PURPOSE AND DESCRIPTION OF THE PRUDENTIAL INDICATORS

PURPOSE AND KEY OBJECTIVES OF THE PRUDENTIAL CODE

Local authorities determine their own capital programmes for capital investment in fixed assets that are required to deliver local public services. The Prudential Code is the professional code of practice that supports local authorities in taking these decisions. Local authorities are required by Regulation to have regard to the Prudential Code when carrying out their duties under Part 7 of the Local Government in Scotland Act 2003.

The key objectives of the Prudential Code are to ensure that the capital investment plans of local authorities are affordable, prudent and sustainable, as well as being consistent with and supporting local strategic planning, local asset management planning and proper option appraisal. To demonstrate that local authorities have fulfilled these objectives, the Prudential Code sets out a number of Prudential Indicators that must be considered when the Council sets its budget covering prudence (in particular capital expenditure and external debt) and affordability.

The key indicators that drive the capital budget decision making process continue to be those concerning affordability, as these measure the impact of capital investment decisions on the overall revenue budget.

PRUDENCE

CAPITAL EXPENDITURE

Prudential Indicator: Capital Expenditure

Local authorities are required by regulation to comply with the Prudential Code in terms of meeting their statutory duty under Section 35(1) of the Local Government in Scotland Act 2003 to *"determine and keep under review the maximum amount which it can afford to allocate to capital expenditure"*). The amount so determined is termed the "Affordable Capital Expenditure Limit".

The Prudential Code requires Angus Council to make reasonable estimates of the total gross capital expenditure that it plans to incur during the forthcoming financial year and, at minimum, the following two financial years. The basis of this information is the Council's General Fund Capital Plan, but must also include any capital expenditure that will be dealt with as other long term liabilities (e.g. lease and private finance arrangements).

In addition to these forward year estimates of capital expenditure the Prudential Code also requires councils to note the actual capital expenditure for the most recently completed financial year (as reflected in the audited year end accounts).

Prudential Indicator: Capital Financing Requirement

Angus Council has available to it a number of ways of financing its capital expenditure. A number of these financing options involve resourcing the investment at the time at which it is incurred, namely:

(i) the application of useable capital receipts;
(ii) a direct charge to revenue for the capital expenditure (CFCR);
(iii) the application of capital grants and contributions; and
(iv) securing an upfront contribution from another party towards the cost of a project.

Capital expenditure that is not financed upfront by one of these methods will increase the capital financing requirement of the Council. The calculation of the capital financing requirement is therefore intended to reflect the Council's underlying need to borrow for a capital purpose and it is used as a key measure in treasury management decisions for this reason.

In accordance with best professional practice the Council does not associate borrowing with particular items or types of expenditure. The Council manages its borrowings and investments in accordance with approved treasury management policy which means that in day to day cash management no distinction can be made between revenue cash and capital cash. External borrowing arises as a consequence of all the financial transactions of the Council and not simply those arising from capital spending. In contrast the capital financing requirement reflects the Council's underlying need to borrow for a capital purpose.

The Prudential Code requires that the capital financing requirement is estimated for the end of the forthcoming financial year and, at minimum, the following two years. The Council is also required to note the actual capital financing requirement for the most recently completed financial year. The estimated capital financing requirement at each year end will reflect all capital expenditure – i.e. it includes relevant capital expenditure incurred in previous years.

EXTERNAL DEBT

Prudential Indicator: Authorised Limit

The Prudential Code requires the Council to set an authorised limit for its total external debt. In this context total external debt needs to be expressed as gross of investments and split between borrowing and other long term liabilities (such as finance leases held by the Council and the liabilities associated with the Council's Public Private Partnerships (PPP) / Private Finance Initiatives (PFI) projects and projects with similar private finance arrangements (e.g. Forfar Community Campus)).

Based on the Council's plans for capital expenditure and financing, the authorised limit represents a maximum value beyond which the Council's total external debt must not exceed. This indicator is intended as a backstop control mechanism over the Council's external debt position and is based on possible rather than probable events. A comparison of the Council's actual external debt and the authorised limit is made on a regular basis as part of the Finance service's treasury management activities.

An authorised limit needs to be set for the forthcoming financial year and, at minimum, the following two financial years. This indicator is a Council wide indicator so there is no separation between General Fund and the Housing Revenue Account (HRA).

Members are asked to note that although this indicator represents a maximum to which the Council could potentially borrow, in practical terms the Council will operate within the borrowing element only in this regard.

