NOTTINGHAMSHIRE
Fire & Rescue Service
Creating Safer Communities

Nottinghamshire and City of Nottingham
Fire and Rescue Authority

PRUDENTIAL CODE FOR CAPITAL FINANCE 2017/18

Joint Report of the Treasurer and Chief Fire Officer

Date: 24 February 2017

Purpose of Report:

To inform Members of the Authority's obligations under the CIPFA Prudential Code for Capital Finance.

To seek the approval of Members to the proposed capital plans, prudential limits, and monitoring processes set out in the report.

CONTACT OFFICER

Name :	Sue Maycock Head of Finance
Tel :	(0115) 967 0880
Email :	sue.maycock@notts-fire.gov.uk
Media Enquiries Contact :	Therese Easom (0115) 967 0880 therese.easom@notts-fire.gov.uk

1. BACKGROUND

1.1 The Local Government Act 2003 set out a framework for the financing of capital investments in local authorities which came into operation from April 2004. Alongside this, the Prudential Code was developed by the Chartered Institute of Public Finance and Accountancy (CIPFA) as a professional code of practice to support local authorities' decision making in the areas of capital investment and financing. Authorities are required by regulation to have regard to the Prudential Code, which CIPFA updated in 2011.

1.2 The objectives of the Prudential Code are to ensure that the capital investment plans of authorities are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice. In exceptional cases, the Code should provide a framework which will demonstrate where the objectives may not be ensured, so that timely remedial action can be taken.

1.3 The Prudential Code sets out a number of indicators which authorities must use to support decision making. These are not designed to be comparative performance indicators. In addition, the CIPFA Treasury Management code of practice and guidance notes (also updated in 2011) sets out a series of treasury indicators. The prudential and treasury indicators should be considered in parallel and they are therefore included together in this report.

1.4 This report sets out the proposed prudential and treasury limits for the Authority for the 2017/18 financial year along with the implications of the proposed Capital Programme, which will be presented with the budget report elsewhere on the agenda.

1.5 Reports which monitor the Authority's performance against these indicators will be presented to the Finance and Resources Committee throughout the year.

2. REPORT

PRUDENTIAL INDICATORS FOR AFFORDABILITY

2.1 **Estimates of the Ratio of Financing Costs to Net Revenue Stream for 2016/17, 2017/18, 2018/19 and 2019/20 and Actual Ratio of Financing Costs for 2015/16**

2015/16 Actual £000s	2016/17 Estimate £000s	2017/18 Estimate £000s	2018/19 Estimate £000s	2019/20 Estimate £000s
Ratio of Financing Costs to Net Revenue Stream				
4.5%	5.3%	6.0%	6.6%	6.9%

2.1.1 On 24 October 2008 the Finance and Resources Committee considered a report on Sustainable Capital Plans. This report concluded that in order to meet the Prudential Code requirements of affordability and sustainability, the ratio of financing costs to net revenue stream should not exceed 8%. This ratio has increased from 4.5% in 2015/16 to an estimated 5.3% in 2016/17. This is largely due to an increase in the minimum revenue provision in 2016/17, particularly in relation to capital expenditure in 2015/16 on IT equipment, land and buildings, and appliances.

2.1.2 The estimated ratios for 2017/18 onwards assume an annual council tax increase of 1.95%. The ratio increases between 2016/17 and 2019/20 as the financing costs increase year on year whilst the revenue stream is initially reduced due to funding cuts. However, the rate at which the ratio increases slows towards the end of this four year period as projected increases in council tax begin to compensate for reductions in external funding and the net revenue stream starts to slowly increase again from 2018/19 onwards. If no increase in council is assumed, the ratio increases to 7.2% by 2019/20. The projected ratio is still within the 8% limit.

2.1.3 **Estimates of the Incremental Impact of the New Capital Investment Decisions on the Council Tax (Band D) for 2017/18, 2018/19 and 2019/20, and the Actual Incremental Impact on Council Tax for 2016/17**

2016/17 Actual £000s	**2017/18 Estimate £000s**	**2018/19 Estimate £000s**	**2019/20 Estimate £000s**
Incremental Impact on Council Tax			
£0.55	£0.40	£0.84	£0.53

The table above shows that the effect of increased financing costs in 2016/17 compared with 2015/16, resulting in an increase in the incremental impact on council tax in that year. Beyond 2016/17 the incremental impact fluctuates, reflecting the varying rate at which the net financing costs are expected to increase from one year to the next.

