East Lothian Council

REPORT TO: East Lothian Council

MEETING DATE: 12 February 2013

BY: Executive Director (Support Services)

SUBJECT: Council Financial Strategy 2013/14 to 2015/16

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1 PURPOSE

1.1 To outline the Financial Strategy of the Council, which provides the financial context for Councillors in preparing their budgets for the period 2013-16.

2 RECOMMENDATIONS

2.1 The Council is recommended to approve the attached Financial Strategy.

2.2 As part of presenting their budget proposals, each Group of Councillors is recommended to:

- Use no more than £2.284 million of General Services reserves within the budgets for 2013/14 or 2014/15.
- Develop a sustainable General Services budget avoiding the use of reserves in 2015/16.
- Develop General Services Capital Plans, which when adjusted, are within the maximum Capital Expenditure Limits outlined at Section 3.6.
- Adopt the recommended levels for reserves as detailed in the Financial Strategy.
- Transfer any unexpected reserves and the balance on the Property Renewals Reserve at the end of 2012/13 to the Cost Reduction Fund.
- Prepare balanced budget proposals for General Services taking into account a freeze in the level of Council Tax and the related levels of government grant.
- Retain within the HRA at least £1.0 million of reserves as protection against unexpected costs or loss of income.

- Keep the ratio of income to debt charges within the HRA to below 40%.
- Propose an appropriate rent increase to support the HRA budget proposals

3 BACKGROUND

Constructing the Budget Proposals

3.1 Appended to this report is the Financial Strategy for 2013-2016, which outlines the main opportunities, risks and constraints that face the Council over the next 3 years. This forms the basis of the Council's stewardship of taxpayer's funds over what will be a financially challenging period.

3.2 Constructing a sound budget is the cornerstone of delivering the Financial Strategy. As in previous years, the budget allocates a "bottom-line" budget to each Department and Business Group, and Executive Directors and Group Managers have the task of managing any cost increases within that budget. Managers are expected to achieve any specified efficiency savings and identify how they will meet any savings targets included in the budget allocated. It is part of the job of every Council officer to deliver the Financial Strategy.

3.3 In preparing the 2013/14 budgets, provision to meet all known contractual commitments has been made, but no general inflation increase in budgets has been incorporated. Essentially, services are expected to absorb general inflationary pressures through the efficient management of the resources they have. This 'cost containment' is an important element of the financial strategy.

3.4 The budget includes provision for capital financing (debt) costs that are generated by spending at the Capital Expenditure Limit for each of the three years and the revenue running costs of projects that are sufficiently well advanced for these costs to be estimated with a reasonable degree of accuracy.

3.5 Under statutory regulation the Council has to set annual limits on "the maximum amount which it can afford to allocate to capital expenditure". In the current financial circumstances, I am of the view that the Council should in future set Capital Expenditure Limits for General Services that seek to avoid any new additional borrowing after the 2013/14 financial year.

3.6 The link between capital expenditure and the final level of borrowing is not direct and is affected by factors such as the rate paid on borrowings, the type of capital asset created and the level of capital income receivable. However, based upon current factors, I would recommend the maximum Capital Expenditure Limits as follows;

Year	Capital Expenditure Limits (£m)
2012/13	33.000
2013/14	28.000
2014/15	20.000
2015/16	21.000
2016/17	18.000
2017/18	18.000
Totals	**138.000**

3.7 These Capital Expenditure limits will need to be applied flexibly to take into account additional capital income received by the Council and the potential for inter-year transfers – such transfers will assist in the management of any project slippage that may occur.

3.8 As the Financial Strategy makes clear, the Council is facing substantial financial challenges. Over the next three years the amount of funding available for council services is currently forecast to drop from £195.7 million to approximately £191.4 million. At the same time there are a whole range of ‘unknowns’ and new cost pressures to manage.

3.9 Meeting that challenge implies that the Council will have to continue to make significant changes to how it is organised and operates to deliver the services needed in East Lothian. Some of these changes have been made but much more is still required and this will take further time and careful management. During 2011/12 and 2012/13 the Council has and will draw significantly from reserves and only has limited reserves remaining that it can use to help manage this transitionary period. It is vitally important that the Council maintains a disciplined approach to the implementation of any change programme and delivers the financial efficiencies in accordance with that programme. It is anticipated that the Chief Executive will be establishing a new Transformation Team that will support Executive Directors and Heads of Service, ensuring that the programme is fully delivered.

