

Manchester City Council Report for Information

Report to: Resources and Governance Scrutiny Committee – 5 November 2019

Subject: Capital Requirements and Anticipated Borrowing

Report of: Deputy Chief Executive and City Treasurer

Summary

This report informs members of the Council's capital financing position, forecast borrowing, and the impact on the Council's balance sheet and revenue budget. The report also reviews the changes to PWLB borrowing rates announced in October.

Recommendations

The Committee is asked to note the contents of the report.

Wards Affected: All

Environmental Impact Assessment - the impact of the issues addressed in this report on achieving the zero-carbon target for the city

The capital approval process includes requirements for projects to review the impact on the zero-carbon target as part of the business case.

Manchester Strategy outcomes	Summary of how this report aligns to the OMS
A thriving and sustainable city: supporting a diverse and distinctive economy that creates jobs and opportunities	The capital programme contributes to various areas of the economy including investment in public and private sector housing, education and children's social care, transport infrastructure, major regeneration activities, environmental, cultural and leisure services.
A highly skilled city: world class and home grown talent sustaining the city's economic success	The capital programme includes substantial investment in education and also provides opportunities for the construction industry to bid for schemes that could provide employment opportunities at least for the duration of contracts.
A progressive and equitable city: making a positive contribution by unlocking the potential of our communities	The capital programme includes investment in adult and children's social care, education, housing and the environment, cultural and leisure services, all of which contribute towards the strategy.

A liveable and low carbon city: a destination of choice to live, visit, work	Investment in all areas of the capital programme contributes towards this community strategy, notably the investment in sustainable and affordable housing, building schools for the future, transport, environmental and major regeneration programmes.
A connected city: world class infrastructure and connectivity to drive growth	The capital programme includes investment in highways infrastructure, and broadband expansion.

Contact Officers:

Name: Carol Culley
 Position: Deputy Chief Executive and City Treasurer
 Telephone: 0161 234 3406
 E-mail: carol.culley@manchester.gov.uk

Name: Janice Gotts
 Position: Deputy City Treasurer
 Telephone: 0161 234 1017
 E-mail: j.gotts@manchester.gov.uk

Name: Tim Seagrave
 Position: Group Finance Lead – Capital and Treasury Management
 Telephone: 0161 234 3445
 E-mail: t.seagrave@manchester.gov.uk

Background documents (available for public inspection): None

1.0 Introduction

- 1.1 This report seeks to update members on the Council's capital financing position, the role of internal borrowing in treasury management strategy, the current forecast borrowing requirement, interest rate expectations, borrowing strategy and the impact on the revenue budget.
- 1.2 The report also provides details and analysis on the changes to borrowing rates for the Public Works Loan Board (PWLb) announced in October.

2.0 Background

- 2.1 Local government has the power to make local decisions on capital activity, including the level and structure of borrowing undertaken to fund this activity. The Chartered Institute of Public Finance and Accountancy (CIPFA) provide two frameworks to inform this activity, the Prudential Code and the Treasury Management Code, and in addition there is guidance provided by MHCLG on investments and minimum revenue provision (MRP), which is the means by which the repayment of debt is accounted for within the revenue budget.
- 2.2 The Council adheres to the two Codes, and has regard to the guidance provided by MHCLG.

3.0 Context

- 3.1 Since the financial crisis in the late 2000's interest rates have been historically low, as shown in the graph at appendix A. During that time there has been a consistent and significant difference between interest rates on investments and debt of similar periods.
- 3.2 Under these circumstances, the Council's approach to managing debt has been to seek to minimise cash balances by delaying taking external debt. The implications of this is that the Council has had only relatively minor increases in interest-paying external debt over recent years, until £150m of debt was taken last year.
- 3.3 Balance sheet management is complex as it requires management across a number of years, and this includes the debt required to fund capital expenditure. Whilst there are clear links between capital activity and debt, there are other balance sheet items which influence the level of the Council's external debt.
- 3.4 When, for example, revenue reserves increase the cash associated with this is retained in the Council's bank account and can therefore be invested. However, in seeking to manage the balance sheet in a cost effective manner using that cash to fund capital expenditure in lieu of external debt can be cost effective. This is because the interest cost of external debt can be avoided until the cash is needed for its intended purpose, at the opportunity cost of the lower investment income lost. This is known as internal borrowing, as the Council is in effect borrowing from itself.

