MIDDLESBROUGH COUNCIL	Middlesbrough moving forward

Report of:	Director of Finance (S151 Officer)

Submitted to:	Corporate Affairs and Audit Committee

Date:	5 December 2022

Title:	Capital Strategy 2022/23 – Mid Year Update

Report for:	Information

Status:	Public

Strategic priority:	All

Key decision:	Not applicable
Why:	Report is for information only

Urgent:	No
Why:	

Executive summary

The capital strategy is one of the main elements of the Council's budget approach, alongside the Revenue Budget and the Investment Strategy. Although some high-level metrics on progress are reported as part of the quarterly budget monitoring process, it is good practice to review this information in more detail at Quarter 2. Given the remit in relation to the Statement of Accounts, financial probity, and governance, and that the original strategy was bought for consultation on 9 December 2021, the review role best sits with Members of this Committee.

This report therefore reviews the position on the Investment Strategy, any changes that have occurred during the year to date, plus any implications for affordability since the original budget was set in February 2022. In addition, the report reviews the position on treasury management, including borrowing, investments, and debt repayment.

The second aspect of the report considers a change to the Council's current approach to Minimum Revenue Provision. As this will need further consideration by Executive and then approval by Council, we are consulting with the Committee at this initial stage for comments before the report goes forward for approval.

Purpose

1. The Capital Strategy report gives a high-level overview of how capital expenditure, capital financing and treasury management activities contribute to the provision of local public services at the Council. In addition, it also gives an overview of how the associated risks involved are managed and the implications for future financial sustainability.

2. This is a mid-year review of the strategy, which is considered best practice in line with the CIPFA Codes on the Prudential Code of Capital Finance and Treasury Management, to see how the strategy has developed in the first six months of the year. In addition, the Council is considering a change in its policy on Minimum Revenue Provision (MRP). This change in policy needs approval by Full Council as the decision-making body. However, consultation with the Committee is best practice given its roles and responsibilities.

Background and relevant information

3. The Capital Strategy report for the Council covers the following areas:

   - How the Investment Strategy is funded.
   - The relevant Prudential Indicators to monitor the performance, affordability and sustainability of the capital expenditure being proposed in line with the requirements of the prudential code.
   - Treasury Management arrangements in place for investing surplus funds and borrowing to fund capital expenditure.
   - The types of investments the Council makes as part of managing its cash balances – the Annual Investment Strategy.
   - Minimum Revenue Provision policy – including outlining how much the Council sets aside to re-pay debt built up to fund prior year’s capital expenditure in the Borough.

4. Capital Expenditure relates to what the Council plans to invest in long-term assets and infrastructure (such as property, equipment, vehicles, roads etc.). The Council must consider how this expenditure is paid for and what the long-term financial implications are of undertaking this investment. The Council is also permitted to borrow funds to finance the investment strategy under the Local Government Act 2003. It needs to consider the impact on the revenue budget of the level of borrowing being proposed, how it funds the repayment of this debt and the period over which this debt is repaid.

5. The Capital Strategy and the key assumptions that influenced the setting of the 2022/23 budget are set out at **Appendix 1** for reference purposes and information.

<u>Prudential Indicators and Capital Investment Plans</u>

6. The Council demonstrates the concepts of affordability, sustainability and prudence on its investment plans by setting a range of Prudential and Treasury Management indicators. These are set out in the various tables in Appendix 1 and are key metrics to the Director of Finance when setting the budget plans each year. Any breach of these indicators during a year indicates either a higher level of indebtedness or a lower level of overall prudence on the capital activities of the Council than when the budget was set. The following paragraphs give a brief commentary on these key indicators to assess any changes that have occurred during the financial year to date.

7. Although the Capital Strategy covers the whole of the medium-term financial planning period, this mid-year review focuses solely on the position for 2022/23. Due to the current review of the Investment Strategy and any further changes that may occur before the financial year-end on 2022/23 budgets, it is not appropriate to review the other years at this stage. These will be updated as part of the budget setting report to Council in February 2023.

8. The position at the end of quarter 2 was as follows. This was reported to Executive as part of the regular quarterly budget monitoring arrangements on 8 November 2022:

Prudential Indicators - 2022/23 Quarter 2	Budget (£M)	Actual (£M)
Capital Expenditure	124.825	69.241
Financing		
External Sources	74.344	41.579
Own Resources	6.296	3.257
Debt	44.185	24.405
Capital Financing Requirement	295.865	283.324
External Debt	268.350	205.667
Investments	15.630	21.020
Capital Financing	10.466	10.587
Cost as a % of Revenue Budget	8.8%	8.9%

9. The first point to note is that Investment Strategy for 2022/23 has reduced significantly during the financial year to date. In summary, this relates to slippage on approved capital schemes into later years in the programme, with the funding before re-profiled also. Further analysis of this at individual scheme and directorate levels can be seen within the Quarter 1 & 2 budget monitoring reports.

10. It can also be seen that the amounts of funding needed have also reduced below the original budgeted levels. Some of this is for schemes funded by capital grants and contributions by other bodies, but also there is an in-year reduction on the level of borrowing needed of £19.8m (original budget of £44.2m less current budget of £24.4m).

11. There is total outstanding debt of £205.7 million (including debt and lease liabilities) on 30 September 2022, with a further £40 million - £45 million expected to be needed before 31 March 2022. Cash balances are generally higher in the first two quarters of the financial year as grants and contributions tend to be paid in advance of need. This means that the level of external debt above is lower than it should be based on the level of capital expenditure forecast, as borrowing needs have been deferred.

12. The total amount given for additional borrowing in this financial year is higher than the figure quoted in paragraph 10. This is due to additional cash flow demands, as a result of using earmarked reserves to fund the revenue budget position, plus the early use of grant income in advance which needs to be replaced.