3.10 At this stage there is uncertainty about the extent and precise nature of changes that will be required and the group budget proposals will to varying extents reflect this. Groups have been advised to be as specific as they can be about the scale, timing and nature of the change that is needed. However, it is inevitable that some changes may not be capable of being specified in detail, which means the budget proposed is subject to an increased degree of uncertainty about what will be involved in delivering it. In general, the greater the value of any non-specific changes included in the budget, the bigger the extent of change is being planned. These changes can be either cost reductions or income increases.

Managing the Workforce

3.11 The scale of the change programme required is considerable and it would be impossible to make the required reductions in cost without impacting upon the workforce. Both Groups will incorporate proposals that will introduce a Voluntary Early Release Scheme (VERS). It is expected that this will help streamline the workforce and facilitate necessary organisational changes and associated cost reductions that are necessary. The introduction of such a scheme marks a very significant departure for the Council but I would regard this as a critically important element of the strategy that will help manage down one of the Council's largest cost categories. In delivering such a scheme, it will be necessary to carefully consider implications in respect of both affordability and business need, ensuring where possible that the impact upon agreed Council priorities is minimised. It is anticipated that an early report will be brought to Cabinet.

Managing the budget 2013/14

3.12 Budget review and development is not a once-a-year process. External circumstances are continuously changing and performance compared to this budget will be kept under constant review with regular reports to Cabinet following the end of each quarter and a year-end report to the Council following submission of the draft accounts for audit.

3.13 In addition, monthly and quarterly performance reports are issued to managers with budget responsibility and the overall finances of the Council are subject to detailed annual independent audit review.

3.14 Heads of Service will be required to manage within the budgets approved at this meeting. If at any time spending pressures are not containable within the Business Group, the business group manager should report this to their Head of Service and Executive Director. In consultation with their Cabinet Spokesperson, the Executive Director has the flexibility to move budgets between business groups. Should this not resolve the spending issue, it is the service Directors' responsibility to formally report this to the Head of Council Resources. In this situation the matter may be reported to Cabinet and the Council may be asked to reconsider the policies applying within that Group with a view to reducing services and costs or increasing charges and income. If this cannot be achieved, then the Council may be asked to approve policy changes elsewhere that will yield the necessary savings through service reductions or increased charges.

Council Tax

3.15 Since the 2007/08 financial year the Council has operated a Council Tax freeze. In overall terms however, the funding received from the tax will increase over the coming year as a result of house building and an increase in the number of taxable properties. The estimated 2013/14 Band D equivalent tax base in East Lothian is 42,486 properties (last year 42,149) after adjusting for single taxpayers and exemptions.

3.16 It is anticipated that Council Tax collection will continue to be adversely affected by the difficult economic conditions. This situation is being kept under review. However, for the time being it is recommended that bad debt provision remain at 2% for 2013/14.

4 POLICY IMPLICATIONS

4.1 The Council has a range of plans and strategies and this budget is an important part of putting those into effect.

5 EQUALITIES IMPACT ASSESSMENT

Equalities – the Financial Strategy and subsequent budget proposals will have significant impact on the future delivery of services by East Lothian Council and therefore a potential impact on the wellbeing of equality groups. The EQIA on the Council Financial Strategy recommends that EQIA is considered as an ongoing process as part of the development and delivery of Council budgets.

6 RESOURCE IMPLICATIONS

6.1 Financial – the respective group proposals will provide an overview of the finances of the Council reflecting the constraints outlined in this report. The approved budget will be the 3 year summary and the explanation of the changes in each of the three years provided by each group.

6.2 Personnel - none directly from this report although there will be implications arising from subsequent service reviews and new initiatives.

6.3 Other – none.

7 BACKGROUND PAPERS

7.1 Council 12 February 2012 – “Council Financial Strategy 2012/13 to 2014/15”

7.2 Council 23 October 2012 – “Financial Strategy 2012-15 – Mid Year Review”

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East Lothian Council

Financial Strategy Statement

2013/14 to 2015/16

FINANCIAL STRATEGY STATEMENT 2013/14 to 2015/16

Objective and Principles

The financial objective of the Council is to provide the services that the Councillors believe are required for the lowest Council Tax or service charge possible.

Underpinning this objective are two key principles of public finance that the Council must observe – that there should be no taxation in advance of need and that there should be fairness in the tax burden between generations of taxpayers.

In practice, the principle of taxing only when necessary is closely related to the question of how much reserves the Council should hold. In setting a budget a balance has to be struck between holding funds in reserve for specified reasons, with any excess of reserves being used for the benefit of or returned directly to the taxpayers. This amounts to a decision on how much should be taken from reserves when setting the budget and this is explained further below.