PRUDENTIAL INDICATORS FOR PRUDENCE

2.2 Gross Debt and the Capital Financing Requirement

In order to ensure that over the medium term gross debt will only be for capital purposes, this indicator requires that external debt does not, except in the short term, exceed the total of the capital financing requirement estimated up to the end of 2019/20. Performance against this indicator will be monitored throughout the year. For information, at 31 March 2016 (2015/16 financial year), the Capital Financing Requirement was £25,758k, Net Debt (total debt less investments) was £14,908k and Gross Debt was £20,393k. The estimate of the Capital Financing Requirement at the end of 2019/20 is £28,676k, thereby demonstrating that the indicator has not been breached. At the end of 2019/20, Gross Debt is expected to be in the region of £23.3m, with the Capital Financing Requirement estimated at £28.7m showing that this indicator should be achievable.

2.3 **Treasury Management**

As required by this indicator, the Authority has adopted the CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes.

PRUDENTIAL INDICATORS FOR CAPITAL EXPENDITURE AND EXTERNAL DEBT

2.4 **Estimate of Total Capital Expenditure to be Incurred in 2016/17, 2017/18, 2018/19 and 2019/20, and Actual Capital Expenditure for 2015/16**

2015/16 Actual £000s	2016/17 Estimate £000s	2017/18 Estimate £000s	2018/19 Estimate £000s	2019/20 Estimate £000s
Capital Expenditure Total				
5,282	3,588	5,113	989	3,588
Capital Expenditure – Financed by Borrowing / Finance Lease				
3,600	1,701	948	-1,327	1,596
Capital Expenditure – Financed by Revenue Contributions				
109	190	0	0	0
Capital Expenditure – Financed by Internal Funds				
1,103	1,402	1,580	1,883	1,962
Capital Expenditure – Financed by Capital Grant				
440	280	117	41	0
Capital Expenditure – Financed by Capital Receipt				
30	15	2,468	392	30

The estimates for 2017/18 to 2019/20 are submitted to the Fire Authority for approval elsewhere on this agenda. However, the totals shown in the above table includes assumed slippage in addition to new capital expenditure and are therefore higher than the estimates included in the Budget Report. The final capital expenditure for each year may be different from the figures shown above but overall should be similar. Various financing methods have been assumed for the future years but in reality, decisions relating to financing methods will be taken as part of options analyses which will consider the best long term options for the Authority. These options need to be assessed at the time of financing. “Internal funds” in the above table refers to the use of cash available within budgeted resources generated by the minimum revenue provision charge, which is a non-cash transaction. Unused cash from this source is assumed to be carried forward for use in future years. In 2018/19 the amount to be financed by borrowing or leasing is shown as a negative figure. This means that our requirement to borrow is reduced by this amount in these years, and this occurs because a decision has been made to apply a level of financing from capital receipts, grants, and internal funds which is greater than the amount of capital expenditure incurred in those years. This approach has the benefit of reducing capital financing costs in future years.

2.5 **Estimate of Capital Financing Requirement as at the end of 2016/17, 2017/18, 2018/19 and 2019/20, and Actual Capital Financing Requirement as at 31/03/16**

2015/16 Actual £000s	2016/17 Estimate £000s	2017/18 Estimate £000s	2018/19 Estimate £000s	2019/20 Estimate £000s
Capital Financing Requirement				
25,758	27,459	28,407	27,080	28,676

2.5.1 The Capital Financing Requirement is the sum of money required from external sources to fund Capital Expenditure, and represents the Authority's underlying need to borrow for capital purposes. It will therefore be the aggregate of all capital expenditure, less any revenue contributions, capital grants or capital receipts. The above table shows that the Capital Financing Requirement increases year on year between 2015/16 and 2017/18 as annual capital expenditure exceeds the funding available from capital receipts, government grants and internal sources. However, in 2018/19 capital expenditure is forecasted to decrease by £4.1m to £989k and this causes the capital financing requirement to decrease as capital receipts and internal funds will exceed capital expenditure. The capital financing requirement then increases again from 2018/19 to 2019/20 as capital expenditure is forecasted to increase from £989k to £3.6m.

2.5.2 The Sustainable Capital Plans report referred to in paragraph 2.1 also concluded that in order to meet the Prudential Code requirements of affordability and sustainability, the capital financing requirement in future years should not exceed £40m.

Operational Boundary and Authorised Limit for External Debt

2.6 The Operational Boundary is the Authority's estimate of its total external debt, including other long-term liabilities (such as finance leases) which are separately identified. This is to reflect the most likely scenario and not the worst case. It is possible for the operational boundary to be temporarily breached to take account of unusual movements in cash flow but this should not be a regular occurrence. A variation from the operational boundary is permissible, but will be reported to the Fire Authority.