13. The forecast overall total long term external debt at the end of 2022/23 is expected to be around £250million. This should be compared with the estimated *Capital Financing Requirement* (the underlying value which the Council needs to borrow to fund capital activities) of £283m million. The Council therefore has an expected under-borrowed position of circa £33 million or 12%, which has provided some annual savings in interest payments, as other revenue and capital cash has been used in lieu of borrowing. This is a key strategic decision each year as to whether the under-borrowing position is increased or reduced and does not diverge from that used as part of the budget position.

14. Table 6 in Appendix 1 shows the profile of outstanding debt over the whole of the medium-term financial planning period and that this was expected to rise to a maximum of £268 million at 31st March 2023, before starting to reduce in the following financial year. This increase in debt is not expected to rise much further than £250m now given the recent review of the capital programme, which has reduced borrowing requirements from when the original budget position was agreed. This position will be updated again as part of the budget setting report.

15. The Council holds revenue budgets for repaying debt (known as Capital Financing Costs). This costs £10.6m (8.9% of the net revenue budget) for the 2022/23 financial year). The Council has a nominal threshold of 10% of its revenue budget as a cap for capital financing, so there is still some headroom for borrowing on urgent priorities if required, subject to overall council affordability

16. Table 9 in Appendix 1 shows that the proportion of capital financing costs is relatively stable at a time when the level of external debt is rising. This is due to the commercial income achieved on recent capital investments in Centre Square, Teesside Advanced Manufacturing Park and Captain Cook Square. It is important that these income levels are maintained otherwise the proportion of the revenue budget attributed to capital financing costs will start to increase.

17. One way to reduce capital financing costs is to reschedule the debt. This means to repay the debt earlier than expected and then to reborrow at a rate lower than the existing interest rate on the loan. This has been very difficult to do since 2008 due to low interest rates and high premiums on any early repayment options. Given the increase in interest rates in recent months, these premiums are starting to reduce and there may be some options for the Council to pursue. These are monitored on a regular basis by our treasury management advisers and if any of these are felt to be financially beneficial, they will be highlighted to Members by the Director of Finance.

18. It is also a statutory requirement for the Council to set an authorised limit for external debt at the start of each financial year. This is an amount beyond which it would be ultra-vires (or outside of the Council's legal powers) to exceed in a particular financial year. The authorised limit for 2022/23 is £356 million.

19. It should be noted that the authorised limit for the Council is currently much higher than either the level of external debt or the capital financing requirement. This is not uncommon within local authorities, to build in extra headroom for unexpected capital investment, possible debt re-financing opportunities and the remote possibility of needing to borrow for exceptional revenue purposes. At present, the Council's authorised limit is set at £73m above its capital financing requirement and allows a degree of flexibility within the Council's planning processes and this legal limit. It should be noted that any unexpected debt financing in a year could breach some of the other prudential indicators so this would need to be identified as part of the quarterly performance monitoring reports to Executive.

Treasury Management

20. Treasury Management is defined as the management of the Council's cash flows, borrowing and investments, and the associated risks. The main risks that affect a local authority include credit risk, interest rate risk, liquidity risk and refinancing risk.

21. The Council is generally cash rich in the short term, as many grants and contributions are paid in advance of need. Because of this, any excess cash is invested with an appropriate counterparty until the funds are required. When making an investment, the Council follows the advice set out in the Local Government Act 2003 and within the Treasury Management Code, with paramount consideration given to the security of the sum invested, followed by the liquidity position of the Council, and finally the interest rate achievable on the investment.

22. Given that credit criteria is the most important factor when making an investment decision, the Council receives regular updates from its external adviser, Arlingclose, on changes in credit ratings for individual financial institutions. They also advise on maximum amounts to be invested with each counterparty and maximum durations for any fixed term deposits made. This framework helps to protect against the loss of any sums invested (credit risk), ensures liquidity is not compromised and earns interest to support the revenue budget (not a major factor at present.

23. In relation to external borrowing, the Council seeks to achieve a low but certain cost of finance, whilst retaining the flexibility to borrow for short-term periods, and to respond to demands of the Investment Strategy as needed. The Council therefore has a balance between taking advantage of currently low rates of interest for short term borrowing (predominantly from other local authorities), versus the need to achieve certainty over rates of borrowing in the longer term from either government or financial institutions (mainly from the PWLB or other banks).

24. Out of the £205.667m worth of external debt on 30 September 2022, 65% is long term from the Public Works Loan Board – the government agency for local authority borrowing and 30% is long term with financial institutions (generally banks). There is around 5% of short term borrowing in place at present from other local authorities. The average interest rate on this debt is around 2.5% with an average life to maturity of just under 25 years. All longer-term debt held by the Council is at fixed rates of interest.

25. Current long term interest rates for borrowing from the PWLB are between 4% and 5% depending on the length of the loan (local authorities can borrow up to 50 years from central government), with short term rates being between 2.8% and 3.9% for up to one

year in duration. These are significantly higher than in recent financial years and reflect the Bank of England's attempt to control the levels of inflation in the UK economy at present. Although it is expected that interest rates for both borrowing and investments will level off over the next 1-2 years and then start to reduce, any borrowing implemented over the remainder of this year is likely to be short-term in nature. Higher than expected interest rates will put pressure on the capital financing budget as the year progresses.

26. On local authority borrowing, there has been much interest from both regulators and the media in recent months around individual councils taking significant amounts of long-term debt from the PWLB for the sole purposes of commercial activity – generally property investment. Under the Prudential Code, local authorities have lots of freedom to conduct and self-regulate their own borrowing and investment activities.

27. Both the Government and the Chartered Institute of Public Finance & Accountancy have said that borrowing for the sole purposes of commercial investment is against the spirit of the Code. The PWLB no longer provides loans for this type of activity from 1st April 2021 with Section 151 Officers having to confirm each year that their investment plans do not contain any of these types of activity. CIPFA is also updating the Prudential Code during 2022/23 to stop any borrowing for yield purposes and to also highlight and non-prudential practices.