Prudential Indicator: Operational Boundary

This Prudential Indicator is the focus of day to day treasury management activity within the Council. It is a means by which the Council will ensure that it remains within the self-imposed authorised limit. It differs from the authorised limit in that it is based on expectations of the maximum external debt of Angus Council according to probable – as opposed to possible – events and should be in line with the maximum level of external debt projected by the estimates. In this context total external debt needs to be expressed as gross of investments and split between borrowing and other long-term liabilities. As with the authorised limit, above, the liabilities associated with the Council's finance leases and privately financed projects are also included.

Unlike the authorised limit an occasional breach of the operational boundary on a temporary basis should not be regarded as a significant problem, merely a situation which reflects the peaks and troughs nature of the Council's cash flow. An ongoing breach caused by borrowing activity as part of a debt rescheduling exercise should also be regarded as acceptable, albeit this will require specific monitoring by treasury management staff. Any ongoing or regular breach of the operational boundary not due to the aforementioned factors would however require investigation. It will then be the responsibility of the Director of Finance to determine if it would be prudent to raise the current boundary or, alternatively, to instigate procedures to ensure that limits are not breached.

The Prudential Code requires that an operational boundary be set for the forthcoming financial year and, at minimum, the following two financial years. This indicator is a Council wide indicator so there is no separation between General Fund and the HRA.

Members are asked to note that although this indicator represents the operational level within which the Council could potentially borrow, in practical terms the Council will operate within the borrowing element only in this regard.

Prudential Indicator: Actual External Debt

During the course of the year, actual external debt requires to be monitored on a basis that reflects the circumstances and management arrangements of the Council. A daily record of the Council's actual external debt is kept as part of the Finance service's treasury management activities.

The Code requires the Council to note what its actual external debt position was at the end of the latest completed financial year. It should be noted that the actual external debt reflects the position at a particular point in time and is therefore not directly comparable to the authorised limit and operational boundary.

Prudential Indicator: Gross Debt and the Capital Financing Requirement

As part of the Prudential Code the Council must undertake a cross check of how its gross debt compares with its capital financing requirement. The Council's capital financing requirement exceeding its gross external debt position is a demonstration of a prudent capital investment strategy. This Prudential Indicator is intended to ensure that over the medium-term debt incurred by the Council will only be used for capital purposes.

The Council is required to ensure that gross debt does not, except in the short term, exceed the total capital financing requirement in the preceding year plus estimates of any additional capital financing requirement for the current and, at minimum, the next two financial years.

It should be noted that in the assessment of Capital Financing Requirement (CFR) versus gross debt the calculations include both General Fund and HRA. The Council's gross external debt cannot be broken down between General Fund and the HRA. Accordingly for comparative purposes the total CFR for Angus Council requires to be used.

AFFORDABILITY

Relationship Between Capital and Revenue Expenditure

The Prudential Indicators for affordability are considered to be the most important within the Prudential Code because they effectively capture the bottom line revenue impact of capital spending decisions. In this regard it is important to appreciate the relationship between capital and revenue expenditure.

Capital expenditure which is not funded by capital grants and contributions, capital receipts or directly from the revenue budget (as CFCR) will involve borrowing via the Council's loans fund. This borrowing carries with it a requirement to repay the amount borrowed (the principal); the interest charges incurred thereon; and a share of loans fund expenses. The principal repayment, interest and expenses charges are collectively referred to as capital financing costs (sometimes also called loan charges). Capital financing costs need to be paid for through the Council's revenue budget. Other forms of financing costs which require to be paid for through the revenue budget are those associated with finance leases (e.g. the residual waste facility in Dundee), PPP / PFI liabilities and projects with similar private finance arrangements (e.g. Forfar Community Campus).

The Prudential Indicators on affordability are intended to ensure that the revenue budget impact of capital spending decisions are shown on a transparent basis which demonstrates that such capital spending decisions are affordable both now and into the future. A separate report on the long-term affordability of the General Fund Capital Plan is presented to Angus Council which takes the assessment of affordability beyond the minimum requirements of the Prudential Code.

Prudential Indicator: Financing Costs to Net Revenue Stream

This indicator is intended to measure the percentage of the Council's total income that it is estimated will be committed towards meeting the costs of the borrowing and other credit arrangements used to fund capital expenditure. In simple terms the more of the Council's total income that is needed to fund capital financing costs the less is available to meet other revenue expenditure such as salaries, supplies, etc. There is however no right answer as to what the percentage of financing costs to net revenue stream should be.

The Prudential Code requires the Council to make estimates of the percentage of capital financing costs to its net revenue stream for the forthcoming financial year and, at minimum, the following two financial years. The Council is also required to note the actual capital financing costs to net revenue stream for the most recently completed financial year.

For the purpose of calculating these indicators, it is often necessary to make assumptions with regard to levels of revenue income and expenditure in future years on a best estimate basis.