Inter-generational fairness is most clearly apparent in the financing of capital investment projects. Many capital investments have a long-life and will benefit future generations. The use of debt finance ensures that the costs of the capital investment are spread over the life of the asset and paid for through taxes and charges over that life. Similar issues are involved in making provision for the future cost of pensions. These costs will be incurred by future generations even though the pensions have been earned in providing services now unless adequate provision for the full future cost is made from current tax receipts.

Medium Term Financial Position – Housing Revenue Account

The last ten years have seen a number of significant financial landmarks for the Housing Revenue Account. The first was the achievement of a zero net debt position in 2004/05 – mostly as a result of council house sale receipts in the property boom. Another has been the increase in capital spend over the past few years as the modernisation and affordable house building programmes have been expanded.

The medium term position for the Housing Revenue Account (HRA) budget will be set out as part of the budget approved by the Council. As almost all of the income for this service is locally raised the Council can plan, with a good degree of certainty, that it can manage the main financial risks. The overall HRA budget is a balancing act between the income raised through rent, the revenue expenditure such as staffing & repairs and the capital spending which is undertaken on modernisation and provision of affordable homes.

For the HRA, the financial strategy will focus upon the following;

- Ensuring that the HRA can sustainably support the capital programme associated with building new Council Houses and modernising existing homes.

- Ensuring that the rent levels and revenue savings to fund the rising debt costs are actioned and identified;

- Responding to the challenges arising from proposed UK benefit reforms over the coming years;

- Ensuring that the Council stays within the recommended upper limit for the ratio of income to debt charges of 40%. It is my view that this limit maintains an appropriate long term balance between the various elements of the HRA budget.

- Ensuring that the reserve or balance left on the HRA should not fall below £1.0 million. This will allow the Council to maintain a cushion against any unexpected increase in costs or loss of income, and to protect against the risks inherent in the UK welfare reform proposals. Given the uncertainty that exists over the timing and scale of capital investment in new affordable housing, there is no upper limit on reserves.

Medium Term Financial Position – General Services

For the General Services revenue budget, the Council continues to plan for the medium-term through its three-year planning processes. This year the Scottish Government has provided grant figures for the 2 years ahead to assist in that planning. The next Comprehensive Spending Review is scheduled to take place in 2014 and until then the likely grant figures for year 3 is uncertain. The financial assumption being made for Year 3 is that grant will remain at Year 2 levels.

In the medium term it is clear that the Council faces some difficult financial decisions as a result of the following;

- Reductions in the income it will receive from central government;

- New legislative requirements e.g. food waste treatment/homelessness legislation;

- Responding to the challenges arising from proposed UK benefit reforms over the coming years; and

- Increasing population e.g. school rolls/elderly care.

The latest estimate of funding that is available to support council services (after all the other corporate commitments are taken into account) is going to drop from £195.7 million in the current year (2012/13) to £191.4 million by 2015/16. This trend has been evident over the past couple of years but our estimate is that we have only managed 20% of the reduction which will be needed by the end of the budgetary period

This means that the Council is faced with reducing its expenditure commitments or increasing its income, or some combination of both.

Despite the challenging economic conditions that continue to prevail, the Council has an ambitious 5 year Council Plan approved in 2012. It may be possible to introduce new sources of income but a significant part of the medium term deficit is likely to have to be met through cost containment and avoidance. As far as possible, the Council is seeking to contain costs by becoming more efficient, which would minimise the effect on services provided. However, the size of the medium-term deficit suggests that more significant changes in how services are managed and delivered will be required as the means of containing costs whilst maintaining and where possible improving services in accordance with the Council Plan. This includes the Council paying due regard to the statutory obligations of the Equality Act 2010. Understanding the impact of financial decisions on those in the community will help to ensure that decisions about future provision of services meet the needs of the community effectively.

Pensions

All employees working for the Council have access to defined benefit pensions, which means that the Council as employer has substantial unknown future financial liabilities that only materialise when the pensions are actually paid. For teachers this liability is not established for East Lothian as these costs are part of a national scheme administered by the Scottish Government. For non-teaching staff, there is a statutory requirement that these costs are independently assessed as part of an actuarial valuation of each local pension fund every three years.

The actuary for the Lothian Pension Fund, of which the Council is part, makes a triennial assessment of the financial position of the East Lothian share of the local government pension fund and his requirements for employer contributions.

At 31 March 2011 the East Lothian share of Lothian Pension Fund was £30 million in deficit. The actuary has advised that it is the employer’s responsibility to fund this gap over the next twenty years.