28. Although the Council has undertaken some capital projects in recent years that have generated a revenue income stream as set out in paragraph 16 above, the primary aim has always been to regenerate the areas involved and to grow the wider economy within the Town. As a result, these activities would be able to continue under the Code and with funding from the PWLB if required.

<u>Minimum Revenue Provision</u>

29. The Council is required to maintain an annual policy for the repayment of debt incurred over previous financial years. The current policy is split into different elements which are based on: when the borrowing was originally incurred, the type of assets, and the useful economic life of the assets which the borrowing is funding. The Council in 2016/17, amended this policy to more accurately reflect the useful economic life of these assets. No changes have been made since then. The current policy is set out at the end of Appendix 1 of the Capital Strategy report for information.

30. Given the current economic environment the Council has held discussions with our treasury management adviser, Arlingclose, on whether any further changes can be made to the policy whilst still remaining within the statutory guidance issued by government. The rest of the report will set out an option for change on MRP that will better accommodate the revenue costs of the capital programme and provide greater consistency between supported and unsupported borrowing.

<u>What is MRP?</u>

31. Local authorities are required each year to set aside some of their revenue income as a provision for debt repayment. This is termed the Minimum Revenue Provision. There is a simple duty for a Council each year to make an amount of available, which it considers

"prudent". The MRP Guidance makes recommendations to authorities on the interpretation of that term.

32. Local authorities are asked to prepare an annual statement of their policy on making MRP and to have this approved by their decision-making body before the start of each financial year. This is an important element of the budget setting process each year.

What is a prudent provision?

33. The main part to the guidance is concerned with the interpretation of the term "prudent provision". The guidance proposes several options. It explains that provision for repayment of the borrowing, which financed the acquisition of an asset, should be made over a period bearing some relation to that over which the asset continues to provide a service or has economic benefit. It should also cover the gap between the Capital Financing Requirement (the underlying need to borrow) and the various sources of capital income available to the Council to finance its capital programme, such as capital receipts, capital grants, contributions and direct revenue financing.

34. The current options that government recommend for being prudent are set out towards the end of Appendix 1 (Options 1-5). These differ between supported borrowing (pre-2008 debt) and unsupported borrowing (post 2008 debt). The difference between the two relates to the fact that government provided direct funding for supported borrowing, whereas for unsupported borrowing, these resources need to be provided based on the overall resources allocated to the Council via the local government finance settlement.

Council Policy

35. The current Council policy on MRP is as follows:

- For supported capital expenditure, Middlesbrough Council intends to use option 5 - a 2% annuity basis for the coming financial year. This part of the CFR is currently £80.5m.

- For unsupported capital expenditure, Middlesbrough Council intends to use option 3 - the asset life method for the coming financial year. This part of the CFR is currently £202.8m.

36. The total MRP budget for the 2022/23 financial year is £5.9m or 2.05% of the capital financing requirement.

37. The MRP policy for the Council was last reviewed and changed for the 2016/17 year where a 4% allowance for supported debt was changed to a 2% annuity basis. This policy was backdated to 2008 when unsupported borrowing came into being. This resulted in a total backdated saving of £15m plus a lower on-going cost in earlier years. Increased payments in later years have been factored into the Council's budget projections.

38. On unsupported borrowing, the Council maintained the asset life policy which spreads the revenue charges equally over the life of the assets funded by prudential borrowing.

Annuity Basis of MRP

39. An annuity is a type of financial repayment model which repays a loan amount plus interest over the term of the financial instrument. To ensure certainty, it uses a fixed annual payment. Each year of the loan, a combination of principal and interest are repaid.

40. As there is a fixed repayment period, plus a nominal interest rate on the loan, the annuity calculation splits the individual payments between principal and interest. In earlier years, the repayments are predominantly interest based but as the loan period advances, principal is gradually repaid, and the interest charges become lower. In the latter years of the loan the repayments are predominantly principal. This method of debt repayment is very much akin to a mortgage when the sum borrowed is cleared in the later years of the agreement, at the expense of the first half of the term.

41. Increasingly local authorities are moving to an annuity basis of MRP provision which caters for lower debt repayments in earlier years, with the consequence of greater amounts in later years, recognising that interest paid is higher in the earlier years.

Suggested Future Approach for MRP

42. It is proposed that the Council move to an annuity basis of MRP provision on unsupported debt from 2008. This is the significant part of the Council's capital financing requirement.

43. The 2% annuity basis uses a 50-year financial model to allocate principal and interest payments over the life of the asset but as highlighted above, this results in lower charges for the first half of the asset's life and then higher charges over the remaining period. Conversely, interest payments are higher in the early years. This is advantageous to the Council in the light of rising interest rates where new borrowing is required.

44. The impact of the MRP change will be to improve the management of the revenue budget for capital financing and to smooth the total cost of capital financing over many years.

45. Under regulation we are unable to backdate the policy for prior financial years and the Council will continue to hold MRP already provided on our balance sheet. It will only be future charges that are influenced by the new policy.

Is this change prudent?

46. This policy change is fully compliant with the MRP statutory guidance under Section 21(1A) of the Local Government Act 2003. Many local authorities are using this basis for their current MRP policies on both supported and unsupported borrowing, and it is a method that is recommended by treasury management advisers and accepted by government and regulators.

What decision(s) are being recommended?

That the Corporate Affairs and Audit Committee:

- Discuss the current position on the capital strategy for 2022/23.
- Consider the change being proposed on Minimum Revenue Provision and any comments on this prior to submission to Executive & Council.

