

1 To present to Members the Prudential Indicators, Treasury Management Strategy, Investment Strategy and Minimum Revenue Provision (MRP) Policy for 2012/13.

2 This report was presented to the Audit Committee on the 30 January 2012 so they could review the contents before submission to the Fire and Rescue Authority. Some concern was expressed regarding the level of capital expenditure on estates and it was agreed that a separate report be presented to the Fire and Rescue Authority reminding members of the approved capital strategy. The Audit Committee had no other major observations or could find any major risks in the report and would recommend it be approved by the Authority.

INTRODUCTION

3 The draft budget for 2012/13 was presented to Members for approval on 19 December 2011 and the Prudential Indicators and Treasury Management Strategy have been prepared using the relevant data contained in the revenue and capital budgets approved by Members.

4 This report shows the Prudential Indicators for 2012/13 to 2014/15 and outlines the strategy to be followed regarding borrowing and investing the Authority's funds in the financial year 2012/13. The report also sets out proposals for the Authority's policy on MRP for 2012/13. The papers attached set out:-

(i) a list of prudential indicators as required by the CIPFA Prudential Code for Capital Finance in Local Authorities (Appendix A);

(ii) the Treasury Management Strategy outlining the strategy to be followed regarding short and long-term borrowing for 2012/13 in accordance with the CIPFA code of Practice on Treasury Management (Appendix B);

(iii) the strategy to be followed regarding the investment of Fire and Rescue Authority funds (Appendix C);

(iv) Minimum Revenue Provision Statement (Appendix D).

5 Members should note that the strategies in the report have been prepared using guidance from the Treasury Management advisors, Sector, used by Conwy County Borough Council who has the responsibility for the Fire Service Treasury function.

RECOMMENDATIONS

6 Members are recommended to approve each of the four key elements of these reports:

(i) Prudential Indicators set out in Appendix A;
(ii) Treasury Management Strategy for 2012/13 set out in Appendix B;
(iii) Investment Strategy at Appendix C;
(iv) Minimum Revenue Provision Policy in Appendix D.

APPENDIX A

PRUDENTIAL INDICATORS FOR NORTH WALES FIRE AND RESCUE AUTHORITY

1. INTRODUCTION

1.1 The Local Government Act 2003 requires the Authority to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity, and reflects the outcome of the Authority's capital appraisal systems. This report updates currently approved indicators and introduces new indicators for 2014/15. A revised code was issued in 2009 and this report complies with the new requirements, which have asked that this report be subject to greater scrutiny by those charged with governance - for the Fire and Rescue Authority this is the Audit Committee.

1.2 The Capital Programme for 2012/13 was approved by the Fire and Rescue Authority in December 2011 and these indicators support that programme. The Authority has freedom over capital expenditure so long as it is prudent, affordable and sustainable. In order to show it is working within these limits the Audit Committee must approve, revise and monitor at least a basic range of Prudential Indicators for the forthcoming three years.

2. THE CAPITAL EXPENDITURE PLANS

2.1 The Authority's capital expenditure plans are summarised below and this forms the first of the prudential indicators to be approved by Members. All capital expenditure in the forward programme is currently unsupported and must be funded from the Authority's own resources.

2.2 However, the Government may decide to place limits on unsupported capital expenditure by introducing a long stop control on all Local Authorities plans or, in the event of an assessment by Central Government that local plans are unaffordable at a specific Authority, it may implement a local control to limit its capital expenditure plans. No such controls were implemented during 2011/12, and the situation for 2012/13 is unclear at the moment.

	2010/11 Actual £'000	2011/12 Revised £'000	2012/13 Estimate £'000	2013/14 Estimate £'000	2014/15 Estimate £'000
Capital expenditure	6,321	5,311	3,980	7,435	6,015
Financed by:					
Capital receipts	-38	0	0	-1,000	0
Capital grants	-251	0	0	0	0
Revenue	0	0	0	0	0
Net financing need for the year	6,032	5,311	3,980	6,435	6,015

3. The Authority's Borrowing Need (the Capital Financing Requirement)

3.1 The second prudential indicator is the Authority's Capital Financing Requirement (CFR). The CFR is simply the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Authority's underlying borrowing need. The capital expenditure above which has not immediately been paid for will increase the CFR. Members are asked to approve the CFR projections as below:

	2010/11 Actual £'000	2011/12 Revised £'000	2012/13 Estimate £'000	2013/14 Estimate £'000	2014/15 Estimate £'000
Capital Financing Requirement					
Opening CFR	15,122	19,753	23,261	25,168	29,393
Closing CFR	19,753	23,261	25,168	29,393	32,855
Movement in CFR	4,631	3,508	1,907	4,225	3,462
Movement in CFR represented by					
Net financing need for the year (above)	6,032	5,311	3,981	6,435	6,015
Less MRP/VRP	-1,401	-1,803	-2,074	-2,210	-2,553
Movement in CFR	4,631	3,508	1,907	4,225	3,462

3.2 The Authority is required to pay off an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary payments (VRP).

3.3 The expected impact of the capital expenditure decisions above on the Authority's debt and investment position are shown in the Treasury Strategy.

