Performance and Finance Select Committee

21 January 2016

Treasury Management Strategy 2016/17

Report by Executive Director Corporate Resources and Services

Executive Summary

The Council is required by the Chartered Institute of Public Finance and Accountancy (CIPFA) to approve a Treasury Management Strategy Statement for 2016/17 before 1 April 2016. In accordance with governance arrangements approved in February 2013 the Performance and Finance Select Committee will receive the annual strategy statement (before County Council approval), as recommended by the Cabinet Member for Finance in consultation with the Executive Director Corporate Resources and Services and the Treasury Management Panel.

The Council's treasury management activities expose it to a variety of financial risks, the key risks are:

- **Credit Risk**: The possibility that other parties might fail to pay amounts due to the Council;
- **Liquidity Risk**: The possibility that the Council might not have funds available to meet its commitments to make payments;
- **Re-Financing Risk**: The possibility that the Council might be requiring to renew a financial instrument on maturity at disadvantageous interest rates;
- **Market Risk**: The possibility that financial loss might arise for the Council as a result of changes in such measures as interest rate movements.

The Council's overall risk management procedures focus on the unpredictability of financial markets, and implementing restrictions to minimise these risks. The procedures for risk management are set out through a legal framework in the Local Government Act 2003 and the associated regulations (including CIPFA Codes of Practice). Financial risks, relating to both borrowings and investments, are minimised through the annual Treasury Management Strategy, which incorporates the recommended Prudential Indicators as set out in the 2016/17 Budget Report.

Borrowing:

The Council's long-term external borrowing (excluding PFI, finance leases and the loan undertaken on behalf of the Littlehampton Harbour Board) amounted to £409.6m at 31 December 2015, sourced entirely from the Public Works Loan Board (PWLB) at fixed interest rates of between 5.125% and 3.77% with a weighted average rate of 4.52%.

The underlying need to borrow for capital purposes reflects the Council's approved Capital Programme (2015/16 to 2020/21) and the resulting Capital Financing Requirement (CFR). Given historically low rates of investment income

returns and to avoid a “cost of carry”, where the proceeds of long-term borrowing are temporarily held in lower yielding investments, the Cabinet Member for Finance’s recommended policy is to remain under-borrowed against the Council’s CFR position.

Capital plans highlight that a borrowing requirement of up to £58.3m, including £23.4m relating to income generating initiatives, is required to finance the Council’s capital programme in 2016/17. An analysis of the Council’s usable reserves show these continue to be sufficient to avoid external borrowing during 2016/17. The Cabinet Member for Finance therefore recommends an internal borrowing strategy in 2016/17 whereby the Council essentially lends its own surplus funds to itself (as has been the policy since April 2011). Through the continuation of internal borrowing the Council will minimise borrowing costs and reduce overall treasury risk by reducing the level of external investments (despite forgoing investment income).

£7m (plus interest) will however be repaid to the PWLB during 2016/17, as per the terms and conditions of the £70m borrowing taken during April 2011. When external borrowing is required (at some future point in time where this becomes necessary) the strategy has been developed to include a combination of short and long-term (fixed and variable rate) borrowing within a framework that considers cost, certainty, flexibility and need for cash. As a consequence the Executive Director Corporate Resources and Services forecasts that the cost of PWLB borrowing (interest charge) in 2016/17 will be £18.3m (£18.6m in 2015/16).

Investments:

Given the on-going period of low interest rates, the returns generated from investments made by local authorities remain stubbornly low. Additionally the credit risks associated when making unsecured bank deposits remain evident (due to bail-in legislation) relative to the risks of other investment options available to the Council (including bank secured, local authority and non-bank corporate deposits). In response to the bail-in regulations implemented by the UK authorities in January 2015 (and subsequently by other countries), the three main credit rating agencies (Fitch, Moody’s and Standard & Poor’s) completed their reviews of many global financial institutions regarding the impact of bail-in and the removal of potential government support during the first half of 2015. Consequently, whilst global concerns remain the credit profile of financial institutions currently on the Council’s approved lending list has somewhat stabilised.

Given the risks and continued low returns from short-term unsecured bank deposits, an investment strategy is recommended that continues the policy approved and adopted in 2015/16; which aims to diversify investments through the greater use of bail-in exempt and non-bank financial instruments and to extend duration period for investments where appropriate. Unsecured bank deposits (including money market funds) will however remain part of the Council’s short-term (up to one year) investment strategy.

Following advice received from the Council’s treasury management advisors (Arlingclose) and as agreed by the Panel at their November 2015 meeting, the following changes have been incorporated into the 2016/17 investment strategy:

(1) An increase to **unsecured** bank deposit duration limits (up to a maximum of 364 days) as set out below:

- Banks rated A- (including Barclays): 100 days (unchanged)
- Banks rated A (including Lloyds and Nationwide Building Society): 6 months (increased from 100 days)
- Banks rated A+ and above (including HSBC, approved Canadian and Singaporean Banks): 364 days (increased from 6 months).

(2) The inclusion of Coventry Building Society (long-term rating A) and Leeds Building Society (long-term rating A-) in addition to Nationwide Building Society, and Danske Bank, Denmark (long-term rating A, sovereign rating AAA) as appropriate counterparties for unsecured bank deposits in line with exposure limits set out in recommendation (1).

(3) An increase in the monetary limit for secured investments with "other building societies" (including Yorkshire Building Society) from £5m to £15m, allowing a greater use of long-term covered bonds (fixed or variable rate) than approved in 2015/16.

(4) An increase in the maximum invested long-term (greater than one year) with other UK local authorities (excluding fire and police) from £10m to £25m (per authority).

(5) An increase in the maximum limit for the total invested greater than one year from £75m to £100m, based on forecast investment balances up to March 2021.

In line with the recommended investment strategy and Arlingclose's "Economic and Interest Rate Forecast", the Executive Director Corporate Resources and Services forecasts that based on an average investment portfolio of £270m, gross investment interest totalling £2.26m will be received in 2016/17. Following £0.653m interest transfers to internal and external reserve balances held by the Council, including Local Enterprise Partnership monies (slipped from 2015/16), school accumulating funds, PFI/MRMC reserves and cash held on behalf of the Chichester Harbour Conservancy, the Executive Director Corporate Resources and Services forecasts a £0.257m deficit against the budgeted investment income total (2016/17 budget: £1.864m).

Given the constraints on the Council's 2016/17 revenue budget, it is proposed that any actual investment income shortfall will be met via transfers from the Interest Smoothing Account (current balance: £0.976m); however the actual shortfall may be reduced by deferring the final withdrawal from the Investec short-dated bond fund from February to April 2016, thereby realising an investment gain on sale of the remaining £10m Investec holding of around £150,000 in 2016/17. The timing of the Investec withdrawal will be dependent on whether additional income is required prior to March 2016 to meet the 2015/16 investment income target.

Recommendations

That the Committee reviews, comments on and supports the content of the 2016/17 Treasury Management Strategy Statement, ahead of submission for County Council approval in February 2016.

Treasury Management Strategy Statement (2016/17)

1 Background

1.1 Treasury management is defined as: 'The management of the local authority'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'.

1.2 The Council is responsible for its treasury management decisions and activity and as a consequence has borrowed and invests substantial sums of money, which exposes the Council to potentially large financial risks including the loss of invested funds and the revenue effect of changing interest rates. No treasury management activity is without risk; accordingly the successful identification, monitoring and control of risk are integral elements to treasury management activities and include credit and counterparty risk, liquidity risk, market or interest rate risk, refinancing risk and legal and regulatory risk.

1.3 The strategy takes into account the impact of the Council's Revenue Budget and Capital Programme on the Balance Sheet position, the current treasury position (**Appendix A**), the outlook for interest rates (**Appendix B**) and the Prudential Indicators (**Appendix C**).

1.4 All treasury activity will comply with relevant statute, guidance and accounting standards.

2 Governance

2.1 In line with the Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management Code of Practice the Council will report on risk, compliance and performance against the approved Treasury Management Strategy throughout the year.

2.2 The Council maintains a Treasury Management Panel comprising the Cabinet Member for Finance and four other elected members. The Panel functions as a formal consultative body, supporting the Cabinet Member and the Executive Director Corporate Resources and Services in implementing the Council's Treasury Management Strategy and widening Members' involvement in treasury management decisions.

2.3 The Performance and Finance Select Committee is responsible for the scrutiny of treasury management policies and reviews performance of delivering the annual strategy against planned objectives. A mid-year report benchmarking security and liquidity, in addition to the actual yield achieved on Council investments, is made available to this Committee. The Regulation, Audit and Accounts Committee receive quarterly reports on compliance with the Treasury Management Strategy.

2.4 In accordance with the CIPFA Treasury Management Code and the Department for Communities and Local Government's (DCLG) Investment Guidance, a revised Treasury Management Strategy Statement can be approved by the County Council and implemented at any time during the

financial year. County Council delegates the power to amend specific areas of the Treasury Management Strategy Statement between annual reviews to the Cabinet Member for Finance, in consultation with the Executive Director Corporate Resources and Services and the Treasury Management Panel. Such changes will be subject to a full risk appraisal and will be reported within regular compliance reports and may include:

- The types of financial instruments used
- Selection of counterparties (within the creditworthiness parameters as approved by County Council)
- Duration periods for fixed-term deposits
- Country, sector and group limits

3 Balance Sheet and Treasury Management Positions

3.1 In line with CIPFA's Prudential Code for Capital Finance in Local Authorities the Council approves the use of long-term borrowing to finance part of its capital programme. Each year County Council approves its on-going capital programme as part of the annual budget meeting in February. Capital expenditure may be financed from a range of internal and external sources. Internal sources include capital receipts, a direct charge to the revenue budget or contributions from usable reserves; whilst external sources include private sector contributions (such as s106 developer contributions) as well as government grants which may be ring-fenced for specific purposes or non-ring-fenced and available for general application by the Council.