He has also indicated the minimum acceptable level of employer contributions for the 3 years up to 31 March 2015 and these have been drafted into the budget. The Council is ultimately expected to fund more than the minimum sum advised by the actuary but it is recognised that this will be difficult in current financial circumstances and the actuary has left the Council with flexibility as to how it funds the actual deficit in the medium to long-term.

The Pension Act 2011 has placed a number of new obligations upon the Council with changes to eligibility criteria effectively widening access to a greater number Council employees. The Council has also decided to defer the new auto-enrolment provisions until 2017 although it is still anticpated that there is likely to be an increase in scheme membership as a result of both of these issues.

In the longer-term addressing this pension deficit and overall pension costs will become an increasingly significant element of the Financial Strategy of the Council.

Risk Assessment

In setting a budget, the Council must take into account the risks that may impact upon successfully delivering the strategy. The main risks to the budget are listed in the annex including the action the Council should take to manage those risks both in setting the budget and managing its finances over the coming years.

The success of the Financial Strategy depends on how successful we are in mitigating the risks through management action and the extent to which the risks we have to accept actually materialise.

Scottish Government Grant Funding

Central to delivering the Financial Strategy is the grant funding received from the Scottish Government. In the General Services budget, around 80% of the Council's funding is received as grant from the Scottish Government.

As happened last year, in 2013/14 the Scottish Government has offered to provide a specific amount of grant funding to the Council if it chooses to freeze the Council Tax and certain national policy objectives are supported by the Council when they set their budget. A much lower funding offer has been promised if these national objectives are not shown to be supported in the Council budget.

Due to the uncertainty surrounding the future of UK public sector finances and the scheduled Comprehensive Spending Review planned for 2014, there is a significant risk that the grant figures planned for the next three years may be revised. However, the Council must not let this uncertainty undermine their planning for local services in the medium-term. The best way to deal with that uncertainty is to plan ahead as best we can so that damage is minimised as far as possible

Reserves

Holding an adequate reserve to meet unanticipated costs is a key management tool for delivering the Financial Strategy, but this must be balanced against the need to avoid taxation in advance of need as explained above.

To strike this balance the Council must take a view on what the reserves are likely to be at the start of the 2013/14 financial year, any plans that have already been made to use reserves and how much should be held to meet any risks that materialise over the next three years. Any reserves that do not need to be held as part of this strategy should be used for the benefit of or directly returned to tax or rent payers as part of this budget.

Council has been already advised through the various quarterly finance reports that the General Services reserves (excluding HRA reserves) available going into 2012/13 was £14.745 million. The split of these is detailed below;

FINANCIAL STRATEGY STATEMENT 2013/14 to 2015/16

Table 1: Reserves Analysis at 01 April 2012	
Reserve	**(£m)**
General Services Reserves	
Required to Support Future Budgets	6.357
Civil Emergency	2.000
Property Renewals	0.932
Cost Reduction Fund	3.733
Roads Renewals	0.000
Earmarked Reserves	
• DSM (Devolved School Management)	0.573
• MELDAP/DAAT	0.082
Insurance Fund	0.973
Capital Receipts Reserve	0.095
Sub-total General Services Reserves	**14.745**

This analysis includes the Insurance Fund and a range of earmarked funds such as those held for MELDAP and the DSM legislation. My advice going forward is that these should be retained and used for specific purposes already agreed by Council. This means that these are not then available for any alternative use.

The Capital Receipts Reserve balance of £95,000 can be used to meet the cost of debt charges in the year. I would intend that this will be applied at the 2012/13 financial year-end.

I am also advising that the Council should hold a financial reserve within the Civil Emergency Fund as a cushion against the costs of any emergency, such as the severe weather experienced in various seasons over recent years. This should be retained at the £2 million level.

Meeting future financial challenges is likely to mean significant changes in the way in which the Council delivers services. To help make these changes the Council has set up a Cost Reduction Fund. The balance on this Fund currently stands at £3.733 million and, over the last two years, has been used primarily to meet the costs of employee contract severance payments. There is likely to be a further use of this during 2012/13, and beyond, as the Council manages down its staff numbers to match its reduced financial resources. Given the scale of the changes facing the Council and the costs associated with making these changes the balance on this Fund needs to be replenished. On this basis I am recommending that the Cost Reduction Fund should be retained and that, if any future reserves become available, that they are directed towards this Fund.

As part of setting the 2012/13 budget the Council agreed to apply £6.357 million of its reserves to help manage the reduction in budgets over time. £4.073

million of this total was to be used in 2012/13. The current predictions are that fewer reserves will be needed to balance the 2012/13 budget and I am recommending that any unused element of this £4.073 million at the end of the 2012/13 financial year is directed towards the Cost Reduction Fund.

