

STATEMENT ON GENERAL FUND BUDGET STRATEGY
BY THE CHIEF FINANCIAL OFFICER
UNDER S.25 LOCAL GOVERNMENT ACT 2003

Section 25 of the Local Government Act 2003 imposes a duty on the Chief Financial Officer (CFO) to report formally to Council on the following matters:-

- The robustness of the estimates made for the purpose of the calculations (to set the Council Tax), and
- The adequacy of the proposed financial reserves.

These specific matters are dealt with below but it is important to set the whole of the 2012/13 budget process in the context of the exceptional financial circumstances that Local Government finds itself in.

Given the continuing uncertainties of the economic environment and the scale of expenditure reductions required year on year, there will inevitably be significant risks involved in delivering a balanced budget. Whilst considerable pressure exists on the Council's budget because of the severely reduced level of resources available for Local Authorities in the future, further advanced forward planning to deliver the future year's budget savings is in preparation and is absolutely essential.

Past budget processes have been difficult with the £25M gap for 2011/12 being at least double the largest gap ever faced by the Council since it became a unitary authority. For the 2012/13 financial year the budget shortfall as published in this report is £13.8M rising to a cumulative shortfall of £57M by 2014/15 and therefore presents a significant and ongoing challenge to the Authority.

Whilst therefore the basic methodology for putting the budget together at the Council has not changed, it must be recognised that the scale of the changes and some of the measures being introduced do increase the risk built into the budget for 2012/13 and beyond.

There are a number of specific risks which should be noted which either are or could adversely impact on the Authorities financial position:

- i) **Council Tax Freeze Grant** – The government has announced a one off non recurring Council Tax freeze grant for 2012/13, which will fund the equivalent of the difference between a zero percent and a 2.5% council tax increase. For 2012/13, accepting the grant has a nil impact on the council's financial position, but for 2013/14 onwards the impact of not receiving the grant and having not set the council tax rise at 2.5% for 2012/13 is a £2.1M shortfall in income which will add to the overall shortfall in the Council's budget.

My advice to all three political groups was that it was not in the Council's long term financial interest to accept the freeze grant.

Whilst understanding the advice given, and cognisant of the impact of accepting the grant, the Executive are, at the point of preparing this report,

mindful to recommend to Full Council that the Council accepts the council tax freeze grant in order to lessen the burden on council tax payers and keep council tax static for 2012/13. The impact of this would however be to increase the council's budget shortfall by £2.1M from 2013/14.

- ii) **Council Tax Referendum** – The introduction of a Council Tax (CT) referendum for CT increases in excess of 3.5% is likely to be a limiting factor in being able to raise council tax income in the future, as it is felt unlikely that many Authorities will wish to propose increases which trigger a referendum. If this were to be true moving forward in Southampton, then CT increases would be capped at a maximum increase of 3.5% which would limit the ability to use council tax increases in future as a way to address the ongoing funding shortfall.

- iii) **Local Government Settlement** – Although the Comprehensive Spending review (CSR) announced in October last year was for the 4 year period 2011/12 – 2014/15, the government has only announced firm funding for Local Government for the two year period 2011/12 and 2012/13.

Based on the high level assumptions in the CSR, provision has been made within the current medium term forecast to manage this risk of reduced government grant with an assumption that there will be a further reduction in government grant of 7% in both 2013/13 and 2014/15. There is a risk that the actual reductions in government grant will be in excess of 7% for 2013/14 and 2014/15.