- 3.5 Such an approach is not without risk, as if interest rates become more expensive over time the cost of externally borrowing at the point the cash is required for its intended purpose may be more expensive than at the point the debt was originally required.
- 3.6 In managing this risk, it should be noted that the interest rate environment over the last five years has been relatively benign, and the Council's treasury management team actively monitor market rates to seek to mitigate this risk.

4.0 Changes in internal borrowing

- 4.1 By following a strategy to minimise cash the Council has significantly increased the internal borrowing position on the balance sheet. This can be seen by comparing the Council's Capital Financing Requirement (CFR), which is the accounting definition of the Council's indebtedness and is defined as being the sum of all capital expenditure funded by borrowing over time for which the Council has yet to provide repayment for, and the Council's external debt.
- 4.2 The table below shows this comparison over the last three financial years:

	CFR	External Debt	Internal Debt
	£'m		
2016-17	1,168.9	536.0	632.9
2017-18	1,237.1	530.3	706.8
2018-19	1,528.5	726.8	801.7

- 4.3 The revenue budget contains an annual budget for capital financing, which funds the cost of interest payments, Minimum Revenue Provision (MRP) which is explained in more detail in section 6, and an element of direct funding of the capital programme through revenue contribution to capital outlay. The capital financing budget for 2019/20 is c. £44.5m.
- 4.4 Internal borrowing has created revenue savings compared to the cost of externalising the debt and holding cash. To reflect this and to mitigate the risk that future debt may be at higher rates, on an annual basis any unspent capital financing budget is transferred to the capital financing reserve. This has the effect of smoothing the cost of borrowing for the Council across years, and by doing so seek to minimise the impact any changes in financial markets may have on the Council's overall revenue budget each year.
- 4.5 This has been a proactive decision given the relatively low interest for investments and the significant funding requirement for the capital programme, including the Town Hall project. Managing capital financing in this manner mitigates the borrowing requirement becoming an additional pressure on the revenue budget.

5.0 Interest rate expectations

- 5.1 The Council retains the services of a treasury management advisor, Link Asset Services, which provide an interest rate forecast based on the financial market's view of future Gilt rates and other market intelligence. Their latest forecast for PWLB debt, adjusted for the PWLB rate rise discussed in section 9, is shown below.

	Mar 2020	Mar 2021	Mar 2022
	%		
5yr PWLB rate	2.50	2.80	3.10
10yr PWLB rate	2.80	3.10	3.40
25yr PWLB rate	3.40	3.70	4.00
50yr PWLB rate	3.30	3.60	3.90

6.0 Borrowing Strategy

- 6.1 The borrowing strategy is based on aggregating the debt needs of the Council to achieve the optimum risk balance in debt management. This means that the Council borrows based on the CFR and its expected movements over time, rather than for specific projects.
- 6.2 Under the Prudential Code the Council must have a policy in place regarding Minimum Revenue Provision (MRP). This is an element of the revenue budget which is set aside to repay the principal element of debt associated with capital projects funded by borrowing, and is usually spread over the useful economic life of the asset. It is MRP which reduces the CFR over time, acknowledging that providing funding to repay debt reduces the overall indebtedness of the authority, and in this way it acts like depreciation on the Council's indebtedness.
- 6.3 Under the current economic conditions, the Council's borrowing strategy over recent years has been to borrow debt of durations which match to the future profile of MRP, so that the MRP included within the revenue budget in each future financial year is used in that year to repay external debt.
- 6.4 Based on the forward forecast of interest rates, under this strategy it is more cost effective to borrow the longer duration debt first. The current borrowing model assumes debt maturities from 2024-25 through to 2042-43.