Rationale for the recommended decision(s)

47. Although there is no formal decision needs to be made, Members should note the progress to date against the key elements of the capital strategy, and challenge any areas that differ from the original assumptions when the budget was set in February. Emphasis should be paid to the change proposed on Minimum Revenue Provision as this will need to go forward to Executive and then Council for decision to change the policy.

Other potential decision(s) and why these have not been recommended

48. Not appropriate to this report.

Impact(s) of the recommended decision(s)

Legal

49. All activity on capital financing, investments and borrowing is under current local authority powers under either the local government act or the capital finance and accounting regulations

Strategic priorities and risks

50. There are no implications for the policy framework of the Council. The main point to note in relation to risk is that all capital investment, borrowing, and investment decisions are of significant value and thereby of necessity involve a significant degree of financial, credit and interest rate risk. The relevant details are always set out for Members to note in either the capital strategy each year or in the financial instrument elements of the Statement of Accounts.

Human Rights, Equality and Data Protection

51. There are no issues to note on these areas as part of this report.

Financial

52. The financial implications of the various issues covered are highlighted within the main body of the report. The MRP already set aside on the balance sheet will be retained, however, we anticipate that the smoothing impact brought about by the change will lower financing costs on the revenue budget. Any in year savings will be set aside to manage future cost pressures possibly through higher interest rates.

Actions to be taken to implement the recommended decision(s)

Action	Responsible Officer	Deadline
To take forward this report to Executive & then Council on 18 January 2022 for decision.	Head of Finance & Investments	By end of Jan 2022

Appendices

1	Capital Strategy Report – Approved version from the Budget Setting Report – 23 February 2022

Background papers

Body	Report title	Date
Corporate Affairs & Audit Committee	Capital Strategy 2022/23	9th December 2021

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APPENDIX 1

CAPITAL STRATEGY REPORT 2022/23

Introduction

The Capital Strategy report gives a high-level overview of how capital expenditure, capital financing and treasury management activities contribute to the provision of local public services at the Council. In addition, it also gives an overview of how the associated risks are managed and the implications for future financial sustainability.

The report is a requirement of the 2017 Code of Practice on Treasury Management, issued by the Chartered Institute of Public Finance & Accountancy, and has been produced in an accessible way to enhance members' understanding of these often-technical areas. It is a replacement for the prudential indicator and treasury management report included within previous budget setting reports prior to 2019/20 but gives a wider context on the capital financing processes used by the Council.

The Code above is currently out to consultation by CIPFA but it is not expected that any changes being proposed will impact on the Council's borrowing and treasury management approach.

Capital Expenditure and Financing

Capital Expenditure is where the Council spends money on assets, such as property, IT and vehicles that will be used for more than one financial year. In local government, this also includes spending on assets owned by other bodies, finance leases and loans & grants to other bodies enabling them to buy assets. The Council has some limited discretion on what counts as capital expenditure, for example assets costing below £10,000 are generally not capitalised.

- For details of the Council's policy on the capitalisation of assets, see the accounting policies section of the annual statement of accounts on the Council's website (www.middlesbrough.gov.uk).

In the 2022/23 financial year, the Council is planning a total capital expenditure of £124.825m as summarised below:

Table 1: Prudential Indicator: Estimates of Capital Expenditure in £ millions

	2020/21 £000 Actual	2021/22 £000 Estimate	2022/23 £000 Estimate	2023/24 £000 Estimate	2024/25 £000 Estimate
Total Capital Expenditure – Investment Strategy	42.078	59.035	121.325	13.500	9.313
Total Capital Expenditure – Finance Leases	0.000	0.000	3.500	0.500	0.500
Total Capital Expenditure	**42.078**	**59.035**	**124.825**	**14.000**	**9.813**

Governance: Service managers generally bid during the previous financial year to include projects in the Council's forward capital programme. Bids are collated by the Council's finance team who calculate the financing costs of each project (which can be nil if the project is fully externally financed). The Council's Management Team (LMT) appraises all bids based on a comparison of service priorities against financing costs and then makes recommendations to Members for which schemes progress against the capital resources available. The final capital programme to support the Medium Term Financial Plan is then presented to Executive and Council in late February each year for approval.

All capital expenditure has to be financed, from either external sources (government grants and other contributions), the Council's own resources (revenue, reserves and capital receipts) or debt (borrowing, leasing and private finance initiative). The planned financing of the above expenditure is as follows:

Table 2: Capital financing in £ millions

	2020/21 actual	2021/22 forecast	2022/23 budget	2023/24 budget	2024/25 budget
External sources	17.476	27.005	74.344	3.577	0.000
Own resources	6.374	15.158	6.296	5.840	9.313
Debt	18.228	16.872	44.185	4.583	0.500
TOTAL	**42.078**	**59.035**	**124.825**	**14.000**	**9.813**

Any external debt (loans and leases) must be repaid over time by other sources of finance. This comes from the revenue budget in the form of Minimum Revenue Provision (MRP). Alternatively, proceeds from selling capital assets (known as capital receipts) may be used to replace/repay debt finance. The Council generally uses capital receipts to finance new capital expenditure rather than to redeem debt. The total cost of MRP included in the Council's revenue budget is as follows:

Table 3: Minimum Revenue Provision in £ millions

	2020/21 actual	2021/22 forecast	2022/23 budget	2023/24 budget	2024/25 budget
Cost to Revenue Budget	4.743	4.892	5.417	6.485	6.695

- The Council's minimum revenue provision statement for 2022/23 is available towards the end of this report.

The Council's cumulative amount of debt finance still outstanding is measured by the capital financing requirement (CFR). This increases with new debt-financed capital expenditure each year and then reduces with minimum revenue provision and capital receipts used to redeem debt.

The CFR is expected to increase by £38.1m or 14.7% during the 2022/23 financial year. This increase is due to the new capital expenditure funded by external debt of £43.8m less the MRP set aside of £5.4, plus other minor income changes on commercially funded investments.