3.2 External borrowing is required to meet the cost of any capital expenditure not financed by internal and/or external funding sources. External debt however is only a temporary form of finance as loans must be repaid; therefore the Council's underlying need to borrow for capital purposes (including PFI schemes and finance lease liabilities), and the amount that has yet to be permanently financed, is measured by the Capital Financing Requirement (CFR). Usable reserves and working capital are the underlying resources available for investment. The CFR together with usable reserves are therefore core drivers of the Council's treasury management activity.

3.3 The Council's current level of external debt and investments is set out at **Appendix A**. Market conditions, interest rate expectations and credit risk considerations will influence the Council's strategy in determining the borrowing and investment activity against the underlying Balance Sheet position. The Council will ensure that gross external debt will not exceed the CFR other than for short-term cash flow requirements.

3.4 In October 2015 the County Council approved a capital programme which set out the capital pressures facing the Council over the next few years, together with corresponding revenue implications, and included the proposed programme for 2016/17, the indicative programme up to 2020/21 and the proposed methods of capital financing. In order to finance the capital programme up to 2020/21, excluding income generating initiatives totalling £96.2m, County Council approved external borrowing of up to £75m in addition to its current policy of annual 'core' borrowing of £17m as set out in the Medium Term Financial Strategy (MTFS).

3.5 Planned capital expenditure and expected financing up to 31 March 2021, updated to reflect capital decisions made since October 2015 is shown below:

	2016/17 Estimate £'m	2017/18 Estimate £'m	2018/19 Estimate £'m	2019/20 Estimate £'m	2020/21 Estimate £'m
Core Programme & Priority Schemes	133.7	113.4	141.4	78.9	61.0
Income Generating Initiatives (IGI)	23.4	14.0	10.2	8.5	6.9
Capital Expenditure	**157.1**	**127.4**	**151.6**	**87.4**	**67.9**
Financed By:					
Ringfenced Government Grant	-38.0	-45.4	-51.3	-35.1	-26.6
Non-Ringfenced Gov't Grant	-32.0	-30.1	-27.1	-24.4	-22.5
Capital Receipts (including leasing)	-7.7	-2.8	-1.0	-1.0	-1.0
External Contributions	-7.8	-2.6	-1.7	-1.7	-3.1
Revenue Funding	-13.3	-2.6	-8.5	-0.5	-0.6
Total Financing	**-98.8**	**-83.5**	**-89.6**	**-62.7**	**-53.8**
Core Borrowing (as per MTFS)	-34.9	-29.9	-35.0	0.0	0.0
Additional Borrowing (up to £75m)	0.0	0.0	-16.8	-16.2	-7.2
Funding (Borrowing) for IGI's	-23.4	-14.0	-10.2	-8.5	-6.9
Total Borrowing Requirement	*-58.3*	*-43.9*	*-62.0*	*-24.7*	*-14.1*
TOTAL	**-157.1**	**-127.4**	**-151.6**	**-87.4**	**-67.9**

3.6 The updated financial overview (Balance Sheet forecast) through to 31 March 2021, **including** income generating initiatives, is shown below:

	2016/17 Estimate £'m	2017/18 Estimate £'m	2018/19 Estimate £'m	2019/20 Estimate £'m	2020/21 Estimate £'m
Capital Financing Requirement	620.2	642.7	683.1	686.9	677.2
Less Other Debt Liabilities *(i)*	-118.4	-115.7	-113.0	-109.3	-105.4
Borrowing CFR	**501.8**	**527.0**	**570.1**	**577.6**	**571.8**
Existing Borrowing Profile (PWLB)	-402.6	-395.6	-388.6	-381.6	-374.6
Littlehampton Harbour Board Loan	-0.3	-0.3	-0.2	-0.2	-0.2
Short-Term Borrowing *(ii)*	-3.8	-3.8	-3.8	-3.8	-3.8
External Borrowing (iii)	*-406.7*	*-399.7*	*-392.6*	*-385.6*	*-378.6*
Internal Borrowing	**95.1**	**127.3**	**177.5**	**192.0**	**193.2**
Less: Usable Reserves	-183.2	-174.2	-167.8	-162.1	-158.8
Less: Working Capital	-51.0	-52.3	-53.6	-54.9	-56.3
Reserves & Working Capital	*-234.2*	*-226.5*	*-221.4*	*-217.0*	*-215.1*
Investments	**-139.1**	**-99.2**	**-43.9**	**-25.0**	**-21.9**

(i) PFI liabilities and finance leases that form part of the Council's total debt.
(ii) Money held on behalf of the Chichester Harbour Conservancy
(iii) Loans to which the Council is committed to, excluding optional refinancing.

3.7 It is a requirement of the CIPFA Prudential Code to ensure that capital expenditure remains within sustainable limits, and in particular to consider the impact on Council Tax. The Prudential Code also requires local authorities to agree ratios and limits in respect of their borrowing and to demonstrate that their plans are prudent and affordable. Details of the proposed ratios and limits are summarised in the Council's Prudential Indicators (**Appendix C**).

3.8 The Prudential Indicators show that the impact of capital plans as outlined in the above financing table (paragraph 3.5) would add around 2.74% to current Council Tax (Band D equivalent) levels over the five-year period ending 31 March 2021.

4 Borrowing Strategy

4.1 At 31 December 2015, the Council's long-term external borrowing (excluding PFI liabilities, finance leases and the 20-year loan taken on behalf of the Littlehampton Harbour Board) amounted to £409.6m as part of its strategy for funding previous year's capital programmes. This external borrowing has been sourced entirely from the Public Works Loan Board (PWLB) at fixed interest rates of between 5.125% and 3.77%, with a weighted average rate of 4.52%. Whilst the Balance Sheet forecast (paragraph 3.6) indicates that the Council does not expect to borrow in 2016/17, the Cabinet Member for Finance may approve new external borrowing up to the Council's authorised borrowing limit as detailed within the Prudential Indicators (**Appendix C**).

4.2 The Council's primary objective when borrowing money is to strike an appropriately low risk balance between securing low interest borrowing costs whilst achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term capital plans change is a secondary objective. In consultation with its treasury management advisors the following issues will therefore be considered prior to undertaking any external borrowing:

- Affordability.
- Maturity profile of existing debt.
- Interest rate and refinancing risk.

4.3 There is no counterparty risk associated with borrowing, except that associated with money laundering. In conjunction with advice received from its treasury management advisor the Council will continue to investigate other sources of funding (as opposed to the PWLB) that may be available at more favourable borrowing rates. The Cabinet Member for Finance will therefore keep under review the following fixed or variable rate long-term and short-term (in lieu of long-term) borrowing options as sources of finance for the approved capital programme:

- Borrowing against internal resources held by the Council (including usable reserves and working capital) in lieu of external borrowing.
- Public Works Loan Board (PWLB) and any successor body.
- Borrowing from other UK local authorities.
- Borrowing from the money markets (financial institutions authorised by the Prudential Regulation Authority to operate in the UK).
- Borrowing from multilateral development banks (including the European Investment Bank).
- Borrowing from the UK Municipal Bond Agency plc and other special purpose companies created to enable local authority bond issue.

4.4 Additionally capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- Private Partnerships (PFI/PPP)
- Leasing (including hire purchase)

4.5 Capital expenditure levels, market conditions and interest rate levels will be monitored during the year in order to minimise borrowing costs over the medium to longer-term and maintain stability. Given the on-going cuts to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates expected to remain lower than long-term rates throughout 2016/17 (**Appendix B**), the differential creates a 'cost of carry' for any new longer-term borrowing where the proceeds are temporarily held in lower yielding investments.

4.6 Capital plans highlight that a borrowing requirement of up to £58.3m, including £23.4m relating to income generating initiatives, is required to finance the Council's capital programme in 2016/17 (paragraph 3.5). An analysis of the Council's usable reserves and working capital (£234.2m; paragraph 3.6) show these remain sufficient to avoid externally borrowing during 2016/17. By essentially lending the Council's own surplus funds to itself the Council will reduce borrowing costs and thereby minimise overall treasury risk by reducing the level of external investments (despite forgoing investment income). Additionally, the Cabinet Member for Finance may also consider arranging forward starting loans during 2016/17, where the interest rate is agreed in advance (fixed in context with current rates) but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period; however once an agreement with the lender is entered into, financial penalties in terminating the agreement would be incurred by the Council if at a later date it is decided that the borrowing was not actually required.

4.7 The Cabinet Member for Finance and the Executive Director Corporate Resources and Services therefore considers the most cost effective borrowing strategy in 2016/17 will be to continue internally borrowing against usable reserves and working capital, or to borrow short-term loans (normally for up to one month) to cover unexpected cash-flow shortages. Short-term borrowing for cash-flow purposes, up to a maximum of £40m, will be limited to the following external funding sources:

- Borrowing from other UK local authorities (including Police and Crime Commissioners, Fire Authorities and Local Authority Pension Funds).
- Borrowing from the money markets (financial institutions authorised by the Prudential Regulation Authority to operate in the UK).
- Borrowing from the Chichester Harbour Conservancy.

4.8 In accordance with the recommended borrowing strategy, no external borrowing is planned during 2016/17. £7m (plus interest) will however be repaid to the PWLB as per the terms and conditions of the £70m borrowing taken during April 2011. As a consequence the Executive Director Corporate Resources and Services forecasts that the cost of PWLB borrowing (interest charge) in 2016/17 will be £18.3m (£18.6m in 2015/16).

