

SECTION 9

9. THE PRUDENTIAL CODE FOR CAPITAL FINANCE - BACKGROUND AND INDICATORS FOR 2004/2005

Introduction

- 9.1 This section of the report presents the background to the Prudential Code and the various indicators and limits that will govern activity in 2004/5.
- 9.2 CIPFA has prepared the Prudential Code for Capital Finance in Local Authorities (the Prudential Code) in order to underpin the revised system of capital finance introduced under the Local Government Act 2003. The Act enables local authorities to determine their own programme for capital investment in fixed assets. The Prudential Code has been developed as a professional code of practice to support local authorities in taking these decisions. Local authorities will be required by Regulations to comply with the Code in carrying out their duties.
- 9.3 Members are asked to agree the prudential limits for 2004/5.

Background to the Prudential Code

- 9.4 Previously, Part IV of the Local Government and Housing Act 1989 provided for a system of local authority capital finance. The Act provided for a rigorous system of central control – with borrowing consents, provisions to set aside proportions of capital receipts, a credit ceiling for borrowing, a Minimum Revenue Provision (MRP) for the repayment of loan debt, and other detailed rules. As well as allowing local decision making, the new regulations provide for the pooling of capital receipts relating to housing sales (75% of the proceeds of the sale of dwellings, and 50% of proceeds from the sale of land), and the abolition of the MRP for the Housing Revenue Account.
- 9.5 The Prudential Code allows local decision making on the appropriate level of investment expenditure, but within a framework that ensures that:
- (a) Capital investment plans are affordable, prudent and sustainable.
 - (b) Treasury management decisions are taken in accordance with good professional practice and support affordability, prudence and sustainability.
 - (c) Supports local strategic planning, local asset management planning and proper project appraisal.
- 9.6 To demonstrate that authorities have fulfilled these objectives, the Code sets out the factors that must be taken into account and the indicators that must be used. The Code emphasises that the Full Council must agree indicators before the beginning of the financial year.

9.7 A glossary of relevant terms is included as Annex1 to this section of the report.

Factors to be Taken Into Account

9.8 In setting their prudential indicators, local authorities must have regard to:

- (a) Affordability e.g. implications for Council Tax and Council housing rents.
- (b) Prudence and sustainability, e.g. implications for external borrowing.
- (c) Value for money, e.g. options appraisal.
- (d) Stewardship of assets, e.g. asset management planning.
- (e) Service objectives, e.g. strategic planning for the authority.
- (f) Practicality, e.g. achievability of the forward plan.

9.9 These factors are addressed either elsewhere in this report or in the Council's financial regulations, standing orders or other governance arrangements. This section briefly demonstrates how these factors are being addressed.

9.10 Affordability is key to increased investment in Council assets. Formally the Prudential Code requires the Council to calculate the incremental impact on Council Tax and Rents of the cost of "*unsupported*" borrowing over three years. These figures are set out in Section 7. The Director of Finance's view is, however, that affordability of capital expenditure cannot be isolated from the affordability of the Council's overall revenue expenditure. Therefore medium term financial estimates have been included in the budget (Appendix K) and a long term business plan prepared (Appendix N) to test affordability. The current estimates indicate that the Council needs to do more work in the immediate future to bring overall expenditure plans within acceptable limits, but this is within its historic capability. Ultimately affordability remains a political judgement and Members need to assure themselves that the plans set out in the report are affordable in terms of Council tax and rent increases.

9.11 The issues of prudence and sustainability are closely related to that of affordability. Are borrowing levels sensible and prudent and sustainable over the longer period? In particular is borrowing set at a level to finance capital investment in total and not for other purposes? The prudential indicators set out in the rest of this Section are designed to achieve that outcome.

9.12 The third factor is achieving value for money. There are many potential capital projects that are not value for money and the prudential code prohibits borrowing for such purposes. Value for money is addressed in a number of ways including:

- (a) Projects are initially vetted by the Capital Board for amongst other things value for money before being recommended for inclusion in the Capital Programme.

- (b) The Capital Strategy requires all projects to be internally assessed for VFM before being submitted.
 - (c) Major projects require approval by the Executive and reports to Executive have to address VFM considerations.
 - (d) Standing orders ensure that letting of contracts is subject to appropriate competitive processes.
 - (e) Internal and external audit assess systems to ensure that appropriate processes are in place in identifying capital projects.
- 9.13 The fourth factor is proper stewardship of assets. The Capital Programme must deliver properly maintained assets and should not lead to acquisition of assets which put a strain on the Council's ability to achieve this objective for all its stock. The Council has developed an asset management plan for its general fund assets and a long term business plan for HRA stock which identifies the investment needs to keep assets to an appropriate standard. The long term business plans for the General Fund and HRA demonstrate that sufficient resources are available to maintain this stock at an affordable level.
- 9.14 The Capital Programme as a whole is linked to the Corporate Strategy and other plans and objectives of the Council. This is a key criteria for the Capital Board before projects can be recommended for inclusion in the Capital Programme. The Service Development Planning process ensures that spend on revenue and capital is linked to the Council's overall objectives. The budget approval process gives Members a final opportunity to check that this objective has been met.
- 9.15 Is the resulting Capital Programme capable of delivery? Is it practical? The expansion of the Capital Programme does raise issues of capacity to delivery, particularly in the light of the significant slippage in 2003/2004. Additional resources have been included in this budget to address the capacity issue particularly in the areas of Education, Social Services and Corporate Services. Environment and Housing have separately addressed the capacity issues that face their proposed substantially increased capital programmes.
- 9.16 Members need to be satisfied that adequate arrangements are in place to deal with the factors outlined in 9.8 before they agree to the Capital Programme set out in this report.

