Appendix 1

BORROWING

1 Introduction

1.1 The purpose of this paper is to discuss Denbighshire County Council's borrowing. It will cover the following areas:

- How do we borrow?
- Why do we borrow?
- How much do we owe?
- How much does it cost?
- What is our strategy?
- How do we go about it?

2 How do we borrow?

2.1 The legislation which determines how we borrow is included within the Local Government Act 2003. This act introduced the Prudential Code of Borrowing which came into effect on 1 April 2004. The Code stated that local authorities can borrow provided they can demonstrate it is affordable, prudent and sustainable.

3 Why do we borrow?

3.1 We borrow to finance the Capital Plan which includes all the capital projects which have been approved for the next three years. We receive grants and contributions to finance part of the capital expenditure and we can also use capital receipts following the disposal of assets. The shortfall has to be met by borrowing but we don't always use external borrowing as the only means. We are also able to use our own reserves and balances to fund capital expenditure and this is known as internal borrowing. Our external borrowing is broken down into two types as shown below and the proportions of each type which are financed by Revenue Support Grant (RSG) and council tax are also included:

- Unhypothecated Supported Borrowing (USB)

  (80% RSG / 20% Council Tax)
- Prudential Borrowing (PB)

  (100% Council Tax)

The level of USB has reduced in recent years which is why PB has increased to bridge the gap. Graph 1 enclosed overleaf shows the levels of USB and PB over the last 5 years.

4 How much do we owe?

4.1 Our current debt is £134.39m at an average rate of 5.75% and this is made up of individual loans which vary in length from 1 year to 50 years. Some loans are on a Maturity basis and others on an Equal Instalment of Principal (EIP) basis. In the case of Maturity loans, interest is payable annually and the principal is payable at the end of the term. In the case of EIP Loans, an equal instalment of principal is payable annually and interest is also payable annually based on the reduced balance. An annuity loan is similar to an EIP loan but the cost is annualised so the total amount payable is the same each year. The illustration below shows the cost of the various types of loans based on an example of a £10m loan over 10 years:

	EIP			Maturity			Annuity		
Year	Principal £000	Interest 1.81% £000	Total £000	Principal £000	Interest 2.79% £000	Total £000	Principal £000	Interest 1.82% £000	Total £000
1	1,000	176	**1,176**	0	279	**279**	920	178	**1,098**
2	1,000	158	**1,158**	0	279	**279**	937	161	**1,098**
3	1,000	140	**1,140**	0	279	**279**	954	144	**1,098**
4	1,000	122	**1,122**	0	279	**279**	972	126	**1,098**
5	1,000	104	**1,104**	0	279	**279**	990	108	**1,098**
6	1,000	86	**1,086**	0	279	**279**	1,008	90	**1,098**
7	1,000	68	**1,068**	0	279	**279**	1,026	72	**1,098**
8	1,000	50	**1,050**	0	279	**279**	1,045	53	**1,098**
9	1,000	32	**1,032**	0	279	**279**	1,064	34	**1,098**
10	1,000	14	**1,014**	10,000	279	**10,279**	1,084	14	**1,098**
Total	**10,000**	**950**	**10,950**	**10,000**	**2,790**	**12,790**	**10,000**	**980**	**10,980**

Graph 2 illustrates the maturity profile of our debt over 50 years.

5 How much does it cost?

5.1 We have a Capital Financing Budget of approximately £12m to cover the cost of our borrowing. The majority of the budget consists of the following three elements:

- **Minimum Revenue Provision (£6m)**

  (amount set aside each year to repay debt)

- **PWLB Interest Payable (£6.4m)**

  (interest payable each year on the Council's loans)

- **Less Investment Interest (£0.4m)**

  (interest earned each year on the Council's investments)

6 What is our strategy?

6.1 The first principle which we base our strategy on is that we don't borrow more than we need. We do this by ensuring that our borrowing always remains below the Capital Financing Requirement which is a measure of the Council's need to borrow. We also set Prudential Indicators each year which determine our borrowing limits and help us to ensure that capital investment is affordable, prudent and sustainable. These indicators are approved by Council each February. We are not permitted to borrow to invest but we can borrow in advance of need.

6.2 The second principle which we base our strategy on is that we can afford to pay it back. As discussed above, we have a Capital Financing Budget which is the budget set aside to cover the cost of our borrowing. One of the Prudential Indicators which measures affordability is the ratio of financing costs to net revenue stream. This calculates what proportion of our revenue stream is spent on financing our debt.

7 How do we go about it?

7.1 All of our debt is currently from the Public Works Loan Board (PWLB) but we can also borrow from banks and local authorities for short term cash flow purposes. It should be emphasised that our debt cannot be compared to a mortgage which is secured against the asset. Our loans are not linked to particular assets and are secured on future revenue streams.

7.2 We borrow when the time is right by monitoring our cash flow position, the Capital Plan and interest rates. We also consult our treasury management advisers, Arlingclose Ltd, who advise us on the movements in interest rates to ensure that we borrow when rates are at their lowest.

7.2 PWLB fixed interest rates are determined by reference to gilt yields, and variable rates are determined by reference to a formula. Rates for fixed rate PWLB loans are calculated by applying a margin to the corresponding gilt yield. The margin over gilts varies very slightly depending on the average life of the loan, but is approximately 100bps (or 1.00%).

7.3 Gilts are essentially bonds issued and guaranteed by the UK Government. They can either have fixed rates of interest or are index-linked, and each issue has a distinct maturity date, although some are undated. Gilts are listed on the London Stock Exchange and are extremely liquid instruments.

7.4 Graph 3 shows the yield curve for PWLB interest rates from 1 year up to 50 years. It shows that 10 year EIP loans currently offer very good value at levels which are below 2.00%. However, the graph also illustrates that it’s much more expensive to borrow than to invest at the moment with the Official UK Bank Rate expected to remain at 0.5% for some time. The graph shows the difference between investment and borrowing rates which is known as the cost of carry. For example, the cost of carry is approximately £12,000 for every £1m borrowed over a 10 year period because the Council could borrow for 10 years at a rate of approximately 2% but could only invest at a rate of approximately 0.8%.