Appendix 1

ANNUAL REPORT
ON

TREASURY MANAGEMENT & ACTUAL PRUDENTIAL INDICATORS

2007/08

INTRODUCTION

1. The Council undertakes capital expenditure on long-term assets. These activities may either be:-
   - Financed immediately through capital receipts, capital grants etc.; or
   - Through borrowing.

2. Part of the Council's treasury activities is to address this borrowing need, either through borrowing from external bodies, or utilizing temporary cash resources within the Council. The wider treasury activities also include managing the Council's cash flows, its previous borrowing activities and the investment of surplus funds. These activities are structured to manage risk foremost, and then optimize performance. The CIPFA Code of Practice on Treasury Management regulates this area of activity.

3. Wider information on the regulatory requirements is shown in paragraphs 32 to 35.

THE COUNCIL'S CAPITAL EXPENDITURE AND FINANCING 2007/08

4. Actual capital expenditure forms one of the required prudential indicators. The table below also shows how this was financed.

	2006/07	**2007/08**	
	Actual £000's	**Estimate £000's**	**Actual £000's**
Total capital expenditure	53,162	69,335	60,290
Resourced by:			
Capital Receipts	8,121	14,478	8,978
Capital grants	34,229	35,288	30,375
Capital reserves	1,437	5,108	5,903
Revenue	2,366	3,211	4,873
Unfinanced capital expenditure (additional need to borrow)	7,009	11,250	10,161

THE COUNCIL'S OVERALL BORROWING NEED

5. The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This figure is a gauge for the Council's debt position and represents 2007/08 and prior years net capital expenditure that has not been charged to revenue. The Non-Housing Revenue Account element of the CFR is reduced each year by a statutory revenue charge (called the Minimum Revenue Provision – MRP). The total CFR can also be reduced by:-
   - The application of additional capital resources (such as unapplied capital receipts); or
   - Charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision.

6. With effect from 1st April 2008 the Department for Communities and Local Government introduced new MRP guidance which requires an MRP Policy to be approved by members. This policy was included in the Treasury Management

Strategy for 2008/09 – 2010/11 which was contained with the Review of the Medium Term Financial Plan and Budget 2008/2009 Report agreed by Council on 27th February 2008. For 2007/08 MRP has been calculated on the basis of 4% of the Council's Capital Finance Requirement. The Council's CFR for the year is shown below, and represents a key prudential indicator.

Capital Financing Requirement	**31st March 2007**	**31st March 2008**	
	Actual £000's	**Original Indicator £000's**	**Actual £000's**
Opening balance 1st April	258,778	259,943	259,876
Plus unfinanced capital expenditure	7,008	8,521	-3,959
Less MRP	5,910	5,457	5,454
Closing balance 31st March	259,876	263,007	250,463

TREASURY POSITION at 31st MARCH 2008

7. Whilst the Council's gauge of its underlying need to borrow is the Capital Financing Requirement, the Corporate Director of Resources can manage the Council's actual borrowing position by either:-
    - Borrowing to the CFR;
    - choosing to utilize some temporary cash flow funds instead of borrowing (under borrowing); or
    - borrowing for future increases in the CFR (borrowing in advance of need).

8. It should be noted that the accounting practice required to be followed by the Council (the Statement of Required Practice) changed in the 2007/08 accounts, and required financial instruments (debt and investments) to be measured in a method compliant with national Financial Reporting Standards. The figures based in this report are based on the amounts borrowed and invested and so may differ from those in the final accounts by items such as accrued interest.

9. During 2007/08 borrowing was undertaken only to reschedule some of the Council's higher interest debt. During 2006/07 the Corporate Director of Resources decided to take advantage of low long-term interest rates and borrow in advance of need. Part of these funds were used to meet the Council's borrowing requirement in 2007/08. In addition, the proceeds from the sale of Billingham Town Centre were used to repay debt, which reduces the Council's CFR and therefore reduces the statutory MRP charge. These savings are being used to provide funds for the refurbishment of Billingham Forum. The effects of these changes mean that the Council is still over borrowed at the end of March 2008 when compared to the Council's Capital Financing Requirement. The treasury position at the 31st March 2008 compared with the previous year is shown in the tables below.