- iv) **Local Government Resource Review** – In addition to not having firm grant figures for 2013/14 onwards, the government have recently carried out a Resource Review into the way Local Government is financed. This will alter the way Local Government is financed from April 2013 onwards, and includes a system of locally retained business rate income. At this stage, the impact on the Council's future financial position is uncertain and this adds a further element of risk to the budget position for 2013/14 onwards

- v) **Localisation of Council Tax Benefit** – The move away from a nationally prescribed scheme for calculating council tax benefit, and the introduction of a local scheme based on a reduction of 10% in the overall grant available from the government adds further risk to the budget position. The risks are follows:
 - a) That the new scheme does not deliver the 10% saving required from April 2013; although it should be possible to mitigate this risk through careful scheme design.
 - b) That a shift in demographics or economic conditions will cause an increase in demand for benefit which cannot be contained within the reduced budget provision available.
 - c) That with Council Tax benefit being paid direct to recipients there will be an increase in council tax arrears due to non payment.

- d) The time period for introducing the new localised system is very tight, with the new system due to be in place from April 2013.

The Council will seek to limit its exposure to these risks through careful consideration of the scheme design, and through working closely with its partner Capita to ensure timely implementation of the new scheme.

- vi) **Interest Rate Risk** – The global financial position coupled with the current financial crisis in the Eurozone means that there is a considerable amount of interest rate risk within the overall financial system. The current position of securing low interest rate variable debt is providing a positive benefit to the General Fund budget, with borrowing costs significantly lower than they otherwise would have been through borrowing longer term through higher rate fixed term loans.

There are specific measures within the budget to provide a way of managing the risks presented by the current borrowing strategy, namely through the establishment of the Interest Equalisation Reserve (IER) and the further contribution of £563,000 to that reserve as part of agreeing the 2012/13 budget.

It should be noted however that the IER would only be sufficient to provide for transitional funding at the point at which the Council begins to convert from variable rate debt to long term fixed rate debt and that there remains no recurring budget provision to fund the increased interest costs likely to be incurred. The likelihood however, is that based on the current economic conditions, interest rates are likely to stay lower for longer and also the margin between short term variable debt and long term rates is not anticipated to narrow to any significant extent. It is likely therefore that the impact of converting to fixed rate long term debt will materialise towards the end of the current medium term budget horizon, providing the Council with time to manage this potential issue in future budget rounds.

- vii) **Demographic Change and increased Demand** – There remains an upward demographic pressure in social care via an increasing elderly population, and demand continues to grow for expensive interventions within Children's Services. There are specific measures within the proposed budget for 2012/13 through the inclusion of significant sums within the Risk Fund to manage these budget pressures.

- viii) **Pending Employment Tribunal Litigation** – The Trade Unions are currently in dispute with the Council following the introduction of revised Terms and Conditions with effect from 11 July 2011. To date, collective agreement to end the dispute has not been reached. The Trade Unions are proceeding with a claim on based on the Council's alleged failure to consult on the dismissal and re-engagement of the workforce when the new Terms and Conditions were introduced.

Notwithstanding that the Council will rigorously defend its actions at the tribunal; there nevertheless remains a risk that a tribunal could find in favour of

the Trade Unions. The maximum award that a tribunal could award against the Council is a 90 day gross pay award for each employee who was dismissed as part of the implementation of the revised Terms and Conditions and this maximum liability is estimated to be in the region of £12M, (although an award of this magnitude is considered extremely unlikely).

In order to make provision for defending the litigation and for any possible award against the council, the Executive have prudently recommended the setting aside within the 2012/13 budget of £600K on a recurring basis to fund any costs (including legal costs) which arise from defending the Council's position at the Employment Tribunal.

- ix) **Economic Conditions** – The national and international economic conditions remain uncertain and volatile. The UK has been through a sustained recession, and the indications are that economic conditions will remain difficult for some time. At the local level, the recession has impacted on the Council's income streams across a range of services, and it is likely that income will be further impacted in 2012/13. Provision to cover the risk of a further reduction in income is provided for within the Risk Fund

- x) **CSR 2014** – Although some way off, the indication from central government is that the CSR 2014 will be every bit as tough for Local Government as the CSR 2010. Whilst outside the current medium term planning horizon, the potential impact of this for Southampton will form part of the thinking necessary around the sustainable changes which will need to be made in the next few years to ensure the long term viability of service provision.