7.0 Forecast borrowing requirement

- 7.1 The forecast borrowing requirement for the Council is made up of several parts including the internal borrowing position. It includes the projects which

are explicitly funded by borrowing, the use of capital and revenue reserves, the refinancing of maturing debt, and the minimum revenue provision.

- 7.2 The table below is based on the forecast capital and revenue monitoring at period 6, and shows the forecast borrowing requirement.

	2019-20	2020-21	2021-22	2022-23	2023-24
	£'m				
Borrowing for capital programme	149.8	194.2	146.7	116.8	43.2
Changes in capital reserves	(58.3)	29.2	28.5	(16.6)	(21.5)
Changes in revenue reserves	11.2	47.2	28.5	4.7	4.3
Replacement borrowing for maturing debt	30.5	3.0	7.3	8.3	2.9
MRP	(23.0)	(27.4)	(30.4)	(32.2)	(32.6)
Forecast Borrowing Requirement	110.2	246.2	180.6	81.0	(3.7)

- 7.3 This forecast will change over time as it is based on the expected position for all capital projects and revenue budgets at the end of each financial year. Should actual activity vary from these forecasts, it can and will have a material impact on the forecast borrowing.

- 7.4 One of the key elements which can impact the need to take debt is working capital, which for the Council is effectively the net debtor and creditor position at any given point in time. This is not explicitly included within the model, and is assumed to remain stable. Over recent years this has not been the case and there have been changes to working capital, but this is not something that can be easily modelled or forecasted. It is heavily influenced by, for example, the timing of the delivery of the capital programme, or the payment and receipt of business rates.

8.0 Revenue implications of new debt for the medium term

- 8.1 On the basis of the existing borrowing strategy, the forecast borrowing requirement and the expected path and structure of interest rates over the next five years it is therefore possible to model the forecast additional costs associated with the capital and revenue budget.
- 8.2 The table below shows the impact on the revenue budget of the forecast additional borrowing required in terms of interest costs and minimum revenue provision.

	2019-20	2020-21	2021-22	2022-23	2023-24
	£'m				
Forecast MRP from new capital borrowing	0.0	4.5	7.9	10.0	10.6
Forecast additional interest costs	1.6	7.2	14.3	18.3	19.2

- 8.3 The future borrowing requirement, and therefore the interest and MRP costs associated with it, is linked to the investment the Council is making in the delivery of the Our Town Hall project and the Highways Investment Programme, along with other capital investment.

9.0 PWLB rate policy change

- 9.1 The Council has access to the Public Works Loan Board (PWLB) for debt, which is an executive agency of the Treasury. Acting as a lender to the local authority sector, it provides debt at interest costs linked to the equivalent debt costs of Government, known as Gilts.
- 9.2 The PWLB published twice daily the standard rates available to local authorities for loans. The interest rate methodology is complex, but roughly equates to the equivalent of Gilts plus 100 basis points. This means that if the 20 year Gilt was 2.50% the Council would expect the PWLB rate to be 3.50%.
- 9.3 The City Council, by virtue of providing Government with information around expected borrowing and capital expenditure, has access to the certainty rate, which provides a discount of around 20 basis points on the standard rate or the equivalent of Gilts plus 80 basis points.
- 9.4 On the 9th of October the PWLB changed its policy to increase the margin on Gilts to Gilts plus 200 basis points, and therefore the margin on the certainty rate to Gilts plus 180 basis points. This means that interest costs on future debt have increased substantially. Interest rates on PWLB the Council already hold have not changed.
- 9.5 Treasury have taken this step as there had been a significant increase in local authority borrowing in recent months, driven by interest rates falling. As local authority debt forms part of the national debt, and amidst concern about local authorities investing in commercial assets in order to profit from the return, by increasing the interest cost Treasury want the demand for debt to fall.
- 9.6 By increasing rates by 100 basis points the interest costs now faced by the Council are similar to those towards the end of the 2018 calendar year, which were included within the assumptions for the capital financing budget set in February of this year.