Based on the above plans for expenditure and financing, the Council's estimated CFR for the period of the Medium Term Financial Plan is as follows:

Table 4: Prudential Indicator: Estimates of Capital Financing Requirement in £ millions

	31.3.2021 actual	31.3.2022 forecast	31.3.2023 budget	31.3.2024 budget	31.3.2025 budget
TOTAL CFR	**245.966**	**257.747**	**295.865**	**293.463**	286.768

Asset disposals: When a capital asset is no longer needed, it may be sold so that the proceeds, known as capital receipts, can be spent on new assets or be used to repay debt. The Council is currently also permitted to spend capital receipts on service transformation projects until 2022/23. Repayments of capital grants, loans and investments also generate capital receipts.

The Council plans to receive £6.1m of capital receipts in the coming financial year as follows:

Table 5: Capital receipts in £ millions

	2020/21 actual	2021/22 forecast	2022/23 budget	2023/24 budget	2024/25 budget
TOTAL	**6.374**	**14.616**	**6.072**	**5.840**	**9.313**

- The level of capital receipts for each financial year is monitored between Regeneration, Finance and Valuation & Estates teams, and any significant changes are reported to Executive as part of the Quarterly budget updates.

- The Council has recently adopted the Flexible Use of Capital Receipts Policy where these proceeds may be used for funding service transformation costs that would otherwise be classed as revenue expenditure. This is mainly to fund the current year's children services overspend and would be a device to protect reserves if required.

Treasury Management

Treasury Management is concerned with keeping sufficient but not excessive cash resources, available to meet the Council's spending needs, while managing the risks involved in these investments. Surplus cash is invested until required, whilst a shortage of cash will be financed by borrowing, to avoid excessive credit balances or overdrafts in the bank current account.

The Council is typically cash rich in the short-term as revenue income is received and before it is spent, but cash poor in the long-term as capital expenditure is incurred before being financed. Revenue cash surpluses are therefore offset against capital cash shortfalls to reduce the overall borrowing amount required, as part of an integrated strategy on Treasury Management. This is in line with best practice.

The Council at the end of January 2022 had £210.2m of borrowing at an average interest rate of 2.5% and £40.6m of treasury investments at an average rate of around 0.1%.

Both investment and borrowing rates available to the Council continue to be at historic lows due to ongoing government policy plus also the impact of the current coronavirus pandemic. It is expected though that interest rates will start to rise from December 2021 but in a slow, stepped approach. It is thought that this will not have a significant on medium to long term interest rates.

Borrowing strategy: The Council's main objectives when borrowing are to achieve a low but certain cost of finance for long-term capital projects whilst retaining flexibility should plans change in future. These objectives are often conflicting, and the Council therefore seeks to strike a balance between using cheap short-term loans (currently available at variable rates between 0.4% & 0.8%) and long-term fixed rate loans where the future cost is known but interest costs are higher (currently between 1.27% to 2.5%). In recent years, the Council has also been in negotiation with funders around lease arrangements as an alternative method of securing external finance for its capital projects.

Projected levels of the Council's total outstanding debt (which comprises borrowing and relevant finance leases) are shown below, compared with its capital financing requirement (need to borrow).

Table 6: Prudential Indicator: Gross Debt and the Capital Financing Requirement in £ millions

	31.3.2021 actual	31.3.2022 forecast	31.3.2023 budget	31.3.2024 budget	31.3.2025 budget
External Debt	218.756	213.967	**268.350**	261.622	253.272
Capital Financing Requirement	245.966	257.747	**295.865**	293.463	286.768

Statutory guidance is that debt should remain below the capital-financing requirement, except in the short-term where the benefits of short-term borrowing may be taken. As can be seen from Table 6, the Council expects to comply with this in the medium term with debt being lower than the capital-financing requirement in all relevant financial years. There may be some opportunity to take more capital funding than is needed whilst interest rates are at low levels. Discussions are ongoing with our treasury advisers on this position and what approach the Council should take.

Affordable borrowing limit: The Council is legally obliged to set an affordable borrowing limit (also termed the authorised limit for external debt) each year. In line with statutory guidance, a lower "operational boundary" is also set as a warning level should debt levels start to approach the legal limit and is a more realistic rather than worst-case view of what will happen during the financial year. Any need to change these during the 2022/23 financial year from the original budget assumptions will be reported by the Director of Finance to the Executive at the earliest opportunity.

Table 7: Prudential Indicators: Authorised limit and operational boundary for external debt in £m

	2021/22 limit	2022/23 limit	2023/24 limit	2024/25 limit
Authorised Limit (OB + £30m)	315.000	**356.000**	353.000	347.000
Operational Boundary (CFR + £30m)	285.000	**326.000**	323.000	317.000

Investment strategy: Treasury investments arise from receiving cash before it is paid out again. Investments made for service reasons or for pure financial gain are not generally considered to be part of treasury management.

The Council's policy on treasury investments is to prioritise security and liquidity over yield, which focuses on minimising risk rather than maximising returns. Cash that is likely to be spent in the short term is invested securely, for example with the government, other local authorities or selected high-quality banks, to minimise the risk of loss.

Table 8: Treasury management investments in £millions

	31.3.2021 actual	31.3.2022 forecast	31.3.2023 budget	31.3.2024 budget	31.3.2025 budget
Short-term investments	24.810	23.856	15.630	15.000	15.000
Longer-term investments	0.000	0.000	0.000	0.000	0.000
TOTAL	**24.810**	**23.856**	**15.630**	**15.000**	**15.000**

Governance: Decisions on treasury management in relation to investment and borrowing are made daily and are therefore delegated by the Director of Finance to the Head of Finance & Investments and staff within the central finance team, who act in line with the treasury management strategy approved by Council. Quarterly updates on treasury management activity are reported to Executive as part of the regular budget monitoring process.