4.9 Internal Borrowing: In accordance with CIPFA's Prudential Code the Council may borrow up to its Capital Financing Requirement (CFR); the CFR representing the total of all of the Council's past capital expenditure that has yet to be financed. At any point in time the Council can be in a position whereby actual debt exceeds its CFR ("borrowing in advance of need") or remains lower than its CFR ("internal borrowing").

4.10 The cost of new long-term external borrowing is calculated with reference to UK gilt yields. With official interest rates forecast to remain below long-term gilt yields (**Appendix B**), an internal borrowing strategy will most likely be beneficial throughout 2016/17. Internal borrowing is however unlikely to be sustainable in the longer-term as it can only be applied to the extent of the Council's available balances, reserves and cash-flow surpluses. The risk to an on-going internal borrowing strategy is that given the continuing need to spend on capital investment (paragraph 3.5) and the expected reduction in usable reserves (paragraph 3.6), there will be a future point in time when internal borrowing will have to be externalised at potentially higher borrowing rates than those currently available.

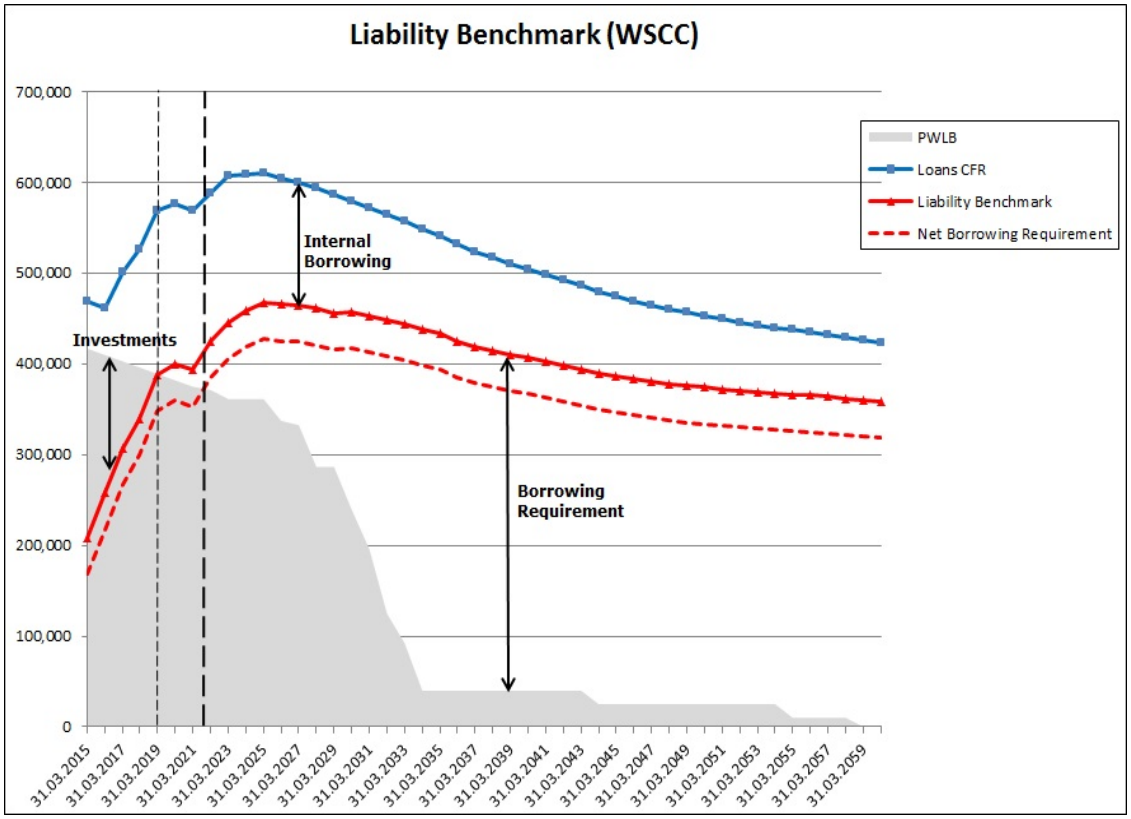
4.11 The Council's "Minimum Revenue Provision" (MRP) is the mechanism for charging the taxpayer for capital expenditure which is funded through borrowing (not financed by other sources such as capital receipts, grants, external contributions or revenue contributions). MRP does not charge 100% of the capital expenditure funded by borrowing to the taxpayer immediately, rather the expense is spread over the useful life of the asset. The Council's current policy for calculating annual MRP is set out in **Appendix D**. Under this policy MRP is applied regardless of the extent to which the borrowing required by the capital programme is financed externally; therefore even if the entirety of the borrowing requirement is funded internally MRP would still be applied at the same value as if all of the borrowing was financed externally.

4.12 Through the above mechanism, cash builds in the Council's bank account year-on-year as the MRP charge is applied. At the end of an asset's useful life the cumulative MRP charge is equal to the original expense financed by borrowing, thereby increasing the Council's cash balances by this amount. In theory, if the Council's borrowing requirement (CFR) had been fully financed externally then cash would have accumulated in the bank account and would be available to repay external borrowing upon debt maturity. Since April 2011 however, the Council has undertaken an internal borrowing strategy whereby annual MRP charges have effectively been used to avoid the need for further new external borrowing rather than being accumulated to repay existing debt. In the absence of 'cash-backed' MRP the Council's ability to repay historic debt will therefore be constrained by its levels of available balances and reserves, thereby increasing the likelihood that existing debt will have to be refinanced on loan maturities.

4.13 The benefits of internal borrowing will be regularly monitored against the potential for incurring costs through deferring new external borrowing into future years when long-term borrowing rates are forecast to rise. The Council's treasury management advisor (Arlingclose) will assist by producing an on-going 'cost of carry' breakeven analysis, its outputs determining whether the Council should consider borrowing additional sums now, with the view of minimising future borrowing costs, even if this causes additional costs in the short-term.

4.14 Liability Benchmark: To further assist the long-term borrowing strategy, the Executive Director Corporate Resources and Services and Arlingclose have created a liability benchmark (as introduced within the CIPFA "Risk Management Toolkit") which forecasts the minimum amount of debt the Council could hold if its internal resources are used in lieu of external borrowing, assuming a £40m liquidity buffer is maintained (previously calculated at one and half times the Council's working capital forecasts) representing just over two times the Council's general fund balance. Extending the medium-term 'Balance Sheet and Treasury Management Position' forecasts (paragraph 3.6) the liability benchmark can be used to project the Council's need to borrow over a longer-term period.

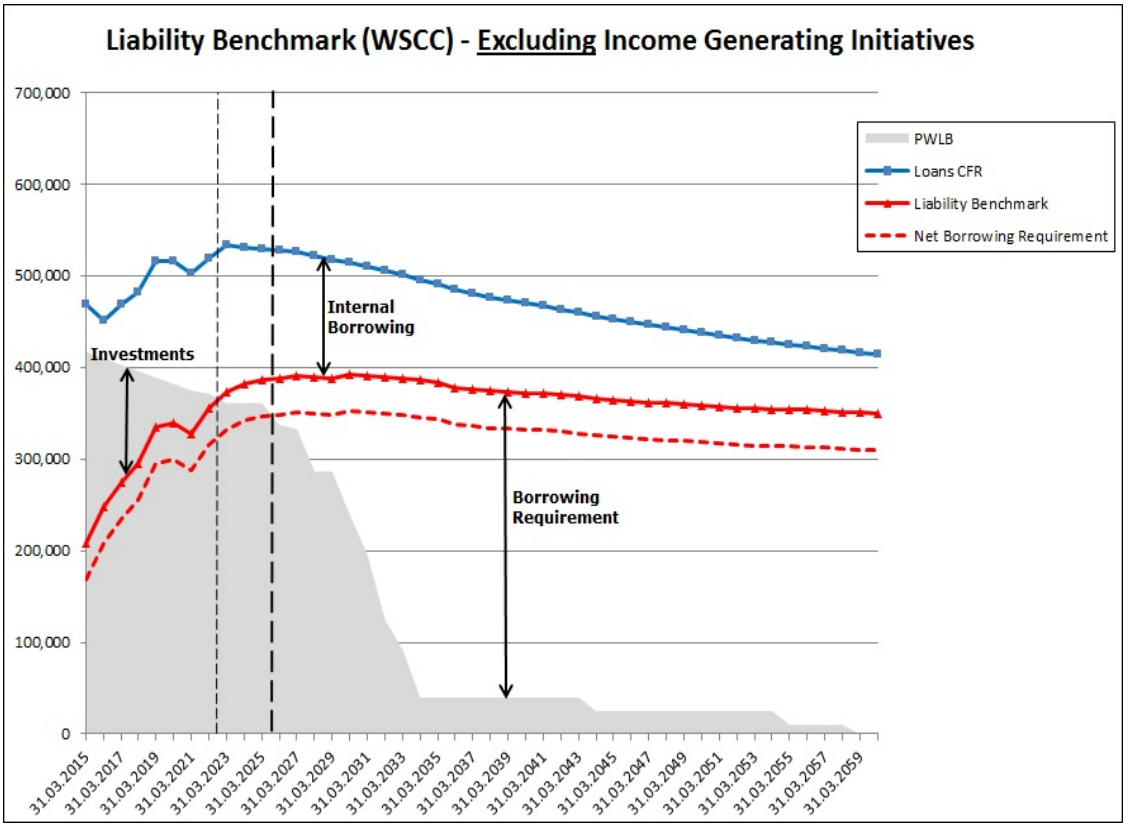
4.15 Long-term capital programme projections have been based on the Council's Medium Term Financial Strategy (MTFS) and assumes an annual 'core' borrowing requirement capped at £17m from 2021/22 onwards. Corresponding annual MRP contributions have been based on this borrowing assumption. Usable reserve forecasts have been based on revised projections as at December 2015. The resulting liability benchmark that includes planned capital expenditure up to March 2021 (including the income generating initiatives) and borrowing assumptions from 2021/22 onwards is shown below:



4.16 The graphical presentation above shows the profile of the Council's maturing PWLB debt, the forecast for its Loans CFR (Capital Financing Requirement excluding long-term PFI/finance lease liabilities) and the liability benchmark over a forty-five year period. The Executive Director Corporate Resources and Services currently forecasts that under the current capital programme (including income generating initiatives), usable reserves and cash-flow liquidity assumptions, the Council could avoid

externally borrowing up to 2019. The Council's "net borrowing requirement" is also included to demonstrate the minimum amount of debt the Council could hold if 100% of its internal resources are used in lieu of borrowing (no assumed liquidity buffer); under this scenario external borrowing could be deferred until 2021.