The Council is required to have regard to this report in approving the budget and CT. It is appropriate for this report to go first to Cabinet and then to be made available to the Council in making its final decision.

Notwithstanding the above, as required under Section 25 of the Local Government Act 2003 I would make the following formal comments on the Robustness of the Estimates and the Adequacy of Reserves:

A) ROBUSTNESS OF ESTIMATES

Budget setting is made up of several estimates some involving quite complex forecasting. By the very definition of the word, estimates are not factual and the degree of accuracy will not only vary but also take different periods of time to be proven to be correct or otherwise.

During the summer of 2011 the Executive, (supported by the Management Board of Directors), developed a series of detailed budget proposals which were subsequently published in October. Whilst some figures were changed and new proposals have been put forward, these have also been validated by the Management Board of

Directors prior to their inclusion in the final proposed budget. There is therefore a high degree of validation inherent within the final budget proposals.

Key elements within the budget are provisions for inflation on pay and prices, projected levels of income and achievability of savings. Details of these items are included in the reports and have already been through the validation process as set out above. However, there are a number of points to draw out:

- i) Assumptions made in all of the forecasts are basically sound. A zero pay award has been incorporated into the budget for 2012/13 and for future years the budget forecast now reflects the announcement made by the Chancellor in his Autumn Statement to “set public sector pay awards at an average of 1% for each of the two years after the current pay freeze comes to an end”. Employer contributions to the Hampshire Local Government Pension will remain at their current level for the three year period, 2011/12 to 2013/14, equivalent to 19.1% of pensionable pay, following the actuarial review at 31 March 2010.
- ii) The scale of the reductions in local government funding has meant that the Council has been forced to look at radical options for reducing expenditure across services. One of these options approved in 2011/12 was to reduce the terms and conditions of staff to produce ongoing revenue savings. Collective agreement was not reached as hoped and the process of dismissing and re-engaging staff after a period of 90 days notice was undertaken. The impact of this has been managed in 2011/12 but the ongoing dispute has yet to be resolved, and there is a potential future liability as a result of the employment tribunal claims submitted by the Trade Unions. The estimates for 2012/13 include a recurring contribution of £600,000 to make provision to cover off this risk.

Proposals which involve significant change to current structures, systems and processes, or which have major implications for service design inherently involve higher levels of risk than those which broadly maintain current arrangements. At the most practical level those risks begin with the possibility of slippage and disruption in the transition from old to new arrangements.

The Executives recommendations for efficiencies, income generation and service reductions now total £13.8M, including £1.0M from changes to the discretionary redundancy scheme.

Individual savings items have been approved by relevant Executive Directors and Senior Managers and have been subject to scrutiny by the Management Board of Directors. Responsibility for actioning any changes in the budgets will fall to me as CFO, and all savings approved will be actively monitored throughout the year although responsibility for the delivery of these savings rests with the relevant Executive Director.

- iii) The Council's external auditor gave an unqualified opinion on the 2010/11 financial statements and an unqualified conclusion on the Council's arrangements for securing value for money.

The Council has maintained a robust system of budget monitoring and control evidenced by the small unplanned variances from budget on final outturn in recent years. Where over spends or under spends have arisen, potential

variances have been identified early enough to enable corrective action to have effect.

The CFO considers that the financial control arrangements remain sufficiently robust to maintain adequate and effective control of the budget in 2012/13.

- iv) The current recommendation by the Cabinet retains a general contingency of £400,000 together with a risk based contingency sum of £6.3M within the Risk Fund, which should cover any estimation issues or activity changes that arise during the year.
- v) The current economic climate and national issues surrounding social care and the safeguarding of children have impacted on the budget. Adequate provision to cover all of these issues has been included within the final budget proposals and will be the subject of detailed monitoring throughout the year.
- vi) A prudent but realistic view of interest rates has been taken in constructing estimates for interest charges in 2012/13 budget. Whilst these estimates are considered to be adequate at this point in time the considerable turbulence within the financial markets may lead to further consideration. Interest rate trends and capital financing operations will be monitored closely throughout the year to facilitate timely action designed to optimise the Authority's position.