Revenue Budget Implications

Although capital expenditure is not charged directly to the revenue budget, interest payable on loans and MRP are charged to the revenue budget, offset by any investment income received. The net annual charge is reported as capital financing costs; this is compared to the net revenue stream i.e. the amount funded from council tax, business rates and general government grants. This is an important indicator around the affordability of the Council's capital plans going forwards.

Table 9: Prudential Indicator: Proportion of financing costs to net revenue stream

	2020/21 actual	2021/22 forecast	2022/23 forecast	2023/24 forecast	2024/25 forecast
Financing costs (£m)	9.955	9.599	**10.489**	11.159	11.216
Net Revenue Budget (£m)	116.397	116.492	**118.329**	124.541	127.686
Proportion of net revenue stream	8.6%	8.2%	**8.9%**	9.0%	8.8%

Sustainability: Due to the very long-term nature of capital expenditure and its financing, the revenue budget implications of this expenditure incurred in the next few years could extend for up to some 50 years into the future.

The figures in table above remain relatively stable at a time when debt levels for the Council are still increasing. Members should be aware that this is as a result of various capital investments in commercial property made by the Council over the last few years for regeneration purposes. This results in around £2.0m of income per year being credited to the capital financing budget by the end of the 2024/25 financial year. It is imperative and a key budget risk that these rental levels are maintained and the income assumed in the estimates above are generated. Progress will be reported as part of future budget monitoring and performance reports each quarter to Executive. The forecasts above may also differ slightly from the total included in the revenue budget for 2022/23 due to timing.

The Director of Finance is satisfied that the proposed capital programme is prudent, affordable and sustainable because appropriate resources have been allocated from the Council's medium term financial plan, any finance leases have been appropriately vetted and any borrowing plans have been fully costed and reviewed.

Table 10 – Total Borrowing required for each year of the MTFP

	2021/22 £000 Estimate	***2022/23 £000 Estimate***	2023/24 £000 Estimate	2024/25 £000 Estimate
Investment Strategy	15,000	***60,000***	10,000	0
Finance Leases	0	***3,500***	500	500
Debt Restructuring	0	***0***	0	0
Total	15,000	***63,500***	10,500	500

This takes into account any debt needed by the Council to either finance the capital programme, in respect of leasing arrangements, or to finance any debt restructuring required.

Current interest rates at present (with historical lows) mean that this is not possible for the next three financial years and therefore no amounts have been factored into the borrowing plans of the Council for this. If this situation changes, this will be reported to Executive at the earliest opportunity.

The prudential indicators & limits set out in this report are consistent with the Council's current commitments, existing plans and the proposals in the budget report for capital expenditure and financing, and with its approved treasury management policy statement and practices.

The Director of Finance confirms that these are based on estimates of the most likely and prudent scenarios, with in addition sufficient headroom over and above this to allow for operational management and some scope for flexibility. For example unusual cash movements or any unbudgeted capital expenditure required. Risk analysis and management strategies have been taken into account; as have plans for capital expenditure, estimates of the capital financing requirement and estimates of cash flow requirements for all purposes.

Prudence – Treasury Management Indicators

It is recommended that the Council sets an upper limit on its fixed interest rate exposures for 2022/23, 2023/24 and 2024/25 of 100% of its estimated total borrowing undertaken.

It is further recommended that the Council sets an upper limit on its variable interest rate exposures for 2022/23, 2023/24 and 2024/25 of 25% of its estimated total borrowing undertaken.

This means that the Director of Finance will manage fixed interest rate exposures on total debt within the range 75% to 100% and variable interest rate exposures on total debt within the range 0% to 25%.

It is also recommended that the Council sets upper and lower limits for the maturity structure (when the debt needs to be repaid) of its total borrowing as follows.

<u>Amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate at the start of the period:</u>

	Upper limit	**Lower limit**
under 12 months	50%	0%
12 months and within 24 months	30%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	75%	0%
10 years and above	90%	20%

Currently investments are limited to a maximum of 3 years, with any deals being arranged so that the maturity will be no more than 3 years and one month after the date the deal is arranged.

The maximum % of the total of all investments that have an outstanding period of one year or longer, at the time the investment is made, is 10%.

Knowledge and Skills

The Council employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. For example, the Head of Finance and Investments has in excess of 20 years' experience in local government treasury management. There is similar experience within the finance teams in relation to budgeting & accounting for capital expenditure and financing. The Council also pays junior staff to study towards relevant professional qualifications including CIPFA, CIMA, ACCA, AAT and other relevant vocational studies.

Where Council staff do not have the knowledge and skills required, use is made of external advisers and consultants that are specialists in their field. The Council currently employs Arlingclose Limited as treasury management advisers. This approach is more cost effective than employing such staff directly, and ensures that the Council has access to knowledge and skills commensurate with its risk appetite.

- Further details on staff training and the policy on the use of external advisers can be seen with reference to its Treasury Management Practices document which is on the Council's website.

Treasury Management Practices

Further details of how the treasury management function operates, the procedures used to manage banking, treasury and capital market transactions, how risk is managed by the in-house team and how this fits with the CIPFA Code of Practice is included in the Council's set of Treasury Management Practices.

This document is available to Members for further information on request.

ANNUAL INVESTMENT STRATEGY

& TREASURY

MANAGEMENT POLICY STATEMENT 2022/23

1. In accordance with revised guidance from the Ministry of Housing, Communities and Local Government (MHCLG) a local authority must prepare and publish an Annual Investment Strategy which must be approved by full Council before the start of the financial year to which it relates.

2. The MHCLG guidance offers councils greater freedom in the way in which they invests monies, providing that prior approval is received from Members by approving the Annual Investment Strategy. The guidance also considers the wider implications of investments made for non-financial returns and how these can be evaluated.

