ABERDEEN CITY COUNCIL

COMMITTEE	Finance, Policy & Resources
DATE	1 December 2016
DIRECTOR	Richard Ellis
TITLE OF REPORT	Financing Strategy for the Capital Programmes
REPORT NUMBER	CG/16/150
CHECKLIST COMPLETED	Yes

1. PURPOSE OF REPORT

The purpose of this report is to provide committee with details of the outcome of the recent project to obtain a Credit Rating and to secure funding towards the Council's Capital Programmes by issuing bonds up to £370 million pounds in value.

2. RECOMMENDATION(S)

It is recommended that the Committee:

i) Notes the work undertaken and the outcome of the project

3. FINANCIAL IMPLICATIONS

3.1 Whilst there are no financial implications arising directly from this report, it is important to note that the issue of the bond places a financial commitment on the Council until 2054. The purpose of the bond was to put in place capital financing for the Council's two capital programmes – namely the Non Housing Capital Programme and Housing Revenue Account Capital Programme, which would normally be done through other forms of long term borrowing.

3.2 Detailed financial implications were covered in a previous report to Council on 17th August 2016, including consideration of: Best Value; Affordability; Investment Strategy; Counterparty List; Prudential Indicators; and Credit Rating

3.3 Best Value

The Council has statutory duty to secure best value and ensure the long term affordability of its capital investment programme. Three products were identified which were independently assessed to determine their suitability.

With market rates varying on a daily basis the initial recommended financing solution was an index linked public bond providing the optimal solution as:

- It delivers the lowest net present cost of debt service over the terms of the finance (35 years);
- It provides a better inflation hedge with AECC income than the next best option (PWLB), given AECC income is generally expected to rise with inflation over time;
- It provides an ability to provide debt service to meet the cash flows of the capital programmes thereby offering flexibility that is not possible using PWLB;
- A public Bond can be traded in the secondary bond market thereby potentially offering the Council the opportunity to “buy back” its own issued bonds at a point in the future. Please note that any future sale of the bond has no impact on the cost to the Council as this is fixed; and
- This solution also means that the repayment of the bond will not start until 2019 thereby offering the council the additional benefit of deferring repayment (in line with private sector construction) during a period of austerity that the Council is likely to face over the next few years which means this solution provides all round better financial resilience for the Council.
- When compared with the original financing solution, the net present value of the cash flows associated with the bond offers potential savings to the Council of up to £99.8m over the 35 year lifespan of the instrument.

3.4 Affordability

Audit Scotland published a report in 2015 called “Borrowing and treasury management in councils” which stated that:

“Councils are using the prudential indicators to demonstrate and monitor the short-term affordability of borrowing. But councils are not clearly analysing and reporting their assessment of the longer term affordability and sustainability of borrowing. Officers present the repayment profile of borrowing to councillors, but are not presenting this together with other information such as different budget scenarios, interest rates scenarios, or capital investment strategies. This is important to inform councillors of the future risks to the affordability and sustainability of current and new borrowing.’’

In working towards obtaining a credit rating a long term financial model was developed based on a range of assumptions and modelled accordingly.

As previously indicated the Council has considered different investment strategies. What the Audit Scotland report does not touch on however, is the access to liquidity, level of working capital and financial management exhibited by an authority. These are three of the most critical elements in examining long term affordability and this is demonstrated through a 35 year projected cash flow position.

The Prudential Code also requires the Council to demonstrate affordability in making investment decisions and the use of a 35 year financial forecast on an “all things being equal” basis demonstrates this.

3.5 Investment Strategy 2016/17 to 2018/19

The Council is required annually to set an Investment Strategy covering at least a three year period. The strategy is required to cover a number of area’s including the type of investment that will be permitted and the amounts that can be invested. The strategy for the period 2016/17 to 2018/19 was updated taking account of the additional investment capacity required to invest the funds resulting from the bond issuance and approved by Council on 17th August 2016.

The Council has invested the bond proceeds across a range of fixed term deposits, call deposits and notice deposits, in line with the revised Counterparty list. This mix of investments will provide the Council with the necessary liquidity to meet its anticipated cash flow requirements over the coming years.