4.17 For information, the liability benchmark is restated below to show the impact of excluding the income generating initiatives from capital plans (all other benchmark assumptions remaining unchanged). Under this scenario the Council could avoid externally borrowing up to 2022 (or 2025 if all internal resources are used in lieu of external borrowing).



4.18 The Executive Director Corporate Resources and Services will monitor and update the liability benchmark assumptions on an on-going basis, and report any significant changes within treasury management reports to both the Performance and Finance Select Committee and the Regulation, Audit and Accounts Committee.

4.19 Debt Rescheduling: The PWLB allows local authorities to repay loans early and either pay a premium or obtain a discount according to a formula based on current interest rates. Repayment and/or rescheduling opportunities within the Council's debt portfolio, whilst difficult in the current market environment, will be reviewed throughout 2016/17. The rationale for undertaking any debt repayment or rescheduling would be one or more of the following:

- Reduce investment balances and credit exposure via debt repayment
- Align long-term cash flow projections and debt levels
- Savings in risk adjusted interest costs
- Rebalancing the interest rate structure of the debt portfolio
- Changing the maturity profile of the debt portfolio

4.20 All borrowing and rescheduling activity will be reported quarterly to the Regulation, Audit and Accounts Committee and Treasury Management Panel meetings.

5 Annual Investment Strategy

5.1 The County Council's main treasury management activity continues to be the investment of its surplus funds, representing income received in advance of expenditure plus balances and reserves held. At 31 December 2015 the Council's investments amounted to £260.7m (**Appendix A**), £52.1m less than 31 December 2014. In the past twelve months the Council's average investment balance was £306.4m and is forecast to average around £270m throughout the forthcoming calendar year given the continuation of internal borrowing and plans to fully spend the Local Enterprise Partnership (LEP) grant received in April 2015 (£42m) by 31 March 2016.

5.2 Both CIPFA's 'Treasury Management Code of Practice' and DCLG's 'Investment Guidance' require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return ("SLY" investment principles). As a consequence, the Council's primary objective when investing money is to strike an appropriate balance between risk and return; minimising the risk of incurring losses from defaults against the risk of receiving unsuitably low investment income.

5.3 Risks associated with the generation of investment income will be continually monitored throughout the year. Provided that proper levels of security and liquidity are achieved then the Cabinet Member for Finance may consider it reasonable to seek the highest yield consistent with these priorities. Accordingly, the Executive Director Corporate Resources and Services will comply with the following strategy when investing funds, whether directly or via the London money market.

5.4 Investments arranged via the London money market will be made through approved brokers. The current list of approved brokers comprises:

- BGC Partners (including Martin Brokers UK plc)
- ICAP Securities Limited
- Institutional Cash Distributors (ICD) Ltd
- King and Shaxson Limited
- Tradition (UK) Limited
- Tullett Prebon Group Limited

5.5 <u>Credit Outlook</u>: The varying fortunes of different parts of the global economy are reflected in market indicators of credit risk. UK banks operating in the Far East and parts of mainland Europe have seen their perceived risk increase (for example Standard Chartered Bank), whilst those with a more domestic focus continue to show improvement (for example Lloyds Bank). The sale of most of the UK Government's stake in Lloyds and the first sale of its shares in the Royal Bank of Scotland have generally been seen as credit positive.

5.6 Bail-in legislation, which regulates that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the UK, USA and Germany. The rest of the European Union will follow suit in January 2016, whilst Australia, Canada and Switzerland are well advanced with their own plans. Meanwhile changes to the UK Financial Services Compensation Scheme (FSCS), and similar European schemes, in July 2015 mean that most private sector investors are now partially or fully exempt from contributing to a bail-in, placing more of the burden of rescuing failing banks onto other investors including local authorities.

5.7 The three main credit rating agencies (Fitch, Moody's and Standard & Poor's) completed their reviews of many global financial institutions regarding the impact of bail-in regulations and the removal of potential government support during 2015. Consequently, whilst global concerns remain the credit profile of financial institutions currently on the Council's approved lending list has somewhat stabilised.

5.8 The credit risks associated with making unsecured bank deposits remain evident (due to bail-in legislation); relative to the risks of other investment options available to the Council (including bank secured, local authority and non-bank corporate deposits). The Executive Director Corporate Resources and Services continues to remain alert for any signs of credit or market distress that might adversely affect the Council's treasury management activities and corrective action will be taken when deemed appropriate to ensure the security of the Council's total investment portfolio.

5.9 Investment Strategy: Given the increasing risk and continued low returns from short-term unsecured bank investments, the Cabinet Member for Finance and the Executive Director Corporate Resources and Services aims to further diversify investments into more secure and/or higher yielding asset classes during 2016/17; this is especially the case for an estimated £100m that is available for longer-term investment.

5.10 At 31 December 2015, 50% of the Council's investment portfolio is invested in short-term unsecured bank deposits and short-term money market funds (excluding pooled funds). The diversification away from bank unsecured deposits represents a continuation of the investment strategy adopted in 2015/16. The Executive Director Corporate Resources and Services confirms that the Council will not be holding any investment at 31 March 2016 that will be in breach of the recommended 2016/17 strategy.

5.11 Investments are categorised as either 'Specified' or 'Non Specified', based on the criteria in the DCLG Investment Guidance. Specified investments are designed to offer high liquidity and high security, with the minimum of formalities. The DCLG Guidance defines specified investments as those:

- denominated in Sterling
- with a maximum maturity of 364 days
- not defined as capital expenditure by legislation; and
- invested with one of:
  - the UK Government
  - a local authority in England, Wales, Scotland or Northern Ireland
  - an institution or investment scheme of 'high credit quality'.

5.12 The Council defines ‘high credit quality’ institutions and securities as those having a long-term credit rating of **A-** or higher that are domiciled in the UK or a foreign country with a sovereign rating of **AA+** or higher. For money market funds ‘high credit quality’ is currently defined as those having a **AAA** credit rating with the aim of maintaining a constant net asset valuation (no or very low daily volatility) and assets exceeding £1bn (subject to forthcoming EU regulatory changes). For other pooled funds ‘high credit quality’ is defined as those having a **AAA** credit rating.

5.13 In assessing credit ratings, the Executive Director Corporate Resources and Services employs the ‘Lowest Common Denominator (LCD)’ approach, meaning that it uses the lowest rating of those published by Fitch Ratings Ltd, Moody’s Investors Service Ltd or Standard & Poor’s. Specific institutions (or individual securities) must be rated by at least two out of the three rating agencies to be regarded as a specified investment (approved short-term money market funds and pooled funds to be rated AAA by at least one of the rating agencies). Any other institution holding only one credit rating will be treated as if it were unrated (non-specified investment). Where applicable, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

5.14 DCLG Investment Guidance requires the Council to consider other means of assessing the credit-worthiness of countries and institutions, over and above sole reliance on credit ratings. To meet this objective the Executive Director Corporate Resources and Services will consider a range of criteria, over and above the sole reliance on credit ratings, to assess the credit quality of sovereigns and individual institutions, including:

- Credit Default Swap prices (where quoted)
- Share prices
- Financial statements for specific institutions
- Information on potential sovereign support mechanisms
- Corporate developments, news articles, market sentiment

5.15 The Executive Director Corporate Resources and Services and the Council’s treasury advisors continue to analyse and monitor market indicators and credit developments on a regular basis and respond as necessary to ensure the security of the capital sums invested. No investments will be made with an organisation if there are substantive concerns about its credit quality, even though it may meet the approved minimum credit rating criteria (as set out in paragraph 5.12 and 5.17).

5.16 In response to the evolving credit outlook (paragraphs 5.5 to 5,8) together with the aim of increasing investment diversification in accordance with both CIPFA’s and DCLG’s guidance, the Cabinet Member for Finance, in consultation with the Treasury Management Panel and the Executive Director Corporate Resources and Services recommends the following investment strategy changes be adopted in 2016/17:

(1) An increase to **unsecured** bank deposit duration limits (up to a maximum of 364 days) as set out below:

- Banks rated A- (including Barclays): 100 days (unchanged)
- Banks rated A (including Lloyds and Nationwide Building Society): 6 months (increased from 100 days)
- Banks rated A+ and above (including HSBC, approved Canadian and Singaporean Banks): 364 days (increased from 6 months).

(2) The inclusion of Coventry Building Society (long-term rating A) and Leeds Building Society (long-term rating A-) in addition to Nationwide Building Society, and Danske Bank, Denmark (long-term rating A, sovereign rating AAA) as appropriate counterparties for unsecured bank deposits in line with exposure limits set out in recommendation (1).

(3) An increase in the monetary limit for secured investments with "other building societies" (including Yorkshire Building Society) from £5m to £15m, allowing a greater use of long-term covered bonds (fixed or variable rate) than approved in 2015/16.

(4) An increase in the maximum invested long-term (greater than one year) with other UK local authorities (excluding fire and police) from £10m to £25m (per authority).

(5) An increase in the maximum limit for the total invested greater than one year from £75m to £100m, based on forecast investment balances up to March 2021.

