NOTTINGHAMSHIRE
Fire & Rescue Service
Creating Safer Communities

Nottinghamshire and City of Nottingham
Fire and Rescue Authority

PRUDENTIAL CODE FOR CAPITAL FINANCE 2019/20

Joint Report of the Treasurer and Chief Fire Officer

Date: 15 February 2019

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.

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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.

1.2 CIPFA released an updated version of the Prudential Code in December 2017. The revised code is in a similar format to the previous 2011 edition, but includes the removal of some indicators and a new requirement for authorities to produce a Capital Strategy. The Authority's Capital Strategy was presented to the members at the December 2018 meeting of the Fire Authority.

1.3 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.

1.4 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 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. The most recent version of the Prudential Code removed the requirement to produce the "Incremental Impact on Council Tax" indicator.

1.5 In addition to the indicators that are required by the Prudential Code and the Treasury Management Code of Practice, this report proposes the adoption of a local indicator for internal borrowing and investment benchmarks which will help the Authority to more effectively manage the risks involved with certain elements of treasury management activity.

1.6 This report sets out the proposed prudential and treasury limits for the Authority for the 2019/20 financial year along with the implications of the proposed Capital Programme, which will be presented with the budget report also on the agenda.

1.7 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 2018/19, 2019/20, 2020/21 and 2021/22 and Actual Ratio of Financing Costs for 2017/18**

2017/18 Actual £000s	2018/19 Estimate £000s	2019/20 Estimate £000s	2020/21 Estimate £000s	2021/22 Estimate £000s
Ratio of Financing Costs to Net Revenue Stream				
5.5%	5.3%	5.5%	6.3%	6.2%

2.2 On 24 October 2008 the Finance and Resources Committee set a maximum limit of 8% for this ratio in order to meet the Prudential Code requirements of affordability and sustainability (as part of the Sustainable Capital Plans report). This is periodically reviewed by Treasury staff and it is still felt to be appropriate. This ratio is set to increase from 5.3% in 2018/19 to 6.3% in 2020/21. This is largely due to an increase in the minimum revenue provision as a result of significant capital expenditure in 2019/20 on equipment including replacement personal protective equipment. The ratio is then forecast to remain fairly steady at 6.2% as the capital programme remains at a relatively high level in 2020/21 due to the proposed headquarters project. The longer term estimates for this ratio are included in the Medium Term Financial Strategy.

2.3 The estimated ratios for 2018/19 onwards assume an annual council tax increase of 2.95% for the 2019/20 and 1.95% thereafter.

PRUDENTIAL INDICATORS FOR PRUDENCE

Gross Debt and the Capital Financing Requirement

2.4 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 2021/22. Performance against this indicator will be monitored throughout the year. For information, at 31 March 2018 (2017/18 financial year), the Capital Financing Requirement was £26,278k, Net Debt (total debt less investments) was £15,782k and Gross Debt was £25,183k. The estimate of the Capital Financing Requirement at the end of 2021/22 is £32,192k, thereby demonstrating that the indicator has not been breached. At the end of 2021/22, Gross Debt is expected to be in the region of £31.4m, with the Capital Financing Requirement estimated at £32.2m showing that this is realistic.

PRUDENTIAL INDICATORS FOR CAPITAL EXPENDITURE AND EXTERNAL DEBT

2.5 **Estimate of Total Capital Expenditure to be Incurred in 2018/19, 2019/20, 2020/21 and 2021/22, and Actual Capital Expenditure for 2017/18**

	2017/18 Actual £000s	2018/19 Estimate £000s	2019/20 Estimate £000s	2020/21 Estimate £000s	2021/22 Estimate £000s
Capital Expenditure	**4,060**	**1,913**	**5,448**	**4,296**	**2,204**
Funded by:					
Borrowing	1,916	0	3,835	1,713	380
Revenue	0	110	0	0	0
MRP re-investment	1,490	1,454	1,613	1,933	1,824
Capital Grant	25	0	0	0	0
Capital Receipts	629	349	0	650	0
Total	**4,060**	**1,913**	**5,448**	**4,296**	**2,204**

2.6 The estimates for 2019/20 to 2021/22 form part of the budget report on this agenda. However, the totals shown in the above table include assumed slippage in addition to new capital expenditure and are therefore higher than the estimates included in the budget report. 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. “MRP re-investment” in the above table refers to the use of the minimum revenue provision which is used to reduce the borrowing need rather than repayment of debt due to the Authority’s loans being payable on maturity.

2.7 **Estimate of Capital Financing Requirement as at the end of 2018/19, 2019/20, 2020/21 and 2021/22, and Actual Capital Financing Requirement as at 31/03/18**

2017/18 Actual £000s	2018/19 Estimate £000s	2019/20 Estimate £000s	2020/21 Estimate £000s	2021/22 Estimate £000s
Capital Financing Requirement				
26,278	26,263	30,098	31,811	32,192

2.8 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 2017/18 and 2021/22 as annual capital expenditure exceeds the funding available from capital receipts, government grants and revenue sources.