4. AFFORDABILITY PRUDENTIAL INDICATORS

4.1 The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Authority's overall finances. Members are asked to approve the following indicators:

4.2 **Actual and Estimates of the ratio of financing costs to net revenue stream** – This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. The estimates of financing costs include current commitments and the Capital Programme approved by members in December.

	2010/11 Actual %	2011/12 Revised %	2012/13 Estimate %	2013/14 Estimate %	2014/15 Estimate %
Ratio	5.57	6.96	8.58	9.48	10.78

4.3 **Estimates of the incremental impact of capital investment decisions on the contributions from the Constituent Authorities** – This indicator identifies the revenue costs associated with the proposed three year capital programme recommended in the budget report.

	Proposed Budget 2012/13 £'000	Proposed Budget 2013/14 £'000	Proposed Budget 2014/15 £'000
Contribution Increase	60	503	1,224

APPENDIX B

Treasury Management Strategy for 2012/13 -2014/15

1. Introduction

1.1 The treasury management service is an important part of the overall financial management of the Authority's affairs. The prudential indicators in Appendix A consider the affordability and impact of capital expenditure decisions, and set out the Authority's overall capital framework. The treasury strategy considers the effective funding of these decisions. Together they form part of the process which ensures the Authority meets balanced budget requirement under the Local Government Finance Act 1992. There are specific treasury prudential indicators included in this strategy which require approval.

1.2 The Authority's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). The Authority adopted the CIPFA Code of Practice on Treasury Management and a Treasury Management Policy Statement on 15 December 2003. This adoption meets the requirements of the first of the Treasury Prudential Indicators.

1.3 The Code requires an annual strategy to be reported to the Authority outlining the expected treasury activity for the forthcoming 3 years. A further mid-year monitoring report is produced and after the year-end a report on actual activity for the year.

1.4 A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. The strategy report will cover several areas as follows:

(i) The Authority's debt and investment projections;
(ii) The Authority's estimates and limits on future debt levels;
(ii) The expected movement in interest rates;
(iii) The Authority's borrowing strategy;
(iv) The Authority's investment, counterparty and liquidity framework;
(vi) Treasury performance indicators.

2. DEBT AND INVESTMENT PROJECTIONS 2011/12 – 2014/15

2.1 The current position as at 11 January 2012 is as follows:

Public Works Loan Board (PWLB)	- £8,203,987	Fixed Rate
	- £5,562,107	Variable Rate
Other Local Authorities	- £7,000,000	Fixed Rate

Investments - £880,000

2.2 The borrowing requirement comprises the expected movement in the CFR and any maturing debt which will need to be re-financed. The table below shows this effect on the treasury position over the next three years. It also highlights the expected change in investment balances.

£'000	2011/12 Revised	2012/13 Estimated	2013/14 Estimated	2014/15 Estimated
External Debt				
Debt at 1 April	19,391	23,261	25,168	29,393
Movement in CFR	3,508	1,907	4,225	3,462
Maturing Debt Replacement	9,500	11,062	3,000	2,000
Adjustment for prior years /under borrowing	362	0	0	0
Debt at 31 March	23,261	25,168	29,393	32,855
Annual change in debt	3,870	1,907	4,225	3,462
Investments				
Total Investments at 31 March	1,000	2,000	1,500	1,000
Investment change	-2,350	+1,000	-500	-500

3. LIMITS TO BORROWING ACTIVITY

3.1 Within the prudential indicators there are a number of key indicators to ensure the Authority operates its activities within well defined limits.

3.2 For the first of these the Authority needs to ensure that its total borrowing net of any investments, does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2012/13 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

	2011/12 Revised £'000	2012/13 Estimate £'000	2013/14 Estimate £'000	2014/15 Estimate £'000
Gross Borrowing	23,261	25,168	29,393	32,855
Investments	1,000	2,000	1,500	1,000
Net Borrowing	22,261	23,168	27,893	31,855
CFR	23,261	25,168	29,393	32,855

3.3 The Treasurer reports that the Authority complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the budget report.

3.4 **The Authorised Limit** – this represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the Fire and Rescue Authority. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

3.5 **The Operational Boundary** – this indicator is based on the probable external debt during the course of the year; it is not a limit. Actual external debt could vary around this boundary for short times during the year. It should act as a monitoring indicator to ensure the authorised limit is not breached.