5.17 The Executive Director Corporate Resources and Services, under delegated powers, will undertake the most appropriate form of investments in keeping with the Cabinet Member for Finance's recommended strategy objectives, income and risk management requirements and the Council's approved Prudential Indicators (**Appendix C**). Accordingly the Council may invest its surplus funds over a range of maturity periods with any of the approved counterparty types listed below, subject to maximum monetary and duration limits (per counterparty) as shown, to ensure that prudent diversification of the investment portfolio is achieved.

Bank / Issue Rating	Unsecured (Bank Deposits)		Secured / Government Backed / Non-Bank *(i)*	
	Cash Limit	**Time Limit**	**Cash Limit**	**Time Limit**
UK Government			Unlimited	50 Years
Local Authorities			£25m	20 Years
AAA	£15m	364 Days	£25m	10 Years
AA+	£15m	364 Days	£25m	5 Years
AA	£15m	364 Days	£25m	4 Years
AA-	£15m	364 Days	£25m	3 Years
A+	£15m	364 Days	£25m	2 Years
A	£15m	6 Months	£25m	364 Days
A-	£15m	100 Days	£25m	364 Days
BBB+	£10m	Overnight	£15m	6 Months
Other Building Societies	NIL	NIL	£15m	5 Years
Short-Term Money Market Funds	£25m *(ii)*	Overnight	£25m	Overnight
Pooled Funds	£25m	tba *(iii)*	n/a	n/a
Registered Providers (rated A- or higher)			£15m	5 Years
Registered Providers (Other)			£10m	5 Years

(i) The monetary limits shown above represent the maximum amounts approved per counterparty (for Corporates a maximum cash limit of £15m is approved).

(ii) Maximum monetary limits per fund approved as £25m or 0.5% of the fund's total assets under management (AUM), whichever is lowest.

(iii) New investments in pooled funds subject to explicit Cabinet Member for Finance approval (in consultation with the Treasury Management Panel and the Executive Director Corporate Resources and Services).

5.18 Banks Unsecured: Includes current accounts, call (instant-access) accounts, notice accounts, fixed-term deposits, certificate of deposits and senior unsecured bonds with banks and building societies, other than multilateral development banks (for example the European Investment Bank). These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. Unsecured investments with banks rated **BBB+** (including the Royal Bank of Scotland and National Westminster Bank) are restricted to overnight deposits only.

5.19 Banks Secured: Includes covered bonds, reverse repurchase agreements (repos), and other collateralised arrangements with banks and building societies. These investment types are secured against the bank's assets, which consequently limits the potential losses in the unlikely event of insolvency and means that they are exempt from bail-in. Covered bonds will be considered when secured against a 'pool' of prime residential and/or low loan-to-value mortgages held by the issuing bank. Covered bonds differ from mortgage or asset-backed securities because the bank which issues the bond remains responsible at all times for paying dividends and repaying capital. The Council's investments are therefore protected firstly by having a direct call on the 'pool' and secondly by a call on the general assets of the issuer.

5.20 For secured bank deposits, where there is no investment specific credit rating but the collateral upon which the investment is secured has a credit rating, then the higher of the collateral credit rating or the counterparty credit rating will be used in determining monetary and duration limits (as set out in paragraph 5.17). The combined secured and unsecured investments in any one bank will not exceed the monetary limit approved for secured investments.

5.21 Government Backed: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in and there is an insignificant risk of insolvency. Investments with UK local authorities can be made for up to twenty years (and may include early repayment conditions for both lender and borrower). The Executive Director Corporate Resources and Services will approve a local authority as suitable for a Council long-term investment (greater than one year) before the investment is placed.

5.22 Although UK economic conditions continue to improve, in any future period of significant market stress the Council will maintain required levels of security by restricting new investments to those organisations of high credit quality only and reducing maximum duration limits in accordance with the prevailing market conditions. If there are insufficient financial institutions of high credit quality then the Council's surplus cash will be deposited with the UK Government, via the Debt Management Office (DMO) and UK Treasury Bills, or other local authorities. The rates of interest offered through short-term DMO/local authority deposits are below equivalent money market rates thereby reducing the levels of investment income earnings, but the returns are an acceptable trade-off for the guarantee that the Council's capital is secure.

5.23 Corporates: Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in but are exposed to the risk of the company going insolvent. The Cabinet Member for Finance approves the use of investments issued by companies that hold a credit rating (as set out in paragraph 5.17) by at least two of the three rating agencies, up to a maximum of £15m per company.

5.24 Registered Providers: Loans and bonds issued by, guaranteed by or secured against the assets of Registered Providers of Social Housing (formerly known as Housing Associations). These bodies are tightly regulated by the Homes and Communities Agency and as providers of public services they retain a high likelihood of receiving government support if needed.

5.25 Short-Term Money Market Funds: Pooled investment vehicles consisting of unsecured money market deposits and similar instruments, unless the fund consists of government backed securities only (paragraph 5.28). Such funds have the advantage of providing wide diversification of investment risks and high liquidity, coupled with the services of a professional fund manager. Fees of between 0.10% and 0.20% per annum are deducted from the interest paid to the Council.

5.26 The Council continues to use short-term money market funds that offer same-day liquidity and aim for no (or very low) asset value volatility as an alternative to instant access bank accounts, subject to approved monetary limits per fund set as £25m or 0.5% of the fund's total assets under management (calculated against the previous working day's closing assets under management), whichever lower. Currently these funds must hold a AAA credit rating by at least two of the three rating agencies and hold underlying assets in excess of £1bn to be considered appropriate for Council investments.

5.27 New EU regulation expected to be passed in the near future may remove the requirement for a money market fund to hold a credit rating. At this point in time the Cabinet Member for Finance, the Executive Director Corporate Resources and Services and the Treasury Management Panel will consider new criteria for considering a money market fund to be of 'high' credit quality. Such criteria will reference the Institutional Money Market Funds Association (IMMFA) Code of Practice and for selected funds is expected to include the minimum credit quality of the underlying assets, the weighted average maturity of the fund (maximum WAM of 60 days) and upper limits representing amounts held with any one issuer.

5.28 In times of significant market stress the Council will consider the use of Government backed money market funds as an alternative to DMO deposits, up to a limit per fund of £25m or 2% of the fund's total assets under management, whichever lower. A Government backed money market fund will be treated as a separate counterparty to a standard cash money market fund provided by the same sponsor.

5.29 Pooled Funds (Collective Investment Schemes): Shares in diversified investment vehicles which may consist any of the investment types listed above, plus equity shares and property. These funds allow the Council to diversify its investment portfolio into asset classes other than cash without the need to own and manage the underlying investments (undertaken by a professional fund manager in return for a fee). Bond, equity and property funds provide the potential for enhanced returns over the longer-term, but are more volatile when viewed in the short-term. Consequently funds may experience times of displaying capital losses when viewed over a short-term horizon, contravening "SLY" investment principles.

5.30 Recommendations of pooled funds considered appropriate for Council investments will be made following a full credit risk appraisal of the selected funds by both Council Officers and its treasury advisor. Actual deposits in selected funds will only be undertaken on the explicit approval of the Cabinet Member for Finance, in consultation with the Executive Director Corporate Resources and Services and the Treasury Management Panel. The Council's current investments in such funds are listed in **Appendix A**. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives are regularly monitored and will be reported within quarterly compliance reports to the Regulation, Audit and Accounts Committee.

5.31 Investment Limits: All limits including duration, monetary, country, sector and banking group are subject to the explicit approval by the Cabinet Member for Finance, in consultation with the Executive Director Corporate Resources and Services and the Treasury Management Panel. Specific limits for which investments may be placed are set out below:

	Cash Limit
UK Central Government	Unlimited
Any single UK Local Authority (excluding Fire Authorities and Police & Crime Commissioners)	£25m
Any single financial institution, excluding UK Building Societies	£25m
Coventry, Leeds and Nationwide Building Societies	£25m
Any single UK Building Society (other than those listed above)	£15m
Any single Corporate or Registered Provider, rated A- or above	£15m
Any single Registered Provider without a credit rating, or below A-	£10m
Maximum % invested in UK domiciled institutions/organisations	100%
Maximum investment amount per Banking Group	£25m
Maximum Corporate exposure	£50m
Maximum Registered Provider exposure	£50m
Maximum Money Market Fund exposure (excluding pooled funds)	£125m
Maximum investment total for non-UK countries	£90m
Maximum investment per individual non-UK country	£30m
Maximum invested in negotiable instruments held in a broker's (currently King & Shaxson) nominee account	£100m

5.32 Investments in multilateral development banks and pooled funds do not count against the limit for any single non-UK country as shown above (£30m), since the risk is diversified across many countries.

6 Non-Specified Investments

6.1 Any investment not meeting the DCLG definition of a specified investment is classified as 'non-specified'. Having considered the rationale and risks associated with non-specified investments, the following have been determined for the Council's use:

- Long-term (greater than one year) investments
- Investments with credit ratings below A- (or unrated)
- Investments denominated in foreign currencies (Euros)
- Investments that are defined by legislation as capital expenditure

6.2 The Cabinet Member for Finance, in consultation with the Executive Director Corporate Resources and Services and the Treasury Management Panel approves the following monetary limits for non-specified investments:

Investment Type	**Cash Limit £'m**
Total long-term Investments (greater than one year)	100.0
Total investments with credit ratings below A- (or unrated)	30.0
Total investments denominated in foreign currencies	2.8
Total investments defined as capital expenditure	0.2
Total Non-Specified Investments	**133.0**

6.3 Long-Term Investments: Limits on long-term investments, those that are due to mature twelve months or longer from the date of arrangement, are set by reference to the Council's Medium Term Financial Strategy (MTFS) and cash flow forecasts (paragraph 3.6). As required by the Prudential Code, the Cabinet Member for Finance has placed a maximum limit for principal sums invested in 2016/17 for greater than one year as £100m. This limit is to contain exposure to the possibility of loss that may arise as a result of the Council having to seek early repayment of the sums invested. No long-term investment will be arranged with any bank or building society on an unsecured basis.