2.9 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

2.10 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 upper limit of debt. 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.

2.11 The operational boundary includes allowances to borrow to fund the capital programme, replace maturing debt and to allow for any short term borrowing that may be needed to cover the cashflow of the authority.

2.12 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.

	2018/19 £'000s	**2019/20 £000s**	**2020/21 £000s**	**2021/22 £000s**
Operational Boundary				
Borrowing	34,239	30,600	33,512	32,959
Other long term liabilities	0	0	0	0
Total External Debt	34,239	30,600	33,512	32,959
Authorised Limit				
Borrowing	36,663	32,660	35,863	35,255
Other long term liabilities	1,000	1,000	1,000	1,000
Total External Debt	37,663	33,660	36,863	36,255

2.13 **Actual External Debt as at 31/03/18**

	2017/18 £000s
Actual borrowing	25,183
Actual other long term liabilities	0
Total – Actual External Debt	**25,183**
Operational Boundary	29,723
Authorised Limit	32,695

INDICATORS FOR TREASURY MANAGEMENT

2.14 The Service carries out its own treasury management in accordance with the CIPFA Code of Practice for Treasury Management, which was revised in 2017. 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 to carry out its business.

Gross and Net Debt

2.15 The actual amount of external long term borrowing as at 31/03/18 was £20,599k, with short term borrowing totalling £4,584k. There were no other long term liabilities at the same date. At the same date, the amount of investments was £9,401k, giving a net debt position of £15,782k as at 31/03/18.

2.16 The Treasury Management Strategy 2018/19 report, also 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.

2.17 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 2018 was 63%, and it is forecast to be 71% 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:

	2019/20	2020/21	2021/22
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

2.18 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.

2.19 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 proposed that Fire Authority approval should be sought.

2.20 The total value of lending is not expected to exceed £8m, which is likely to peak around July 2019 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. All investments are made in line with the Treasury Management Strategy.

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

	Benchmark %	2018/19 %	2019/20 %	2020/21 %	2021/22 %
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%

2.22 In addition to the upper limit for variable rate exposures in relation to external debt, it is proposed that the Authority adopts a local indicator to set a limit for the acceptable level of internal borrowing. This is because the use of internal borrowing exposes the Authority to interest rate risk, as there is a chance that cash balances may need to be replenished at a time when interest rates are higher. In this respect, internal borrowing is effectively variable rate debt. The level of internal borrowing is calculated as follows:

Capital Financing Requirement – External Borrowing = Internal Borrowing

2.23 At 31 March 2018 internal borrowing was £1,095k, which was 4% of the Capital Financing Requirement.

It is proposed that the Authority sets the following limits for internal borrowing:

	2019/20 %	2020/21 %	2021/22 %
Upper Limit for internal borrowing as a % of the Capital Financing Requirement	20%	20%	20%

Investment Benchmarking

2.24 The Treasury Management Strategy 2019/20, which is also on this agenda, recommends that the Authority adopts the following local benchmarks to assess the security, liquidity and yield of its investments:

- Security: a risk benchmark of 0.08% historic default when compared to the whole investment portfolio.
- Liquidity: a “Weighted Average Life of investments” benchmark of approximately 3 months, with an upper limit of 0.40 years.
- Yield: internal returns to be above a benchmark of the 3 month London Interbank Bid Rate (LIBID).

2.25 Further details of these recommended benchmarks can be found in the Treasury Management Strategy 2019/20.

Loan Maturity

2.26 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.

2.27 It is recommended that the maturity structure limits remain unchanged for 2019/20. The Authority holds a loan of £4m which is structured as a “Lender Option Borrower Option” (LOBO) loan. Whilst the end date of the loan is March 2078 there are options every five years for the lender to revise the interest rate. The Authority may choose to repay the loan without penalty if the amended rate is not advantageous. The next opportunity for the revision of the interest rate is 7 March 2023. The limits for these years will be kept under review to reflect that the investment may mature on these dates. 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 currently considered to be low.

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%

Principal Sums Invested for Periods Longer than 365 Days

2.28 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.

2019/20 £000s	2020/21 £000s	2021/22 £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. COLLABORATION IMPLICATIONS

There are no collaboration implications arising from this report.

10. RECOMMENDATIONS

It is recommended that Members:

10.1 Approve the Prudential Limits for 2019/20 as follows:

Estimate of Ratio of Financing Costs to Net Revenue Stream	5.5%
Estimate of Total Capital Expenditure to be Incurred	£5,448,000
Estimate of Capital Financing Requirement	£30,098,000
Operational Boundary	£30,600,000
Authorised Limit	£33,660,000
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

10.2 Approve the following local indicator for 2019/20:

Upper limit for internal borrowing as a % of the Capital Financing Requirement	20%

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

None.

John Buckley
CHIEF FIRE OFFICER

Charlotte Radford
TREASURER TO THE FIRE AUTHORITY