3.6 Counterparty List

The Council, as part of its Treasury Policy, has an approved listing of banks and other financial institutions (the Counterparty list) with which it can undertake short-term money investments. Basically, if the Council has “cash” then the counterparty list determines where officers can invest this cash.

The Council's Counterparty list is compiled using credit rating information supplied by the major credit rating agencies to Capita Asset Services who are the Council’s appointed Treasury Management advisors.

A revised Counterparty list taking account of the additional capacity required to invest the funds resulting from the bond issuance was approved by Council on 17th August 2016.

3.7 Prudential Indicators

As stated earlier the Council is required to comply with the requirements of the Prudential Code, which includes the setting of a number of Prudential Indicators. Included within these indicators are a number of Treasury Management Indicators for External Debt. Taking account of the bond issuance and other anticipated borrowing over the next 35 years, the Prudential Indicators 2015/16 to 2020/21 were updated and approved by Council on 17th August 2016.

3.8 *Credit Rating*

Before the Council was able to issue its bond on the London Stock Exchange, it had to secure a credit rating from a recognised credit rating agency. The demands and detail of that process are set out below.

In determining a credit rating, the agency considered the strength of the institutional framework within which a Scottish local authority operates as well as considering the economic performance of the economy within which the local authority operates.

The Council was required to submit detailed financial information to the ratings agency in order to demonstrate its stewardship. This information was studied by the agency in great detail, and was followed up by many questions and queries on particular aspects.

The Council was also required to submit detailed information outlining the institutional framework in which Scottish local authorities operate. This was particularly important, with this being the first time a Scottish Council had been publically rated.

Information was also provided to the agency describing the Council's local governance framework, the political make-up, the committee structure, the executive structure, the decision making process and its key functions and responsibilities.

The Council was also required to submit a wealth of economic information about the city and the wider city region, outlining both its economic performance and potential.

Having supplied the credit rating agency with the above information, the final step was for key Council officials to make a management presentation to Moody's at their London offices. This was undertaken in late July.

On 23rd August 2016, Aberdeen City Council received an indicative credit rating score from Moody's Investor Services of Aa2, and was placed on negative outlook. The 'negative outlook' mirrors the negative outlook on the UK sovereign rating, following the vote to leave the European Union. This rating is one notch below UK government, and the third highest rating out of the 21 that Moody's award.

After further examination and due diligence by Moody's, on 7th October 2016 the Council was publically awarded the credit rating of Aa2, with a negative outlook. Having secured the rating, we were then in a position to issue the bond.

On 7th November 2016, based on the final Offering Circular, Moody's assigned the rating of Aa2 to the £370 million bond.

4. OTHER IMPLICATIONS

4.1. A suitable credit rating will be required to be maintained during the term of the bond. In order to maintain a credit rating, the appointed credit rating agency will be required to conduct reviews at least once every twelve months.

4.2. Officers will be required to provide such information promptly and the way the Council conducts business will have to change. As part of the Governance Review, the Governance Review Programme Board will require to work with relevant organisations to ensure that the outcomes of the Governance Review are aligned to the requirements/expectations of holding and maintaining a suitable credit rating and being an Issuer of Bonds.

4.3. With a requirement to maintain a credit rating comes an increased emphasis on the need for caution by officers and members in discussing and/or disclosing information on major projects in advance of them being announced publicly. There will be potential for adverse impact not only on the individual project but also on the overall position of the Council in relation to its credit rating and the issued bonds. Further information on this will be the subject of a report to Council in December 2017.

5. BACKGROUND/MAIN ISSUES

5.1. Bond Background

A bond is essentially an IOU; it is a promise by a borrower (called an issuer – in this case the Council) to repay (or pay) money to an investor (called a bondholder), usually with interest.

Issuing bonds is a way of raising finance. The issuer borrows money by selling bonds to bondholders; the issuer receives the money and the bondholder receives a promise from the issuer to repay the debt at a later date, usually with interest. Bonds are a type of debt security that can be traded (bought and sold) in the capital markets.

5.2 *Bond Issuance Process*

With a suitable level of Credit Rating achieved, the Council was in a position to proceed towards issuing its bond. HSBC, the Council's appointed book runner, had already been 'soft-sounding' potential investors about the issuance and initial feedback had been encouraging.