	31st March 2007		31st March 2008	
	Principal £m	**Average Rate %**	**Principal £m**	**Average Rate %**
BORROWING				
Fixed Interest Rate Debt	239.258	5.97	238.998	5.73
Variable Interest rate Debt	28.652	4.91	16.000	4.86
Total Debt	267.910	5.69	254.998	5.67

	31st March 2007		31st March 2008	
	Principal £m	**Average Rate %**	**Principal £m**	**Average Rate %**
INVESTMENTS				
Fixed Interest Investments	100.865	4.87	103.418	5.94
Variable Interest Investments	0.000	0	11.000	6.29
Total Investments	100.865	4.87	114.418	5.95
Net Borrowing Position	167.045		140.580	

PRUDENTIAL INDICATORS AND COMPLIANCE ISSUES

10. Some of the required prudential indicators provide either an overview or specific limits on treasury management activity. These are shown below:-

11. Net borrowing and the Capital Financing Requirement – In order to ensure that borrowing levels are prudent, over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. Net borrowing should not therefore, except in the short term, exceed the Capital Financing Requirement for 2007/08 plus the expected changes to the Capital Financing Requirement in 2008/09 and 2009/10. The table below highlights that the Council has complied with this requirement.

	31st March 2007	31st March 2008	
	Actual **£m**	**Original Indicator** **£m**	**Actual** **£m**
Net borrowing position	167.045	170.957	140.580
Capital Financing Requirement	259,876	263,007	250,463

12. The Authorised Limit - is the "Affordable Borrowing Limit" required by section 3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2007/08 the Council has maintained gross borrowing within its Authorised Limit.

13. The Operational Boundary - is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

14. Actual financing costs as a proportion of 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.

	2007/08
Authorised Limit	£284.800m
Maximum gross borrowing position during 2007/08	£267.942m
Operational Boundary	£261.000m
Average Gross Borrowing position during 2007/08	£256.223m
Minimum Gross Borrowing position during 2007/08	£254.998m
Financing costs as a proportion of net revenue stream	
HRA	21.3%
General Fund	2.2%

<u>ECONOMIC BACKGROUND FOR 2007/08</u>

15. During the first half of the 2007/08 financial year UK interest rates continued to rise. In the early summer the domestic economy continued to present problems for the Monetary Policy Committee. CPI inflation breached the 3% upper limit of the Government's target range in April (reported in May), consumer spending was remaining buoyant and an expanding number of companies expressed their intentions to raise prices. As a consequence base rate was raised to 5.5% in May and 5.75% in July. In addition, the Bank of England's May and August Inflation Reports indicated that more increases in the base rate might be necessary.

16. The financial markets were plunged into chaos in late August as the tightening of credit conditions, triggered initially by the failure of a selection of US mortgage lending institutions, undermined investor confidence. Interest rates rose to well over

6.5% as financial organizations' reluctance to lend money to counterparties sparked a severe shortage of funds in the market. In the UK, the crises came to a head with the failure of the Northern Rock Bank in September. Although the danger of potential meltdown was defused by the Government's decision to guarantee all deposits with this institution, this failed to loosen credit conditions and so the margin between the official bank rate and the rates charged in the financial markets remained stubbornly wide.

17. Central Banks strove to boost market liquidity by injecting funds into the banking system. There were signs that this might be working but a series disappointing financial results and a general distrust in the financial markets ensured that interest rates remained high.

18. The credit crises provoked a significant change in the Bank of England's assessment of UK economic prospects over the medium term. It was clearly concerned that the tightening of liquidity and the consequent rise in borrowing rates across the entire economy could lead to recession. This was considered to be a bigger problem than the risk of higher inflation in the economy. Bank Rate was therefore cut by 0.25% on two occasions, December and February to end the financial year at 5.25%.

19. Long-term (PWLB) interest rates continued to follow an erratic course but the overall trend in the early part of the year was towards higher levels as concerns persisted that interest rates around the world would have to rise to combat mounting inflation pressures. The events in August and September last year caused investors to move funds to more secure investments and consequently this placed downward pressure on Government Gilts. Long term interest rates started to fall, a trend which continued till the end of the financial year.

THE STRATEGY AGREED FOR 2007/08

20. The borrowing strategy for 2007/08 was set against an expected modest rise in long-term fixed interest rates with base rates peaking at 5.25% (base rates actually peaked at 5.75%). Money was borrowed in advance of need in 2006/07 while rates were relatively low and this was used during the year to meet the Council's borrowing requirement. Excluding any Prudential borrowing, the Council's borrowing requirement for 2007/08 was estimated to be approximately £12.8m, of which loan repayments accounted for approximately £12.7m.

21. The Council's investment strategy was again based on the expectation of shorter-term interest rates peaking at 5.25% in early 2007. As a consequence it was expected that, if the opportunity arose then, investments would be made for longer periods with fixed interest rates to lock in good value and security of return.

22. These strategies were set on the understanding that the Corporate Director of Resources would undertake the most appropriate form of borrowing and investments depending on the prevailing interest rates at the time.