During the year the Council has reviewed its approach to asset management – and how property renewals are funded. Rather than having a separate Property Renewals Reserve officers recommended that there should be an identifiable line with the Council's capital budget. This recommendation has been accepted by both political groups and each set of budget proposals have made allowance for property renewals within the capital plans. To complete this process I am recommending that the existing Property Renewals Reserve is closed and that any remaining balance is transferred to the Cost Reduction Fund at the end of the 2012/13 financial year.

Taking all these factors into account, this means that £2.284 million remains available to support the 2013-2016 budgets or be returned to taxpayers.

The regulations that surround the use of prudential borrowing powers require that the Council demonstrate that its capital investment plans are affordable and financially sustainable.

Affordability is demonstrated by the incorporation of all the costs associated with the investments within a balanced three-year budget.

Financial sustainability is demonstrated by having the final year of the budget showing balanced income and expenditure without the use of reserves. Borrowing is usually repaid over a longer period than three years, and the best indicator of whether the future repayments are sustainable is a 2015/16 budget that does not rely on temporary sources of funding such as reserves. In other words, to sustain the capital investment plan the Council needs to demonstrate that there is no structural deficit in its budget by 2015/16.

Summary

The Council faces a wide range of risks and an increasingly difficult financial environment. For General Services, in the short and medium term expenditure is outstripping income. In the longer-term, pension liabilities are increasing and should be funded now rather than passed on as a burden for future taxpayers.

However, I am confident that by effectively working together, and by delivering the required change programme, this challenge can be managed and that, by the end of the budgetary period we will be delivering our priority outcomes for the people of East Lothian within a sustainable and balanced budget.

To achieve this, over the next three years, the Council's financial strategy will be focused upon;

- Delivering a Change Programme that will achieve significant efficiency savings across all areas and all inputs such as staffing and supplies;

- Constraining cost growth – through effective demand management, good financial control by managers and by effective negotiation with suppliers;

- Generating additional income and ensuring that, where the Council has decided, there is full cost recovery;
- Progressing integrated working with our partners where there is a promise of greater efficiency;
- Avoiding any new additional borrowing after the 2013/14 financial year.

Jim Lamond
Head of Council Resources
07 February 2013

ANNEX: FINANCIAL STRATEGY RISKS

Risk	Action	Mitigation Method
Efficiency savings are not achieved	Mitigate	1) Identify required savings in the budget as part of a comprehensive change programme and report progress on achievement to Cabinet on a regular basis. 2) Participate in national efficiency initiatives 3) Compare efficiency with comparable organisations 4) Test the competitiveness of in-house services against similar services available in the market and vice versa.
Budget is not effectively managed	Mitigate	1) Subdivide the budget to allow clear allocation of responsibility to managers and link those budgets to operational responsibility 2) Report on the budget position to managers on a monthly basis and Cabinet on a quarterly basis 3) Provide training in financial management to all responsible officers
Loss of key suppliers leads to additional costs	Mitigate	1) Maintain active relationships with key suppliers to assist in early identification of problems 2) Hold a financial reserve to provide funding to meet costs arising should a supplier be lost
Events occur that were not fully anticipated in the budget	Mitigate	1) Encourage wide participation in budget setting to capture as much service information as possible 2) Hold a financial reserve to provide funding to meet costs arising from such an event

ANNEX: FINANCIAL STRATEGY RISKS

Risk	**Action**	**Mitigation Method**
Wider changes in the economy impact on our costs (e.g. energy prices, interest rates) and income	Mitigate	1) Identify volatile costs/income within the budget and adopt management processes to limit exposure 2) Hold a financial reserve to provide funding to meet costs/income loss arising
The Council does not carry through its plans	Mitigate	1) Regularly monitor progress against the Council Plan 2) Regularly monitor the financial position compared to budget
A service fails to meet statutory requirements resulting in the cost of emergency corrective action	Mitigate	1) Regularly monitor progress against the Council Plan 2) Hold a financial reserve to provide funding to meet costs arising from corrective action
Failure of key financial and other systems	Mitigate	1) Ensure business continuity measures are effective 2) Hold a financial reserve to provide funding to meet costs arising should a system fail
UK welfare reform leads to a loss of income and increased demand for council services	Mitigate	1) Monitor the development of welfare reforms and seek to influence wherever possible 2) Hold a financial reserve to cover increased costs or income loss
The Council has to meet a major unanticipated insurance or compensation claim	Mitigate	1) Ensure insurance arrangements are adequate for the risks anticipated and that provision is made for claims 2) Hold a financial reserve to provide funding to meet costs arising should a claim arise