5.3 *Bond Documentation*

A suite of necessary bond documents had been prepared in draft form early on in the process and these were worked on by officers, our legal representatives and the legal representatives which had been appointed on behalf of the investors. Challenges and suggested amendments to clauses in these documents were made on a daily basis, right up until launch day.

5.4 *Investor Marketing*

A comprehensive investor presentation was produced. This was an extension of the management presentation which had been produced for the credit rating agency, with additional slides to answer investor's questions. This was sent to potential investors by HSBC to complete the soft-sounding process. Investor feedback was still encouraging, however caution was urged by the book-runner, and it had been suggested that despite strong interest in the issuance, due to uncertain market conditions, we should not expect to be over-subscribed.

5.5 *Bond Announcement*

On 24th October an announcement was made to the markets by HSBC via Bloomberg of a potential bond issuance by Aberdeen City Council. This was followed up by a series of roadshow meetings to potential investors. These were presented over three days at the end of October by key Council officials in both Edinburgh and London.

5.6 *Bond Pricing Day*

After some follow up calls to investors by HSBC to gauge both appetite and pricing indications, it was agreed that the bond would be launched on 1st November. The bond documentation was then finalised and executed as required.

The bonds were being issued 'above-par'. This meant that the Council would receive a premium of around 12% on the bonds, on the understanding that the council would pay interest of 0.1% on the outstanding sum.

On the morning of 1st November, the book for the bond issuance opened at 9am. Investors placed bids steadily throughout the morning. Around lunchtime it became clear that the bond issuance had been slightly over-subscribed. Although the Council had sought £350m of bonds, it had received offers for £373m. A decision had to be made whether to accept the previously ratified level of £350m, or to obtain permission from the Council to accept a higher level, by means of an Urgent Business Committee meeting.

An Urgent Business Committee meeting was quickly convened, and this approved that the Head of Finance could now accept up to £400m of bonds. The book was closed at £370m and the bonds were allocated to investors.

5.7 *Bond Settlement Day*

The bond proceeds of approximately £415 million (being the total cash receivable based on the above par issuance) were received into the

Council's settlement account on 8th November. These were subsequently invested in a range of high-rated fixed term deposits, Money Market Funds and notice deposits, in line with the recently revised Counterparty list.

6. IMPACT

Improving Customer Experience –
The bond provides a source of financing which allows part of the Capital Programme to be funded while diversifying the financial portfolio of borrowing to allow an element of long term flexibility within the portfolio.

Improving Staff Experience –
The ongoing requirements in relation to the credit rating and LSE listing requires that the governance around decision making and the processes that the Council adopts remains clear. This will allow employees and citizens to have a greater confidence in the decision making and actions of the Council.

Improving our use of Resources –
The index linked public bond provides the optimal solution as it delivers the lowest net present cost of debt service over the terms of the finance (35 years). The proposal allows a diversified financial portfolio of borrowing to allow an element of long term flexibility within the portfolio.

Corporate -
The bond allows the Council to part fund the Capital Programme and assist the Council in moving forward to achieve its objectives in line with the strategic infrastructure, Smarter City. Carrying out this funding places Aberdeen City Council at the forefront of creative lending solutions and drives Aberdeen City forward as a Council for the future.

Public –
This report may be of interest to the public as it explains part of the Council's proposed strategy to finance the Capital Programme which the Council wishes to pursue. It also explains the rationale for the Council obtaining a credit rating.

An Equalities and Human Rights Impact Assessment (EHRIA) has not been undertaken as this is not relevant to this project

A Privacy Impact Assessment (PIA) has not been undertaken as none of the proposed projects should impact on the privacy of any individual

7. MANAGEMENT OF RISK

7.1. The Council requires to ensure that it takes all steps within its control to maintain a suitable credit rating and that the Credit Rating is maintained at Aa2. Should the credit rating fall the liquidity of the Bonds in the secondary market will drop and the confidence in the Council will weaken. This will place pressure on the Council from Bondholders and alternative financial products may become more difficult/expensive to access. This may be mitigated by the Council putting in place and maintaining robust governance around capital projects to ensure that the Council is able to react promptly to commercial situations arising from the various capital projects and address these promptly to ensure that these projects are delivered in a timely and cost efficient manner.

8. BACKGROUND PAPERS

None

9. REPORT AUTHOR DETAILS

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