6.4 Long-term investments including gilts, covered bonds, corporate bonds, supranational bank bonds, local authority and registered provider (housing association) investments and an equity investment with the UK Municipal Bond Agency are approved by the Cabinet Member for Finance, with support of the Executive Director Corporate Resources and Services and the Treasury Management Panel. The maximum monetary limit for long-term investments with any one organisation is set at £10m (£25m for individual UK local authorities). At 31 December 2015 the Council has £26.2m invested for greater than one year including:

- £0.2m equity held with the UK Municipal Bond Agency
- £25m invested with three UK local authorities
- £1m invested in a Places for People Capital Markets plc (registered provider) fixed-rate bond.

6.5 The existing long-term investments held with the three local authorities and registered provider are all expected to mature in 2016/17; and are yielding interest at between 1.05% and 1.50%.

6.6 Non-Sterling Investments: Occasionally the Council may receive grant funding denominated in Euros and subsequently incurs expenditure in Euros. To remove the exchange rate risk associated with converting such funds into Sterling, these can be held in a Euro current account. The Executive Director Corporate Resources and Services may therefore make investments denominated in Euros up to a maximum limit of €3.8m (£2.8m equivalent based on a 1.3571 exchange rate).

6.7 Investments Defined as Capital Expenditure: Investments defined by legislation as capital expenditure, such as company shares, are only arranged on the explicit approval of the Cabinet Member for Finance, in consultation with the Executive Director Corporate Resources and Services and the Treasury Management Panel. In 2016/17 this is limited to a £0.2m investment in the UK Municipal Bond Agency, a capital finance company established in 2014 by the Local Government Association with the aim of providing local authorities a borrowing alternative to the Public Works Loan Board (PWLB).

7 Monitoring Credit Ratings

7.1 The Council uses long-term credit ratings from the three main rating agencies (Fitch Ratings, Moody's Investors Service and Standard & Poor's Financial Services) to assess the risk of investment default. The lowest published counterparty credit rating will be used to determine credit quality, unless an investment-specific rating is available.

7.2 Credit ratings will be monitored by both Council Officers, together with our treasury management advisors who will notify the Council of any changes as soon as they occur. Where an institution has its credit rating downgraded so that it fails to meet any of the approved investment criteria then:

- No new investments will be made after the date of notification,
- Any existing investments that can be immediately recalled or sold at no cost will be,
- Full consideration will be given to the recall or sale of all other existing investments with the affected counterparty, and
- Details will be reported to the Cabinet Member for Finance, Executive Director Corporate Resources and Services, Treasury Management Panel members and all authorised signatories.

7.3 Where an institution is placed on negative rating watch (notification of a possible rating downgrade) the reasons for the rating action will be evaluated. Unless there is sufficient cushion to absorb a two-notch downgrade to the long-term credit rating (to remain at or above the Council's minimum approved rating criteria) then decisions on new investments will be subject to approval by the Executive Director Corporate Resources and Services. This policy will not apply to negative 'outlooks', which indicate a longer term view rather than an imminent change to an institution's rating.

7.4 If an institution is placed on negative rating watch and is at (or likely to fall below) the Council's minimum rating criteria then deposits, including time periods, will only be placed with the explicit approval of the Cabinet Member for Finance, in consultation with the Executive Director Corporate Resources and Services and the Treasury Management Panel, until the outcome of the review is announced. Again, this policy will not apply to negative 'outlooks'.

7.5 Any institution will be suspended or removed from the Council's approved counterparty list should any credit indicators give rise to concern, even though it may meet the minimum credit rating criteria.

8 The County Council's Banker

8.1 The Council currently banks with Lloyds Bank, the contract being effective from 1 October 2013 for an initial three year period, with the Council having options to extend the contract up to a maximum of ten years. Lloyds currently meets the Council's minimum credit criteria, however should its credit rating fall below the minimum rating criteria as prescribed in this strategy report (paragraph 5.12), the provider may continue to be used for short-term (overnight) liquidity requirements and business continuity arrangements.

8.2 Balances held within current accounts will be aggregated together with investments held with the Council's banker on a daily basis, and should remain within set counterparty monetary limits as prescribed within this strategy report (paragraphs 5.17 and 5.31). Occasionally the Council is in receipt of 'large' amounts of income, which cannot be deposited into separate investment counterparties due to intra-day dealing deadlines. In such instances the Cabinet Member for Finance approves that an operational breach of the Council's main banker's set monetary limits may occur for a maximum period of one working day, with corrective action being taken on the next available working day as appropriate.

9 Policy on the use of Financial Derivatives

9.1 The Council has previously made use of financial derivatives that are embedded into investments, to reduce interest rate risks through the use of forward dated deals and to increase income through the use of callable deposits. The 'General Power of Competence' in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (those not embedded into an investment), including swaps and options. The CIPFA Treasury Management Code of Practice requires the Council to clearly state their policy on the use of financial derivatives in the annual strategy.

9.2 The Council does not intend to use standalone financial derivatives unless they can be clearly demonstrated to reduce the overall level of financial risks the Council is exposed to. Embedded derivatives, including those present in pooled funds and forward starting investments, will not be subject to this policy; however the risks they present will be managed in line with the overall treasury risk management strategy. Should this position change the Executive Director Corporate Resources and Services, after seeking a legal opinion on the use of standalone financial derivatives, will develop a detailed and robust risk management framework governing their use and will ensure that treasury management officers have the appropriate training.

10 Investment Income (2016/17)

10.1 The UK is currently experiencing the longest period of unchanged interest rates since WWII. The Bank of England's base interest rate has been maintained at 0.5% since March 2009, but is now forecast to gradually rise from August 2016 and likely to average around 0.70% throughout 2016/17 (with a downside risk that rates will remain unchanged at 0.5% throughout 2016/17), as per the economic and interest rate outlook provided by the Council's treasury management advisor, Arlingclose Ltd (**Appendix B**).

10.2 The Council is expected to have an average investment portfolio of £270m (including usable reserves) throughout 2015/16. Given the investment portfolio attracting an average interest rate of 0.84% (as per interest rate forecasts and likely yields attainable on the Council's expected investment portfolio), the Executive Director Corporate Resources and Services expects to receive gross investment income totalling £2.26m in 2016/17.

10.3 Following £653,000 interest transfers to internal and external reserve balances held by the Council, including Local Enterprise Partnership monies (slipped from 2015/16), school accumulating funds, PFI/MRMC reserves and cash held on behalf of the Chichester Harbour Conservancy, the Executive Director Corporate Resources and Services forecasts a £0.257m deficit against the budgeted investment income total (£1.864m).

	Average Portfolio £'m	**Interest Rate**	**Interest £'000**
Existing deposits as at 31 March 2016	50.1	1.13	565
New investments during 2016/17	219.9	0.77	1,695
Gross Interest	**270.0**	**0.84**	**2,260**
Less interest transfer specific reserves	-85.0	0.70	-594
Local Enterprise Partnership (LEP)	-7.0	0.84	-59
Net Interest			**1,607**
Investment Income Budget (2016/17)			1,864
Interest Surplus/(-)Deficit			**-257**

10.4 If actual levels of investments and interest rates differ from the forecasts then performance against the budget will be correspondingly different. Given the constraints on the Council's 2016/17 revenue budget, it is proposed that any actual investment income shortfall will be met via transfers from the Interest Smoothing Account (current balance: £0.976m). The Executive Director Corporate Resources and Services will monitor the investment income budget throughout 2016/17 and transfers from the Interest Smoothing Account to fund the actual income shortfall (if required), will be made through the monthly Total Performance Monitors (TPM's).

11 Treasury Management Advisors

11.1 The Council has appointed Arlingclose Limited to provide treasury management advice. This is subject to triennial reviews, with the next review scheduled during 2016/17. The Council receives specific advice on a wide range of areas including:

- Credit advice
- Investment advice
- Debt management advice
- Capital and financial accounting advice
- Economic and interest rate forecasts

11.2 For investments, advice is provided on the nature and appropriateness of different counterparties, the types of financial instruments employed, the duration of deposits and the merits of employing external fund managers. The Council also benefits from regular workshops and training. Specific investment decisions remain the responsibility of the County Council and will be approved by the Cabinet Member for Finance in consultation with the Executive Director Corporate Resources and Services and Treasury Management Panel in accordance with this strategy report.

12 Liquidity Management

12.1 The Council uses purpose-built short-term cash flow forecasting software (SAP Treasury Management Module) to determine the maximum period for which funds may prudently be invested. The forecast is entered on a prudent basis, with income under-estimated and expenditure over-estimated, to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments.

12.2 The Council operates a number of interest paying call (instant-access) accounts and money market funds where cash is deposited at competitive short-term interest rates and can be withdrawn without notice. These funds are therefore highly liquid. The Council also seeks to maintain a smooth profile of maturing investments, allowing it to cover unexpected items of expenditure and to react to favourable market conditions as they arise. Monetary limits on long-term investments are set by reference to the Council's Medium Term Financial Strategy (MTFS) and cash flow forecasts.

13 Training

13.1 CIPFA's Code of Practice requires the Cabinet Member for Finance and the Executive Director Corporate Resources and Services to ensure that all Members and Officers tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities.