ACTUAL DEBT MANAGEMENT ACTIVITY DURING 2007/08

23. Borrowing – Loans totaling £34.853m were drawn to finance the net capital spend,

naturally maturing debt and to reschedule loans. An analysis of these loans is shown at Appendix A.

24. The actual interest rate on these loans was 4.6% and compares with a budget assumption of borrowing at an interest rate of 5%.

25. Rescheduling – On 30/05/2007 the Council repaid £34.853m at an average rate of 4.97% with breakage costs of £51,328. These loans were replaced with £34.853m at a rate of 4.6%. As a result, annual savings of £54,152 will be made to the General Fund after taking account of the effect on the HRA.

26. Change of Policy – In November 2007 the PWLB changed its structure of interest rates so that any repayment of PWLB debt will have a more penal repayment rate applied. As such the cost of rescheduling PWLB will be higher from November onwards and as a consequence opportunities for future rescheduling will be limited.

27. Summary of Debt Transactions – the overall position of the debt activity resulted in a fall in the average rate by 0.02%, representing a net General Fund saving of £237,960 p.a.

INVESTMENT POSITION

28. The Council's investment policy is governed by ODPM Guidance, which is implemented in the annual investment strategy approved by Council on 28/02/2007. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

29. The Council's longer term cash balances comprise primarily revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources comprised as follows, and meet the expectations of the budget:

Balance Sheet Resources	**31st March 2007 £m**	**31st March 2008 £m**
Balances	17.668	20.404
Earmarked reserves	44.196	56.229
Provisions	0.339	.238
Usable Capital Receipts	20.282	22.758
Total	**82.485**	**99.629**

30. The Council does not have the expertise or the resources to use a wide range of investment products and therefore opportunities to invest are limited to cash deposits. During the year the Council maintained an average balance of £125.5m and received an average return of 5.95%. The comparable performance indicator is the average 7-day LIBID rate, which was 5.61%. This compares with a budget assumption of average investment balances of £85.5m at 5.125% interest rate.

PERFORMANCE INDICATORS SET FOR 2007/08

31. The Treasury Management service has set the following performance indicators:-
    - Debt – movement in the Council's consolidated rate of interest over the year (paragraph 27 refers);
    - Debt – rate of new borrowing taken out during the year compared to the rates that were available (paragraph 23 & Appendix A refers);
    - Investments-returns above the 7 day LIBID rate (paragraph 30 refers)

REGULATORY FRAMEWORK RISK AND PERFORMANCE

32. The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:
    - The Local Government Act 2003 (the Act) which provides the powers to borrow and invest as well as providing controls and limits on this activity;
    - The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (although no restrictions were made in 2007/08);
    - Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;
    - The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;
    - The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;
    - Under the Act the ODPM (now DCLG) has issued Investment Guidance to structure and regulate the Council's investment activities.

33. The Council has complied with all the above relevant statutory and regulatory requirements which limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury management practices demonstrate a low risk approach.

34. The Council is aware of the risks of passive management of the treasury portfolio and, with the support of Butlers, the Council's advisers, has proactively managed the debt and investments over the year. The Council has continued to utilise historically low borrowing costs and has complied with its internal and external procedural requirements. There is little risk of volatility of costs in the current debt portfolio as the interest rates are predominantly fixed, using long-term loans.

35. Shorter-term rates and likely future movements in these rates predominantly determine the Council's investment return. These returns can therefore be volatile and, whilst the risk of loss of principal is minimised through the annual investment strategy, accurately forecasting future returns can be difficult.

J Danks
Corporate Director of Resources

Appendix A

ANALYSIS OF LOANS DRAWN DURING 2007/08

Lender	Principal £m	Fixed or Variable Rate	Interest Rate %	Maturity date	Range of interest rates available during the year	
					High %	Low %
PWLB	5.000	Fixed	4.6	31/03/2053	4.95	4.39
PWLB	5.000	Fixed	4.6	30/09/2053	4.95	4.39
PWLB	5.000	Fixed	4.6	31/03/2054	4.95	4.39
PWLB	5.000	Fixed	4.6	30/09/2054	4.95	4.39
PWLB	5.000	Fixed	4.6	31/03/2055	4.95	4.39
PWLB	5.000	Fixed	4.6	30/09/2055	4.95	4.39
PWLB	4.853	Fixed	4.6	31/03/2056	4.95	4.39

Appendix B

DEBT RESTRUCTURING UNDERTAKEN DURING 2007/08

Date of Restru-cturing	Old loans			New Loans			
	No. of Loans	Amount £m	Average Interest Rate %	Fixed/ Variable	Discount Received/ (Premium Paid) £	Interest Rate %	Annual General Fund Saving £
30/05/07	6	34.853	4.97	Fixed	(51,327)	4.60	54,152