Prudential Indicators for 2004/5, 2005/6 and 2006/7

9.17 The Code requires the following indicators:

(a) Debt

(i) Prudential limit external debt – operational boundary (£m)

	2002/03 £m	2003/04 £m	2004/05 £m	2005/06 £m	2006/07 £m
Borrowing	471.3	478	650	650	650
Other	-	-	-	-	-

The operational boundary sets out the expected total of borrowing for each year, taking into account the capital programme. The proposed boundary also gives flexibility both to restructure debt (as opportunities allow) and to repay maturing loans/take out new loans.

(ii) Authorised limit proposed for external debt (£m).

	2002/03 £m	2003/04 £m	2004/05 £m	2005/06 £m	2006/07 £m
Borrowing	471.3	700	850	850	850
Other	-	-	-	-	-

The authorised limit for external debt allows flexibility to carry out debt restructuring should opportunities arise. For example, it may be appropriate to borrow in advance of repaying the original debt.

(iii) Estimate of ratio of financing costs to net revenue stream (Ratio).

	2004/05 %	2005/06 %	2006/07 %
HRA	28.4	30.3	31.4
Non HRA	6.4	6.6	6.8

(b) Capital Expenditure and Commitments

(i) Estimate of capital expenditure to be incurred.

	2002/03 Actual £m	2003/04 Estimate £m	2004/05 Estimate £m	2005/06 Estimate £m	2006/07 Estimate £m
Total Non-HRA	42.6	46.4	56.6	29.3	16.3
Total HRA	11.6	30.0	27.7	16.8	5.2
Total	54.2	76.4	84.3	46.1	21.5

- (ii) Capital financing requirement – Estimated end of year capital financing requirement for current and future years, and at March 2003

	2002/03 Actual £m	2003/04 Estimate £m	2004/05 Estimate £m	2005/06 Estimate £m	2006/07 Estimate £m
Total Non-HRA	-	-	224.0	240.2	250.0
Total HRA	-	-	273.6	290.1	295.0
Total	440.0	443.8	497.6	530.3	545.0

(c) Treasury Management

- (i) Brent Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Services YES

- (ii) Upper limit for borrowing that is at variable rates less investments that are variable rate investments (percentage).

2002/03 %	2003/04 %	2004/05 %	2005/06 %	2006/07 %
0.5	40	40	40	40

Although Brent has previously taken very few variable rate loans, the approach has been changed recently both to take advantage of low short-term rates and to provide a hedge for short-term lending of balances. The upper limit has also been set with debt restructuring in mind.

- (iii) Lower limit for borrowing that is at variable rates less investments that are variable rate investments (percentage).

2002/03 %	2003/04 %	2004/05 %	2005/06 %	2006/07 %
0.5	(20)	(20)	(20)	(20)

The lower limit assumes that there may be occasions when all borrowing is at fixed rates. This may occur when long-term rates are very low and short-term rates set to rise.

- (iv) Upper limit for borrowing that is at fixed rates less investments that are fixed rate investments (percentage).

2002/03 %	2003/04 %	2004/05 %	2005/06 %	2006/07 %
99.5	100	100	100	100

All borrowing may be at fixed rates if it is anticipated that short-term rates are set to rise and long-term rates are perceived to be low.

- (v) Lower limit for borrowing that is at fixed rates less investments that are fixed rate investments (percentage).

2002/03 %	2003/04 %	2004/05 %	2005/06 %	2006/07 %
99.5	(20)	(20)	(20)	(20)

All borrowing may be converted to variable rates if fixed rates were very high and expected to fall.

- (vi) Upper and lower limits for year 1 for amount of projected borrowing that is fixed rate maturing in each period, expressed as a percentage of total projected borrowing that is fixed at the start of the period.

	Upper %	Lower %
Where periods are		
Under 12 months	40	0
Over 12 months, less than 24 months	100	0
Over 24 months, less than 5 years	100	0
5 years, less than 10 years	100	0
10 years and above	100	0

The limits have been set to allow maximum flexibility to manage loan durations.

- (vii) When investing, or planning to invest, for more than 364 days, indicate an upper limit for the total principal sum invested to final maturities beyond the period end, less projected average cash balances in the period for each forward financial year for which Brent projects such investments to mature.

2004/05 £m	2005/06 £m	2006/07 £m
100	100	100

Brent Council has not invested balances for periods of more than 364 days. The limit proposed allows flexibility to lend for longer periods if interest rates make this advantageous.

GLOSSARY

The operational boundary is the expected level of external debt during the year, accommodating the possibility of unusual cash movements (e.g., late payment of grants, capital receipts etc).

Other long-term liabilities are liabilities in excess of twelve months, and may include items such as leases. The establishment of such liabilities will be dependent on option appraisal as local authorities seek value for money deals.

Financing costs are the costs of financing capital expenditure. These will include interest payments (net of interest received on balances), debt management expenses, and premia/discounts arising from debt restructuring.

Net revenue stream is the amount to be met from government grants and local taxpayers.

The capital financing requirement (CFR) measures the underlying need to borrow for capital purposes. The CFR may reflect future years capital expenditure if it is advantageous to borrow early (e.g. interest rates may be low).