2.7 The Authorised Limit is essentially the same as the Operational Boundary but allows headroom over and above it to take account of unusual movements in cash flow and therefore should be the maximum amount of external debt that the Authority is exposed to at any given time. Any proposed variation from the Authorised Limit must be authorised by the Fire Authority

2.8 Cash flow forecasts have been prepared for 2017/18 to 2019/20 and indicate that there will be no difficulty in maintaining a positive current account balance on a month by month basis and therefore there is no proposal to seek an increase in the Authority's approved overdraft limit of £200,000. However, previous experience shows that these estimates can sometimes be wrong temporarily due to delays in income receipts and it has proved necessary in the past to negotiate temporary increases in this figure of up to £500,000. It is therefore proposed that this buffer of £500,000 should be included within both the operational boundary and the authorised limit.

	2017/18 £000s	**2018/19 £000s**	**2019/20 £000s**
Operational Boundary			
O.B. for borrowing	27,762	30,183	30,100
O.B. for other long term liabilities	0	0	0
Total - Operational Boundary for External Debt	27,762	30,183	30,100
Authorised Limit			
A.L. for borrowing	30,538	33,201	33,110
A.L. for other long term liabilities	0	0	0
Total - Authorised Limit for External Debt	30,538	33,201	33,110

2.9 **Actual External Debt as at 31/03/16**

	2015/16 £000s
Actual borrowing	20,337
Actual other long term liabilities	0
Total – Actual External Debt	20,337

INDICATORS FOR TREASURY MANAGEMENT

2.10 The Service carries out its own treasury management in accordance with the CIPFA Code of Practice for Treasury Management, which was revised in 2011. The Authority has adopted a low risk approach to treasury management, which seeks to ensure that investments are secure and that there is sufficient liquidity of funds to enable the Authority carry out its business.

Gross and Net Debt

2.11 The actual amount of external long term borrowing as at 31/03/16 was £18,262k, with short term borrowing totalling £2,075k. There were no other long term liabilities at the same date. At the same date, the amount of investments was £5,485k, giving a net debt position of £14,852k as at 31/03/16.

2.12 The Treasury Management Strategy 2016/17 report, which is elsewhere on this agenda, outlines the proposal to borrow over the next three years to finance the capital programme and to replace maturing loans, and the decision about when to borrow will depend upon interest rate forecasts. For the purposes of setting indicators, assumptions have been made about when borrowing may take place – the reality of this will be determined by Officers in conjunction with the Authority's treasury advisers.

2.13 The proportion of net debt to gross debt can highlight where an Authority is borrowing in advance of need, as it shows the extent to which funds have been borrowed and then invested. Whilst the Authority is permitted to borrow in advance to finance the capital programme approved within the Medium Term Financial Strategy, where borrowing rates are higher than investment rates this creates a "cost of carry". Therefore when investment interest rates are low, as they currently are, this cost is reduced by keeping the proportion of net debt to gross debt as high as is practicable. For information, the proportion of net debt to gross debt as at 31 March 2016 was 73%, and it is forecast to be 76% at the end of the current financial year. It is proposed that the Authority sets the following limits for the proportion of net debt to gross debt:

	2017/18	2018/19	2019/20
Lower limit for proportion of net debt to gross debt	50%	50%	50%
Upper limit for proportion of net debt to gross debt	85%	85%	85%

Interest Rate Risk Exposure

2.14 In terms of borrowing, it has been considered prudent to use Public Works Loans Board (PWLB) fixed interest loans on most occasions. This is because the PWLB generally offers rates which cannot be obtained elsewhere in the marketplace. However the Authority did take out a market loan in 2007/08, benefiting from an advantageous rate. Unlike lending, borrowing is a low risk activity so future borrowing arrangements will be entered into on the basis of what is most advantageous for the Authority at the time. Any proposals to borrow from alternative sources to the PWLB will be discussed and agreed with the Treasurer.

2.15 Borrowing in the past has been at fixed interest rates although variable rates are not ruled out. It is therefore considered that up to 30% of borrowing might come from variable rate sources if these are considered financially advantageous at the time of financing. For policy changes beyond this, however, it is suggested that Fire Authority approval should be sought.

2.16 The total value of lending is not expected to exceed £13m, which is likely to peak around July 2017 however it is difficult to assess what the likely investment profile might be as this depends upon capital expenditure timings as well as the level of pension top up grant received from the Government, and the timing of borrowing. The aim will be to reduce risk by investing funds in more than one institution at any given time. Members should note, however, that it is not feasible to set a maximum limit for investing with any one institution as the numbers of banks which meet our minimum credit rating criteria is now very few and even those on the list will not always accept our investments as the Authority is a “small player”. The Authority can also invest in Money Market Funds and certificates of deposit in line with the Treasury Management Strategy.

