Appendix 3

Note on ESPO financial position in respect of Treasury Management

ESPO's cash is held separately to the Servicing Authority, although the Servicing Authority is responsible for carrying out treasury management policy for ESPO. Other than the three loans taken (in May and June 2005) to fund the new ESPO building, there is no ESPO borrowing requirement; to all intents-and-purposes ESPO's treasury management activities relate to the lending of cash that is available at any point in time.

At 30th September 2014 ESPO had cash-backed reserves of £5.468m to cover such things as vehicle and IT renewal, property maintenance and extension etc. The actual cash balance of ESPO – the balance available for lending on any day – is, however, quite variable. In the year ended 30th September 2014 the maximum balance was £11.489m (in April 2014) and the lowest point was £2.423m (September 2014).

The variability and unpredictability of these balances and the relatively low level of the balance (even at its peak) makes it very difficult, and highly impractical, to run the ESPO loan portfolio on a stand-alone basis. Committing anything other than relatively small sums to longer term loans runs the risk of having an overdraft (at a relatively expensive cost) on certain occasions, and the current interest rate premium within money markets for being willing to lend for a longer term is insufficient to justify the risks, and costs, of becoming overdrawn. If ESPO's cash balances become consistently higher and the yield advantage for lending in the longer term becomes more attractive, the current position will be reconsidered. At present, however, a simple method of carrying out treasury management activities (transferring fund backwards and forwards to a single counterparty paying an attractive interest rate) remains the optimal position.

As with all lending activities the three main considerations will be security, liquidity and yield – in that order. Repayment of the capital invested is paramount in all lending decisions. A policy in respect to acceptable counterparties that is agreed annually by the servicing authority for its own lending activities is the one that is also used for ESPO. It would be considered strange if the servicing authority was running a looser policy for ESPO in respect of counterparties than it was for itself.

The three loans that were raised on behalf of ESPO in 2005 (and which are recharged to ESPO by the servicing authority on a pound-for-pound basis) have an average interest rate of 4.54%. The loans have just over 15½ years to maturity and are on an 'equal instalments of principle' basis, with half-yearly capital repayments of £250,000.

Questions could be asked about why ESPO continues to have debt on which it is paying 4.54% interest, whilst at the same time it has available cash balances that are currently earning 0.5% and are highly unlikely to be paying as high as 4.54% for many years to come. The three loans are all with the Public Works Loan Board (PWLB) and early repayment would currently incur a substantial additional payment on top of the outstanding capital – for every £100,000 repaid there would be a requirement to meet a repayment premium of just under £21,000. To repay the whole of the existing debt of £8m would actually cost £9,662,000.

There are two main reason for this significant premium – interest rates have dropped very sharply since 2005 (although rates were considered very attractive when the loans were taken!), and the introduction by PWLB of a significant bid/offer spread (the difference between borrowing new money in a specific period and repaying existing debt that has the same period until maturity) in November 2007. This premium makes it very difficult to justify any premature repayment, as it is unlikely to provide good value for money over the remaining period of the loan. Even if it were considered likely to be good value in the long term (which would require average interest rates over the next 15 years to be below 1.6%), ESPO does not have sufficient cash balances to make the repayment.

It is also worth pointing out – although it is fairly obvious – that if the cash balance is used to make a premature debt repayment, it will not be available, when required, for the purpose for which the cash is held.