3.6 Members are asked to approve the following authorised limit and operational boundary:

	2011/12 Revised £'000	2012/13 Estimate £'000	2013/14 Estimate £'000	2014/15 Estimate £'000
Authorised Limit	25,261	27,168	31,393	34,855
Operational Boundary	23,261	25,168	29,393	32,855

4. EXPECTED MOVEMENT IN INTEREST RATES

4.1 Interest rate movement can be linked to the economic activity of the major economies and to estimate the movement in rates economists will look at current conditions and estimate future economic growth to predict the changes in rates. Given the current turbulent conditions there is some uncertainty over the future movement in rates especially in the long term. The current advice from our Treasury Consultants is to delay borrowing activity involving fixed rates of interest and if cash is required then variable rate PWLB and temporary borrowing should be undertaken where possible. A brief explanation of why there is uncertainty over future movement in rates is discussed below.

4.2 The austerity measures in the UK aimed at getting the public sector deficit into order have yet to fully impact on the economy. However coming at a time when economic growth has virtually flatlined and concerns at the risk of a technical recession (two quarters of negative growth) in 2012, it looks likely that the private sector will not make up for the negative impact of the austerity measures given the lack of an export led recovery due to the downturn in our major trading partner, the EU.

4.3 The rating agencies have recently reaffirmed the UK's triple A sovereign rating and have expressed satisfaction with the government's policy of deficit reduction. This credit position has ensured that the UK Government is able to fund itself at historically low levels and with the safe haven status from Eurozone debt also drawing in external investment the pressure on rates has been down, and looks set to remain so for some time.

4.4 It is thought that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in this country and the high volume of debt issuance in other western countries. Given the weak outlook for economic growth, the prospect for any interest rate changes before mid-2013 is very limited. There is the potential of Bank Rate increases to be even further delayed if growth disappoints.

	Base Rate	5-year Gilt	25-year Gilt	50-year Gilt
2011/12	0.5%	2.3%	4.2%	4.3%
2012/13	0.5%	2.4%	4.3%	4.4%
2013/14	0.8%	2.7%	4.6%	4.7%
2014/15	1.5%	3.1%	4.9%	5.0%

5. BORROWING STRATEGY 2011/12 – 2014/15

5.1 The uncertainty over future interest rates increases the risks associated with treasury activity. As a result the Authority will take a cautious approach to its treasury strategy.

5.2 Long-term fixed interest rates are at risk of being higher over the medium term, and short term rates are expected to rise, although more modestly. The Treasurer, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above. It is likely that shorter term fixed rates may provide lower cost opportunities in the short/medium term.

5.3 The PWLB has structured its lending arrangements such that debt restructuring is difficult however with the likelihood of long term rates increasing any possible debt restructuring is likely to focus on switching from longer term fixed rates to cheaper shorter term debt, although the Treasurer and treasury consultants will monitor prevailing rates for any opportunities during the year.

5.4 The option of postponing borrowing and running down investment balances will also be considered. This would reduce counterparty risk and hedge against the expected fall in investments returns. It should be appreciated that the Authority will have to borrow in the future to fund the capital programme.

6. INVESTMENT, COUNTERPARTY AND LIQUIDITY FRAMEWORK

6.1 All investments will be made as cash deposits to banks, building societies and local authorities. Some loans will be made through one of several broking firms who are used by Conwy and others will be direct with the institution. The majority of investments will be no longer than 364 days and will be made according to the latest market forecasts.

6.2 The Treasurer will maintain a counterparty list in compliance with the following criteria:-

Banks £5m limit
All UK banks and their subsidiaries that have good ratings (Fitch or equivalent). This is currently defined as

short term	F1
long term	A

Viability Rating	bbb
Support	3

Banks whose ratings fall below those in the table above will be used if wholesale deposits are covered by a government guarantee.

Central Government £5m limit
Debt management Office

Local Authorities £2m limit
All except those subject to limitation of council tax and precepts under Part 1 of the Local Government Finance Act 1992.

Building Societies £2m limit
Building societies with a rating (as for the banking sector).

Building Societies (Assets £1bn) -£2m /9mths limit
Building societies without a rating but with assets of £1billion or more.

6.3 The criteria set out above for choosing counterparties provide a sound approach to investment and are designed to reduce the financial risks to the Authority of investing money on the money market. Counterparties are monitored closely to ensure institutions on the counterparty list meet the above criteria and treasury staff will adjust activities at short notice to protect the Authority's position.

7. TREASURY PERFORMANCE INDICATORS

7.1 There are three treasury prudential indicators the purpose of which is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs.