- 9.7 Therefore, whilst the existing capital programme and forecast borrowing remains affordable, the true impact of the policy change is on the assumed capacity for further borrowing in the future.

10.0 Impact of PWLB policy change

- 10.1 In simple terms, the cost of debt for local authorities became more expensive immediately upon announcement of the policy change.
- 10.2 The policy change took PWLB rates back to where they were towards the end of 2018, and as such the existing capital programme was predominantly budgeted for at that time, meaning that the programme remains affordable.
- 10.3 There are some issues with projects which relate to either loan finance to a third party or are based on a spend to save proposal, where the financial arrangements will need to be reviewed to ensure that they continue to be robust. This work will be completed through the existing capital approval process as projects come forward for approval.
- 10.4 The table at paragraph 8.2 shows the forecast additional interest costs associated with the forecast borrowing requirement under the new PWLB rate. If the rate had not changed these would have been lower, and the impact is shown in the table below:

	2019-20	2020-21	2021-22	2022-23	2023-24
	£'m				
Forecast additional interest costs	1.6	7.2	14.3	18.3	19.2
Forecast additional interest costs	1.1	5.0	10.0	12.6	13.0
Difference	(0.5)	(2.2)	(4.3)	(5.7)	(6.2)
Cumulative difference	(0.5)	(2.7)	(7.0)	(12.7)	(18.9)

- 10.5 This highlights that perhaps the most significant impact on the Council is in regard to future borrowing capacity. The rate change means that the existing forecast borrowing becomes more expensive and therefore there will be less revenue budget available in future years to service further debt, alongside that future debt also now being more expensive.
- 10.6 The increase in borrowing cost will have an impact on the viability of future capital investment. For example, within the HRA the cost of borrowing to fund new homes has increased significantly which may mean that future schemes become unviable or will need redesign to value engineer costs out of the project due to the limited funding available within the business plan.

- 10.7 Where projects may have been pursued on a spend to save basis, the income from them will need to cover both MRP and the higher interest cost the Council faces, which may mean that they can no longer be self-funding. This could affect regeneration schemes where a return on investment was expected.

11.0 Response to PWLB policy change

- 11.1 Increasing the interest rate on PWLB debt creates an additional margin above Gilts which means that other institutions involved in financial markets may now be able to provide local authorities with debt solutions. Previously the relatively low level of Gilts meant other market participants could not easily find financial products for local authorities which could provide value for money. The increased margin on PWLB debt provides them with an opportunity which may allow the Council to borrow at rates below PWLB, but at the time of writing this report this market is still forming and therefore the availability of debt at such rates is still to be determined.
- 11.2 Once there is clarity on what financial markets may be able to offer, there will be a need to review the Council's borrowing strategy. There may be a case, for example, of looking to borrow for shorter duration and therefore at lower rates, if the Council feels this will provide value for money and is willing to accept the refinancing risk that this would create.

12.0 Conclusion

- 12.1 The Council's careful approach to treasury management and capital financing has been designed to mitigate the impact of the expected future capital financing budget requirement, and to avoid where possible the cost of carrying cash alongside debt.
- 12.2 The Council is extremely disappointed by the decision to change PWLB interest rates. Whilst understanding the concerns about increasing borrowing levels, the change penalises authorities such as Manchester which have been prudent and made sensible decisions.
- 12.3 The rate change may call into question the viability of future capital projects, such as those for housing and regeneration, as the business models for such investment are already challenging. The demand for construction services in Manchester creates a cost pressure and for some schemes the associated income stream may also be restricted, for example due to the Local Housing Allowance. By increasing financing costs under these circumstances, there is a risk that such schemes may not be viable.
- 12.4 The Council is lobbying Government to review this change, and to look at the case for a differential rate which recognises borrowing to fund housing, regeneration and infrastructure schemes that are clearly in line with local authority strategic objectives, rather than for commercial investments.
- 12.5 The Committee is asked to note the contents of this report.