13.2 The Executive Director Corporate Resources and Services has addressed this important issue by:

- Reviewing the training requirements for the elected Treasury Management Panel and Members, as appropriate.
- Officers dealing with treasury management matters will have their training needs assessed every six months as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Various training options available to Officers include:

  (a) Professional qualifications from CIPFA, the Association of Corporate Treasurers (ACT) and other appropriate organisations
  (b) Workshops and seminars run by the Council's appointed treasury management advisors
  (c) Attendance at CIPFA treasury management seminars, and
  (d) On the job training in line with the approved Treasury Management Practices (TMPs), as provided by the Treasury Management Officer.

14 Minimum Revenue Provision (MRP) Statement (2016/17)

14.1 The Council is required to set an annual policy on the way it calculates the prudent provision for the repayment of borrowing (MRP). The MRP policy statement for 2016/17 is attached at **Appendix D**.

15 Balance Sheet Reporting

15.1 To comply with IFRS and in particular International Accounting Standard (IAS) 7, the Executive Director Corporate Resources and Services has adopted the following accounting policy for 'cash' and 'cash equivalents' with regard to its investment portfolio:

- Cash: Represented by cash in hand (Lloyds current accounts)
- Cash Equivalents: Deposits with financial institutions repayable without penalty on notice of not more than 24 hours from date of acquisition
- Short Term Investments: Deposits maturing between 2 and 364 days
- Long Term Deposits: Deposits with a maturity date greater than 1 year

15.2 The current policy for cash and cash equivalents is subject to a general review of the Council's approved accounting policies ahead of Ernst & Young's external audit of the Council's "2015/16 Statement of Accounts". Any change to the cash and cash equivalents policy will be reported to the Regulation, Audit and Accounts Committee at their March 2016 meeting.

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Appendices

Appendix A – West Sussex County Council's Current Portfolio
Appendix B – Economic and Interest Rate Forecast (Arlingclose)
Appendix C – Prudential Indicators – 2015/16 to 2020/21
Appendix D – Minimum Revenue Provision (MRP) Statement – 2016/17

Background Papers

None

APPENDIX A

West Sussex County Council's Current Portfolio

	31/12/15 Portfolio £'000
External Borrowing:	
- Fixed Rate: Public Works Loan Board (PWLB)	409,599
- Fixed Rate: PWLB (on behalf of the Littlehampton Harbour Board)	306
- Variable Rate: Short-Term (from Chichester Harbour Conservancy)	3,576
Total External Borrowing	**413,481**
Other Long Term Liabilities *(*)*:	
- PFI	118,988
- Finance Leases	1,986
TOTAL GROSS EXTERNAL DEBT	**534,455**
Internally Managed Investments:	
(i) Bank Unsecured	
- Short Term Cash Deposits	95,000
- Short Term Money Market Funds	35,569
(ii) Bank Secured	
- Short Term Covered Bonds	22,864
(iii) Local Authority	
- Short Term Investments	39,000
- Long Term Investments	25,000
(iii) Non-Bank	
- Corporates: Short Term Bonds	11,959
- Registered Providers: Long Term Bonds	1,034
- UK Municipal Bond Agency: Long Term Equity	200
Externally Managed Investments:	
Pooled Funds	
- Investec Short Dated Bond Fund	10,164
- Payden Sterling Reserve Fund	19,951
TOTAL INVESTMENTS	**260,741**

(*) Other Long Term Liabilities: Expected position at 31 March 2016

APPENDIX B

1 Arlingclose Economic and Interest Rate Forecast (November 2015)

Note: Will be updated in final report to County Council

1.1 The Council's treasury advisor (Arlingclose) projects the first 0.25% increase in UK Bank Rate in the third quarter of 2016, rising by 0.5% a year thereafter before finally settling between 2% and 3% in several years' time. Persistently low inflation, subdued global growth and potential concerns over the UK's position in Europe mean that the risks to this forecast are weighted towards the downside.

1.2 A shallow upward path for medium-term gilt yields is forecast, as continuing concerns about the Eurozone, emerging markets and other geo-political events weigh on risk appetite, while inflation expectations remain subdued. Arlingclose projects the 10 year gilt yield to rise from its current 2.0% level by around 0.3% a year. The uncertainties surrounding the timing of UK and future US interest rate rises, and global growth weakness, are likely to prompt short-term volatility in gilt yields.

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
Official Bank Rate													
Upside risk		0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	1.75
Downside risk				-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-1.00	-1.00	-1.25	-1.25
3-month LIBID rate													
Upside risk	0.20	0.30	0.30	0.30	0.35	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.40
Arlingclose Central Case	0.55	0.60	0.70	0.80	0.95	1.05	1.15	1.30	1.40	1.55	1.65	1.80	1.85
Downside risk		-0.20	-0.30	-0.45	-0.55	-0.65	-0.80	-0.90	-1.05	-1.10	-1.20	-1.20	-1.20
1-yr LIBID rate													
Upside risk	0.25	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.45
Arlingclose Central Case	1.10	1.20	1.35	1.45	1.55	1.70	1.80	1.95	2.00	2.10	2.15	2.15	2.15
Downside risk	-0.15	-0.25	-0.35	-0.50	-0.60	-0.70	-0.85	-0.95	-1.10	-1.15	-1.25	-1.25	-1.25
5-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	1.50	1.55	1.60	1.70	1.80	1.90	2.00	2.10	2.20	2.25	2.30	2.35	2.35
Downside risk	-0.35	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25
10-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.00	2.05	2.10	2.20	2.30	2.40	2.50	2.60	2.65	2.70	2.75	2.80	2.80
Downside risk	-0.35	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25
20-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.45	2.50	2.55	2.55	2.60	2.65	2.70	2.75	2.80	2.85	2.90	2.95	2.95
Downside risk	-0.30	-0.40	-0.50	-0.55	-0.65	-0.75	-0.85	-0.95	-1.05	-1.10	-1.15	-1.20	-1.20
50-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.45	2.50	2.55	2.60	2.65	2.70	2.75	2.80	2.85	2.90	2.95	3.00	3.00
Downside risk	-0.25	-0.35	-0.45	-0.50	-0.60	-0.70	-0.80	-0.90	-1.00	-1.05	-1.10	-1.15	-1.15

2. Underlying Assumptions

2.1 UK economic growth softened in the third quarter of 2015 but remained reasonably robust; the third estimate showed the economy growing by 0.4% over the quarter and 2.1% year-on-year. Negative construction output growth offset fairly strong services output, however survey estimates suggest upwards revisions to construction may be in the pipeline.

2.2 UK household spending has been the main driver of Gross Domestic Product (GDP) growth throughout 2014 and 2015 and remains key to growth. Consumption will continue to be supported by real wage and disposable income growth.

2.3 UK annual average earnings growth was 3.0% (including bonuses) in the three months to August 2015. Given low inflation, real earnings and income growth continue to run at relatively strong levels and could feed directly into unit labour costs and households' disposable income. Improving productivity growth should support pay growth in the medium-term. The development of wage growth is one of the factors being closely monitored by the Bank of England's Monetary Policy Committee (MPC).

2.4 UK business investment indicators continue to signal strong growth. However the outlook for business investment may be tempered by the looming European Union (EU) referendum, increasing uncertainties surrounding global growth and recent financial market shocks.

2.5 UK inflation is currently very low and, and with a further fall in commodity prices will likely remain so over the next 12 months. The Consumer Price Index (CPI) inflation rate is however likely to rise towards the end of 2016.

2.6 China's growth has slowed and its economy is performing below expectations, which in turn will dampen activity in countries with which it has close economic ties; its slowdown and emerging market weakness will reduce demand for commodities. Other possible currency interventions following China's recent devaluation will keep sterling strong against many global currencies and depress imported inflation.

2.7 Strong US labour market data and other economic indicators suggest recent global turbulence has not knocked the American recovery off course. Although the timing of the first rise in official interest rates remains uncertain, a rate rise by the Federal Reserve seems significantly more likely in December given recent data and rhetoric by committee members.

2.8 Longer-term rates will be tempered by international uncertainties and weaker global inflation pressure.

APPENDIX C

Prudential Indicators – 2015/16 to 2020/21

1 Background

1.1 There is a requirement under the Local Government Act 2003 for local authorities to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the "CIPFA Prudential Code") when setting and reviewing their Prudential Indicators.

1.2 The Council is asked to approve the following Prudential Indicators.

2 Gross Debt and the Capital Financing Requirement

2.1 The Capital Financing Requirement (CFR) measures the County Council's underlying need to borrow for a capital purpose. The calculation of the Capital Financing Requirement is taken from the amounts held in the Balance Sheet relating to capital expenditure and financing. Proposed levels of capital expenditure remain within sustainable limits and are detailed for the period 2015/16 to 2020/21, together with the associated financing, within Section 3 of the main strategy report (paragraph 3.5).

2.2 In order to ensure that over the medium term debt will only be for a capital purpose, the County Council should ensure that gross external debt does not, except in the short term, exceed the total of Capital Financing Requirement in the preceding year plus the estimates of any additional Capital Financing Requirement for the current and the next two financial years.

2.3 The Executive Director Corporate Resources and Services confirms that gross external debt held by the Council has not exceeded the Capital Financing Requirement in 2015/16 (to date). Following County Council approving the capital programme up to 2020/21 in October 2015, the Capital Financing Requirement has been recalculated to include the annual profile of external borrowing (up to £75m) required to finance capital expenditure over the period. On the assumption that annual 'core' borrowing (£17m) will continue to be met from internal usable reserves, gross external debt is not expected to exceed the revised Capital Financing Requirement during the period ending 2020/21.