7.2 It is recommended that the Authority sets upper and lower limits for the maturity structure of its fixed rate borrowings as follows:

	Upper Limit	Lower Limit
Under 12 Months	55%	0%
12 Months and within 24 Months	55%	0%
24 Months and within 5yrs	50%	0%
5 yrs and within 10 yrs	75%	0%
10 yrs and above	100%	0%

The upper limit for the short term borrowing positions, under 12 months to 5 years, have been increased from 50% to 55% due to the uncertainty in the markets over interest rate rises and on advice from our Treasury Consultants to use temporary borrowing as a short term measure. The use of short term borrowing will also be more cost effective due to the availability of loans from other Local Authorities at very low interest rates.

7.3 It is recommended that the Authority approve the following limits on Fixed and Variable interest rates.

	% Borrowing
Fixed Interest Rate	55 – 100
Variable Interest Rate	0 – 45

INVESTMENT STRATEGY

1. CURRENT OUTLOOK

1.1 **Key Objectives** - The Authority's investment strategy primary objectives are safeguarding the re-payment of the principal and interest of its investments on time first and ensuring adequate liquidity second – the investment return being a third objective. The current investment climate has one over-riding risk that of counterparty security risk. As a result of these underlying concerns officers are implementing an operational investment strategy which tightens the controls already in place in the approved investment strategy.

1.2 Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of the current 0.5% Base rate remaining into late 2013, with small increases thereafter leaving the rate at 1.5% by the end of 2015. The Authority's investment decisions are based on comparisons between the rises priced into market rates against the Authority's and advisers own forecasts.

1.3 There is a clear operational difficulty arising from the current banking crisis. Ideally investments would be invested longer to secure better returns, however uncertainty over counterparty creditworthiness suggests shorter dated would provide better security.

1.4 The money available for investment currently is very low due to the level of commutation payments made so far this year which have not yet been offset by Top Up Grant; and postponing borrowing by using investment balances to fund the capital programme temporarily.

2. NATIONAL ASSEMBLY FOR WALES INVESTMENT GUIDANCE

2.1 The National Assembly for Wales issued Investment Guidance in March 2004, and this forms the structure of the Authority's policy below.

2.2 The key intention of the Guidance is to maintain the current requirement for Authorities to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective, the guidance requires this Authority to have regard to the CIPFA publication "Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes". This Authority adopted the Code on 15 December 2003 and will apply its principles to all investment activity. In accordance with the Code the Treasurer has produced its treasury management practices, TMP 1(5), covering investment counterparty policy which requires approval each year.

2.3 Annual Investment Strategy - Approved Instruments

The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

(i) The strategy guidelines for decision making on investments, particularly non-specified investments.

(ii) The principles to be used to determine the maximum periods for which funds can be committed.

(iii) Specified investments the Authority will use. These are high security and high liquidity investments in sterling and with a maturity of no more than a year.

(iv) Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

2.4 The investment policy proposed for the Authority is:

(i) Strategy Guidelines –
The main strategy guidelines are outlined above with the emphasis on security and liquidity.

(ii) Investment Periods –
The Authority's policy is to lend funds for a maximum of 364 days.

(iii) Specified Investments – These investments are sterling investments of not more than one-year maturity. These are low risk assets where the possibility of loss of principal or investment income is small. These would include investments with the:

The Treasury Debt Management Office
Other Local Authorities (except rate capped)
All UK Banks and Building Societies with a high credit rating

(iv) Non-Specified Investments –
Non-specified investments are any other type of investment (i.e. not defined as Specified above). This includes Building Societies with no rating and lending for more than 364 days. The limit for "non-specified" investments had been set at £4m.

APPENDIX D

Minimum Revenue Provision Statement

Background

1. The Capital Financing Requirement (CFR) is simply the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources and is essentially a measure of the Authority's underlying borrowing need. The Authority is required to pay off an element of the accumulated capital spend each year through a charge to the revenue account (the MRP) although it is also allowed to undertake additional voluntary payments.

2. Regulations have been issued which require the Fire and Rescue Authority to approve an MRP statement in advance of each year.

MRP Policy

3. Members are recommended to approve the following MRP policy:

    For capital expenditure incurred before 1 April 2012 and any subsequent expenditure the MRP policy will be to repay
    - 4% of the outstanding balance of capital expenditure incurred on Land & Buildings
    - and for Vehicles, Plant, Equipment and Infrastructure the MRP will be based on the estimated life of the assets.

4. The above policy is in line with the Regulations and also follows the practice operated by the Fire and Rescue Authority for a number of years. The budget for 2012/13 approved by Members in December 2011 was set using the above practices.