3. The Local Government Act 2003, which also introduced the Prudential Code, requires that a local authority must have regard to such guidance as the Secretary of State issues relating to prudent investment practice.

4. In addition the Chartered Institute of Public Finance & Accountancy (CIPFA) has published a revised Code of Practice for Treasury Management in the Public Services in December 2017. This replaces the 2011 Code which had been adopted in full by Middlesbrough Council. The revised Code requires the Council to clearly state, in the Annual Investment Strategy document, its policy on effective control, and monitoring of its treasury management function. These controls are set out in Treasury Management Practices (TMP's) which have been approved as part of acceptance of the previous Code.

5. The revised Strategy, showing where the Guidance has determined Council policy, can be set out as:

ANNUAL INVESTMENT STRATEGY 2022/23

6. Middlesbrough Council 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 (TMPs), 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.

7. The content of the policy statement and TMPs 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.

8. Middlesbrough Council will receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy in advance of the year, a mid-year review which will include an annual report on the previous year, in the form prescribed in its TMP's. Revised Strategies can be presented to the Council for approval at any other time during the year if the Director of Finance considers that significant changes to the risk assessment of significant parts of the authority's investments has occurred.

9. Middlesbrough Council delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Director of Finance. The execution and administration of treasury management decisions is further delegated to *the Head of Finance & Investments*, who will act in accordance with the organisation's policy statement and TMPs and CIPFA's *Standard of Professional Practice on Treasury Management.*

10. Middlesbrough Council nominates the Corporate Affairs & Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

11. The Council is very circumspect in its use of credit rating agencies with the section on Specified Investments setting out the current policy. Ratings are monitored on a real time basis as and when information is received from either our treasury management consultants or any other recognised source. Decisions regarding inclusion on the Approved List are made on the basis of market intelligence drawn from a number of sources.

12. All staff involved in treasury management will, under the supervision of *the Head of Finance & Investments*, act in accordance with the treasury management practices and procedures, as defined by the Council. Such staff will undertake relevant training, identified during the Council's induction process and, on an on-going basis, the Council's appraisal policy.

13. The general policy objective contained in the guidance is that local authorities should invest prudently the short-term cash surpluses held on behalf of their communities. The guidance emphasises that priority should be given to security and liquidity rather than yield. Within that framework the authority must determine a category of borrowers, who must be of "high credit quality" classified as **Specified Investments**, with whom it can invest surplus cash with minimal procedural formalities and further identify a category of borrowers classified as **Non-Specified Investments**, with whom it can also invest but subject to prescribed limits.

14. Although the guidance definition of Non-Specified Investments is "one not meeting the definition of a Specified Investment", the authority is required to identify which categories of investments are identified as prudent to use and the limits on any such

investment either individually or in total. It is because some organisations do not subscribe to credit rating agencies that they have to be included as Non-Specified Investments, rather than any concern over their creditworthiness.

15. The guidance defines investment in such a way as to exclude pension fund and trust fund investments. In practice, Middlesbrough Council, in its role as Administering Authority for the Teesside Pension Fund, follows similar procedures as approved by Members as part of compliance with the CIPFA Code of Practice, albeit with different limits.

LIMITS & DEFINITION OF SPECIFIED INVESTMENTS

16. The following are currently determined as meeting the criteria for Specified Investments:

17. The investment is made with the UK Government, or a local authority (as defined in the Local Government Act 2003), or a police authority, or fire, or a UK Nationalised Industry, or UK Bank, or UK Building Society.

18. The investment is made with a Money Market Fund that, at the time the investment is made, has a rating of AAA.

19. The investment is made with one of the bodies listed in section 4 of Schedule 1E of the current version of the Treasury Management Practices document which, at the time the investment is made, has a short-term "investment grade" rating with either Standard & Poors, Moody's Investors Search Ltd or Fitch Ratings Ltd (or in the case of a subsidiary the parent has such a rating). Where ratings awarded differ between the rating agencies any one award below investment grade will prevent the investment being categorised as a Specified Investment. The rating of all listed bodies must be monitored on a monthly basis. Where officers become aware of a downward revision of rating, that moves the body out of the "investment grade" category, between such monthly checks, the body should be removed from the list of Specified Investments and, if considered appropriate, the investment should be recalled.

20. All specified investments must be denominated in sterling and must be one where the authority may require it to be repaid or redeemed within 12 months of the date on which the investment is made and must be considered of high credit quality. This is defined as having met the criteria set out above. The investment must not constitute the acquisition of share capital or loan capital in any body corporate.

- The minimum % of the total of all investments which must be Specified Investments, at the time the investment is made, is 70%
- The maximum investment with any one counterparty is £15 million, except for the Debt Management Office which is has no limit.

- The maximum investment in any one group (i.e. a bank and its wholly-owned subsidiaries) is £15m.

LIMITS & DEFINITION OF NON-SPECIFIED INVESTMENTS

21. These categories of investment currently meet the criteria for non-specified investments:

22. The investment is made with a UK bank, or UK building society, or a UK subsidiary of an overseas bank.

23. The investment is made with one of the bodies listed in section 4 of Schedule 1E of the current version of the Treasury Management Practices document, which is not a Specified Investment.

24. The investment is for a period of one year or longer.

25. All non-specified investments must be denominated in sterling. The investment must not constitute the acquisition of share capital or loan capital in any body corporate.

- The maximum % of the total of all investments which can be non-specified investments, at the time the investment is made, is 30%.
- The maximum investment with any one counterparty is £15 million
- The maximum investment in any one group (i.e. a bank and its wholly-owned subsidiaries) is £15m.
- The maximum % of the total of all investments that have an outstanding period of one year or longer, at the time the investment is made, is 10%.