	Actual 31.03.15 £'000	Estimate 2015/16 £'000	Estimate 2016/17 £'000	Estimate 2017/18 £'000	Estimate 2018/19 £'000	Estimate 2019/20 £'000	Estimate 2020/21 £'000
Capital Financing Requirement (CFR)	573,309	582,223	620,231	642,646	683,104	686,891	677,216
Gross Debt (including short/ long-Term Borrowing, PFI and Finance Leases)	530,303	539,235	567,699	580,199	610,571	600,563	589,666

3 Incremental Impact of Capital Investment Decisions

3.1 This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax (Band D equivalent) levels.

Impact of Capital Plans on Council Tax (Band D Equivalent)	Base 2015/16	Increase from Base 2016/17	Increase from Base 2017/18	Increase from Base 2018/19	Increase from Base 2019/20	Increase from Base 2020/21
Gross Impact on Capital Plans	1,161.99	1.18%	2.04%	3.24%	3.70%	3.96%
Less Income Generating Provision		-0.47%	-0.74%	-0.94%	-1.10%	-1.22%
Net Impact on Council Tax		0.71%	1.30%	2.30%	2.60%	2.74%

3.2 The Prudential Indicator shows that current capital plans will add 2.74% over the period to current Band D Council Tax levels.

4 Authorised Limit and Operational Boundary for External Debt

4.1 The County Council has an integrated treasury management strategy and manages its treasury position in accordance with its approved strategy and practice. Overall borrowing may arise as a consequence of all its financial transactions and not just those arising from capital spending as reflected in the Capital Financial Requirement.

4.2 The Authorised Borrowing Limit is a statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the "Affordable Limit"). This limit sets the maximum level of external debt on a gross basis (excluding all investments) for the County Council. It is measured on a daily basis against all external debt items on the Council's Balance Sheet, including:

- Long-term borrowing
- Short-term borrowing
- Overdrawn bank balances
- Other long-term liabilities (PFI / Finance Leases)

4.3 The Operational Boundary (borrowing limit) links directly to the County Council's estimates of the Capital Financing Requirement. This indicator is based on the same estimates as the Council's Authorised Borrowing Limit and reflects the maximum borrowing required to meet capital spending plans, without the additional headroom included within the Authorised Limit required to meet unusual cash-flow movements.

	Actual 31.03.15 £'000	Estimate 2015/16 £'000	Estimate 2016/17 £'000	Estimate 2017/18 £'000	Estimate 2018/19 £'000	Estimate 2019/20 £'000	Estimate 2020/21 £'000
Operational Borrowing Limit	530,303	546,251	574,715	587,215	617,587	607,579	596,682
Authorised Borrowing Limit		586,251	614,715	627,215	657,587	647,579	636,682

5 Ratio of Capital Financing Costs to Net Revenue Stream

5.1 This indicator highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet capital financing charges (including income generating initiatives) as defined in the Prudential Code.

	Actual 31.03.15 £'000	Estimate 2015/16 £'000	Estimate 2016/17 £'000	Estimate 2017/18 £'000	Estimate 2018/19 £'000	Estimate 2019/20 £'000	Estimate 2020/21 £'000
Capital Financing Charges (Revenue)	37,382	36,370	35,555	38,679	41,106	42,726	43,268
Net Expenditure	535,837	528,886	529,214	523,940	536,656	555,931	555,931
% Ratio	6.98%	6.88%	6.72%	7.38%	7.66%	7.69%	7.78%

Treasury Management Indicators

6 Adoption of the CIPFA Treasury Management Code

6.1 The County Council approved the adoption of the CIPFA Treasury Management Code of Practice (2009) into the Treasury Management Policy Statement as detailed within the Council's Financial Regulations at its meeting dated 11 February 2011. Subsequent amendments to the CIPFA Treasury Management Code of Practice have been adopted by the County Council as required.

7 Upper Limits for Fixed and Variable Interest Rate Exposure

7.1 These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. The Council calculates these limits on the principal outstanding sums as compared with the respective total borrowing and investment levels.

7.2 The upper limits for variable interest rate exposure has been set with regard to current economic forecasts, to ensure that the County Council is not exposed to interest rate rises which could adversely impact the revenue budget.

	Actual 31.03.15 £'000	Estimate 2015/16 £'000	Estimate 2016/17 £'000	Estimate 2017/18 £'000	Estimate 2018/19 £'000	Estimate 2019/20 £'000	Estimate 2020/21 £'000
Operational Borrowing Limit	530,303	546,251	574,715	587,215	617,587	607,579	596,682
Less: Investments (31 March)	-252,368	-198,891	-139,122	-99,215	-43,886	-25,031	-21,896
Net Borrowing	**277,935**	**347,360**	**435,593**	**488,000**	**573,701**	**582,548**	**574,786**
Maximum Actual Debt at Fixed Rates as a % of Net Borrowing	221%	197%	165%	135%	127%	106%	102%
Maximum Actual Debt at Variable Rates as a % of Net Borrowing	55%	49%	41%	34%	32%	26%	26%

	Actual 31.03.15	Estimate 2015/16	Estimate 2016/17	Estimate 2017/18	Estimate 2018/19	Estimate 2019/20	Estimate 2020/21
Maximum % Borrowing at Fixed Rates	99%	100%	100%	100%	100%	100%	100%
Maximum % Borrowing at Variable Rates	1%	25%	25%	25%	25%	25%	25%
Maximum % Investments at Fixed Rates	63%	100%	100%	100%	100%	100%	100%
Maximum % Investments at Variable Rates	37%	85%	85%	85%	85%	85%	85%

7.3 The limits above provide the necessary flexibility within which decisions will be made for drawing down new loans on a fixed or variable rate basis; the decisions will ultimately be determined by expectations of anticipated interest rate movements as set out in the Council's Treasury Management Strategy.

8 Maturity Structure of Fixed Rate Borrowing

8.1 This indicator highlights the existence of any large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates and is designed to protect against excessive exposures to interest rate changes in any one period, in particular over the course of the next ten years.

8.2 It is calculated as the amount of projected fixed rate borrowing that is maturing in each period as a percentage of total projected fixed rate borrowing. The maturity period of borrowing is determined by reference to the earliest date on which the lender can require payment.

8.3 The upper limits for the maturity structure of fixed rate borrowing are set out below (the lower limits are set at 0% across all periods):

Treasury Management	Actual 31.03.15	Estimate 2015/16	Estimate 2016/17	Estimate 2017/18	Estimate 2018/19	Estimate 2019/20	Estimate 2020/21
Debt Maturity:							
Over 30 Years	6%	10%	10%	10%	10%	10%	10%
Over 25 to 30 Years	3%	10%	10%	10%	10%	10%	10%
Over 20 to 25 Years	0%	10%	10%	10%	10%	15%	20%
Over 15 to 20 Years	48%	55%	50%	40%	30%	25%	20%
Over 10 to 15 Years	29%	45%	60%	60%	65%	65%	60%
Over 5 to 10 Years	5%	20%	20%	40%	45%	45%	50%
Over 1 to 5 Years	7%	15%	20%	35%	35%	35%	35%
Under 12 Months	2%	15%	15%	25%	25%	25%	35%

8.4 The limits above provide the necessary flexibility within which decisions will be made for undertaking new external borrowing in accordance with the Council's capital programme. Should opportunities arise to redeem or restructure existing long-term borrowing, approval is delegated to the Executive Director Corporate Resources and Services to revise these upper limits during the course of 2016/17 as required.

9 Upper Limit for Principal Sums Invested over 364 Days

9.1 The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Council having to seek early repayment of the sums invested.

	Actual 31.03.15	Estimate 2015/16	Estimate 2016/17	Estimate 2017/18	Estimate 2018/19	Estimate 2019/20	Estimate 2020/21
Maximum Invested for a Year or longer (£)	£25.2m	£75m	£100m	£100m	£85m	£75m	£75m

APPENDIX D

Minimum Revenue Provision (MRP) Statement – 2016/17

1 In accordance with the Local Authorities (Capital and Accounting) (England) Regulations 2003, the Council is required to make an annual contribution from revenue to repay long-term borrowing, namely its "Minimum Revenue Provision (MRP)". The 2008 amendment to these regulations gives local authorities the flexibility to set MRP at a level it considers to be prudent.

2 The Department for Communities and Local Government has issued statutory guidance on determining the prudent level of MRP, which presents four ready-made options for the calculation:

- Option 1: Regulatory Method
- Option 2: CFR (Capital Financing Requirement) Method
- Option 3: Asset Life Method
- Option 4: Depreciation Method

3 Options 1 and 2 are only applicable to historical and supported borrowing and options 3 and 4 can only be applied to unsupported borrowing on or after 1 April 2008. Options 3 and 4 can also be used for supported capital expenditure whenever incurred.

4 In 2016/17 the methodology to be adopted by the Council will be option 2 for all government-supported borrowing, and all historical (pre 1 April 2008) self-financed borrowing. This method involves the calculation of MRP on the basis of 4% of the Capital Financing Requirement (CFR) in respect of that expenditure. For unsupported borrowing incurred since 1 April 2008, MRP will be provided for on the basis of option 3 which sets aside an MRP provision on the basis of equal instalments across the estimated life of the asset for which the borrowing is undertaken.

5 Operating and finance leases may be arranged to finance the acquisition of vehicles or equipment as an alternative to borrowing where this is financially advantageous and is in accordance with the strategy for the capital programme. In line with DCLG regulations to mitigate the impact of the move to IFRS on the Council's revenue account, it is the policy of West Sussex County Council to make an annual MRP charge equal to the portion of the payment taken to the Balance Sheet to reduce the liability.

	31-Mar-16 Estimated CFR £'m	**2016/17 Estimated MRP £'m**
Capital Expenditure pre-1 April 2008	261.8	10.5
Unsupported Capital Expenditure after 01/04/08	199.4	6.5
Private Finance Initiatives and Finance Leases	121.0	3.2
Total	**582.2**	**20.2**

6 If the terms of the original MRP Statement are varied during 2016/17 then a revised statement will be submitted to the County Council at that time.