2.17 It is proposed that the Authority sets the following limits for interest rate exposures:

	Benchmark %	**2016/17 %**	**2017/18 %**	**2018/19 %**	**2019/20 %**
Interest Rate Exposures					
Upper Limit for fixed rate exposures	100%	100%	100%	100%	100%
Upper Limit for variable rate exposures	30%	30%	30%	30%	30%

Loan Maturity

2.18 The code of practice and CIPFA guidelines state that there should be no direct linkage between the assets financed and the term of loans taken out. Upper limits in terms of loan maturity are set to ensure that the Authority is not exposed to the risk of having to repay loans and then re-borrow in the short term when interest rates might be high.

2.19 It is recommended that the maturity structure limits remain unchanged for 2017/18. The Authority holds a loan of £4m which is structured as a “Lender Option Borrower Option” (LOBO) loan. This means that on 7 March 2013 and every five years thereafter, the lender may revise the interest rate. The Authority may choose to repay the loan without penalty if the amended rate is not advantageous. The rate was not changed on 7 March 2013, so the next opportunity for revision is 7 March 2018. Unless the Authority chooses to repay the loan early due to an unfavourable interest rate change, the loan will mature in 2078. The uncertainty around the maturity date of this loan has an impact on the calculation of the maturity structure of the Authority’s borrowing. If the loan were to mature in 2018, as is possible under the terms of the LOBO agreement, the limit for debt maturing between 12 months and 5 years will be breached. However, as the risk of the LOBO rate increasing during the medium term is low due to downward pressures on interest rates, the re-financing risk arising from the loan maturing within 5 years is low. Therefore a breach of this nature would be considered acceptable.

Limits on the Maturity Structure of Borrowing		
	Upper Limit	Lower Limit
Under 12 months	20%	0%
12 months to 5 years	30%	0%
5 years to 10 years	75%	0%
10 years to 20 years	100%	0%
Over 20 years	100%	30%

2.20 **Principal Sums Invested for Periods Longer than 365 Days**

Investments arising from borrowing to support the capital programme are unlikely to exceed one year in duration, however for surplus cash which supports reserves it may be desirable to invest monies for a slightly longer period to achieve a level of certainty around interest receipts and perhaps beneficial interest rates. Such decisions will be influenced by market conditions at the time and the liquidity of funds will be of paramount importance. It is proposed that Officers should be able to invest monies for longer than a year if this appears to be an advantageous strategy, but that a maximum limit of £2m be applied to any such investments. This will contain the Authority's exposure to the possibility of loss arising from having to seek early repayment of investments.

2016/17 £000s	2017/18 £000s	2018/19 £000s
Prudential Limits for Principal Sums Invested for Periods Longer than 365 Days		
2,000	2,000	2,000

3. FINANCIAL IMPLICATIONS

The financial implications are set out in full within the body of the report.

4. HUMAN RESOURCES AND LEARNING AND DEVELOPMENT IMPLICATIONS

There are no specific human resources or learning and development implications which arise directly from this report.

5. EQUALITIES IMPLICATIONS

This is not a new policy or service, so no initial assessment has been completed. A previous assessment has shown that there are no specific equality impacts which arise directly from the Prudential Code.

6. CRIME AND DISORDER IMPLICATIONS

There are no specific crime and disorder implications which arise directly from this report.

7. LEGAL IMPLICATIONS

The Local Government Act 2003 imposes an obligation on the Authority to agree and monitor its prudential indicators.

8. RISK MANAGEMENT IMPLICATIONS

The risk exposures in this report relate primarily to three areas:

- The risk of over exposure of the Authority to interest rate fluctuations;
- The risk that the Authority has an unmanageable or unaffordable level of borrowing;
- The risk of tying up investments, thereby reducing liquidity and exposing the Authority to possible losses arising from early repayment of investments.

This paper serves to set out those risks and ensure that they are managed.

9. RECOMMENDATIONS

That Members approve the Prudential Limits for 2017/18 as follows:

Estimate of Ratio of Financing Costs to Net Revenue Stream	6.0%
Estimate of the Incremental Impact of the New Capital Investment Decisions on the Council Tax (Band D)	£0.40
Estimate of Total Capital Expenditure to be Incurred	£5,113,000
Estimate of Capital Financing Requirement	£28,407,000
Operational Boundary	£27,762,000
Authorised Limit	£30,538,000

Upper limit for fixed rate interest exposures	100%
Upper limit for variable rate interest exposures	30%
Loan Maturity:	Limits:
Under 12 months	Upper 20% Lower 0%
12 months to 5 years	Upper 30% Lower 0%
5 years to 10 years	Upper 75% Lower 0%
Over 10 years	Upper 100% Lower 0%
Over 20 years	Upper 100% Lower 30%
Upper Limit for Principal Sums Invested for Periods Longer than 365 Days	£2,000,000

10. BACKGROUND PAPERS FOR INSPECTION (OTHER THAN PUBLISHED DOCUMENTS)

None.

John Buckley
CHIEF FIRE OFFICER

Neil Timms
TREASURER TO THE FIRE AUTHORITY