26. The maximum period for which an investment can be made is 3 years, with the maturity date no more than 3 years and 1 month from the time the deal is agreed.

27. As referred to earlier in the report, borrowing should be kept at, or below, the expected capital financing requirement over the medium term to reduce the risk of exposure to interest rate fluctuations. The balance of ‘net borrowing’ (loans less investments) should also be monitored to, where prudent, minimise interest rate differences.

28. The Council considers that it is empowered by Section 12 of the Local Government Act 2003 for the temporary investment of funds borrowed for the purpose of expenditure in the reasonably near future. While not “borrowing to invest” it is prudent to invest monies raised in advance of expenditure. As required by the Guidance such

investment is permitted providing the anticipated expenditure is within this or the next financial year or within a period of eighteen months, whichever is the greater.

TREASURY MANAGEMENT POLICY STATEMENT

29. Middlesbrough Council defines its treasury management activities as:
'The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.'

30. The Council 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 management activities will focus on their risk implications for the organisation and any financial instruments entered into to manage those risks.

31. The Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

32. The high-level policies and monitoring arrangements adopted by the Council for Borrowing and Investments are as follows:

<u>Borrowing</u>

- Any borrowing decisions will aim to strike an appropriate risk balance between securing low interest rates and achieving cost certainty over the periods for which funds are required. Economic forecasts available from our treasury management advisers and any other available sources will be used to form a view on the target borrowing rates and overall borrowing strategy;
- Any decisions should also look to maintain the stability and flexibility of the longer term debt portfolio, given the current low interest rate environment where short term borrowing or borrowing from internal resources offer revenue budget savings;
- The main sources of funding for external borrowing for the Council are the Public Works Loan Board, Other Local Authorities and private sector financial institutions;

<u>Investments</u>

- The CIPFA and MHCLG guidance require the Council to invest its funds prudently and to have regard to security, liquidity and yield when making these decisions;
- Security being the arrangements in place to protect principal sums invested by a local authority;
- Liquidity being to ensure that enough cash resources are available on a day to day basis for transactional needs;

- Yield being the interest rate and total financial return applicable to the investment being made;
- With these strategic issues in mind, the management of credit risk (or security) is key to the Council's investment strategy and any subsequent activity. The Council uses the external advisers' credit worthiness matrix to determine limits with individual counterparties.

MINIMUM REVENUE PROVISION POLICY 2022/23

INTRODUCTION

33. Local authorities are required each year to set aside some of their revenue income as provision for debt repayment. There is a simple duty for an authority each year to make an amount of revenue provision, which it considers "prudent". (Minimum Revenue Provision) MRP Guidance makes recommendations to authorities on the interpretation of that term.

34. Authorities are legally obliged to "have regard" to any such guidance – which is exactly the same duty as applies to other statutory guidance including, for example, the CIPFA Prudential Code, the CIPFA Treasury Management Code and the CLG Guidance on Investments.

35. Authorities are asked to prepare an annual statement of their policy on making MRP and to have this approved by the body before the start of each financial year.

MEANING OF "PRUDENT PROVISION"

36. The main part to the guidance is concerned with the interpretation of the term "prudent provision". The guidance proposes a number of options. It explains that provision for repayment of the borrowing, which financed the acquisition of an asset, should be made over a period bearing some relation to that over which the asset continues to provide a service or has economic benefit. It should also cover the gap between the Capital Financing Requirement and the various sources of capital income available to the Council to finance its capital programme, such as capital receipts, capital grants, contributions and direct revenue financing.

OPTIONS FOR PRUDENT PROVISION

Option 1: Regulatory Method

37. For debt supported by (Revenue Support Grant) RSG in previous years, authorities will be able to continue to use the formulae in regulations, since the RSG was provided on that basis.

Option 2: CFR Method

38. This is a technically simpler alternative to Option 1 and may also be used in relation to supported debt. While still based on the concept of the Capital Financing Requirement (CFR), which can be derived from the balance sheet, it avoids the complexities of the formulae in the regulations.

Option 3: Asset Life Method

39. For new borrowing under the Prudential system (from 2008) for which no government support is given, there are two main options. Option 3 is to make provision for debt repayment in **equal annual instalments** over the estimated life of the asset for which the borrowing is undertaken. This is a possibly simpler alternative to the use of depreciation accounting (Option 4), though it has some similarities to that approach.

40. The formula allows an authority to make **voluntary extra provision** in any financial year that this is affordable.

41. In the case of the construction of a new building or infrastructure, MRP would not need to be charged until the new asset comes into service. This "**MRP holiday**" would be perhaps 2 or 3 years in the case of major projects and could make them more affordable. There would be a similar effect in the case of Option 4 under normal depreciation rules.

Option 4: Depreciation Method

42. Alternatively, for new borrowing under the prudential framework for which no Government support is being given, Option 4 may be used. This means making MRP in accordance with the standard rules for depreciation accounting.

43. Councils will normally need to follow the standard procedures for calculating depreciation when making this revenue provision.

Option 5: 2% Annuity Method

44. This method recognises the time value of money and the useful life of the assets funded from borrowing and is seen as a fairer way of charging MRP. It is supported by the Council's treasury management advisers (Arlingclose) and is being adopted by many local authorities nationally as the way of accounting for pre 2008 debt.

2022/2023 MINIMUM REVENUE PROVISION -

STATEMENT FOR MIDDLESBROUGH COUNCIL

45. The Secretary of State recommends that before the start of each financial year a local authority prepares a statement of its policy on making MRP in respect of that financial year and submits it to the full council as part of its budget setting process. The statement should indicate which of the options listed above are to be followed in the financial year.

46. For supported capital expenditure Middlesbrough Council intends to use option 5, a 2% annuity basis for the coming financial year.

47. For unsupported capital expenditure Middlesbrough Council intends to use option 3, the asset life method for the coming financial year.