B) ADEQUACY OF PROPOSED FINANCIAL RESERVES

Risk Mitigation – Mindful of the overall risks within the budget, some of which are specifically highlighted in points i) to x) at the start of this report, (of which some are not quantified nor have any specific offsetting financial provision within the budget), I have re-assessed the minimum level of the Council's General Fund (GF) reserves/balances.

The current recommended minimum GF reserves/balances is £4.5M, but based on a revised risk assessment I have recommended that the minimum level of balances be increased by £0.5M to £5.0M.

Cognisant of my advice, the Executive are recommending to Full Council as part of their budget for 2012/13 that the minimum level of balances is increased to £5.0M.

It is also worth setting out that the Council does have an excellent track record of remaining within budget once it has been set, and has never been in the position of reporting an overall over spend on the General Fund despite some very difficult recent years in respect of reducing income and escalating social care costs in both children and adult services.

Issues which it is appropriate to draw specifically to the attention of Cabinet and Council are detailed below:

- i) The Council holds a number of specific reserves for issues like debt write off that are assessed on an ongoing basis against the specific issues to which they relate. Review of these provisions forms part of the budget preparations covered above.

- ii) The general reserves are used to support revenue, capital and strategic pressures and to provide a working balance.

Details of the use of general reserves are included in the report. The level of reserves and the projected use is forecast for three years. The minimum level of balances is recommended by the CFO taking into account issues like the proposed draw from reserves, the level of risk contained within the budget and previous experience on potential levels of net over spend.

Best practice guidance issued by CIPFA is followed in determining a level of reserves based on assessed risks, which are reviewed annually. Based on the current assessment, the CFO has recommended that the minimum level of balances should be increased from the current minimum of £4.5M to a new minimum working balance of £5.0M. There is no legal definition or Audit Commission recommendation on the absolute level of reserves that any authority should hold but the risk based approach does provide a consistent, transparent methodology that can be updated periodically.

- iii) Attention is drawn to the level and use of capital resources in the General Fund Capital Programme report. This identifies that there is currently a forecast deficit in the funding of the overall capital programme based on a revised estimate of capital receipts which have been adversely affected by the current economic climate. The level of deficit is much reduced from the level reported previously but remains an area to monitor as the deficit is based on estimated forecast receipts rather than receipts received.

Slippage in capital receipts could also require a further temporary draw from balances unless accompanied by equivalent slippage in spend. Non-receipt of any planned income will require a permanent draw from balances or savings to found in capital programme. In drawing up the capital programme these risk factors are obviously taken into account but as a backstop position these potential shortfalls will continue to be reviewed over the longer term and where possible, be reduced by re-phasing schemes or bringing forward the use of prudential borrowing. Allowance has been made in the budget for additional temporary unsupported borrowing.

The Council also has key strategic property and land sites which it has been holding until market conditions improve. These have been reviewed to ensure that those held are truly strategic and as a result sites have been identified for sale which has in part served to reduce the forecast capital deficit. The categorisation and potential for sale of sites will continue to be actively monitored and sites held by the Council which are not operational provide a further source of contingency to reduce the risks outlined in the above paragraphs.

- iv) Levels of borrowing and debt and associated treasury risks are fully covered in the Treasury Management Strategy and Prudential Indicators report which appears on the Council agenda. In recognition of the risk associated with the current strategy the Council is maintaining an Interest Equalisation Reserve, and as part of setting the 2012/13 I have recommended that the level of this reserve should be increased further to £2.1M, which I consider to be the prudent minimum at this time based on the current borrowing strategy.

Section 25 concentrates primarily on the uncertainty within the budget year rather than the greater uncertainties in future years. However future uncertainties also inform the need for reserves and balances in the medium term. The current financial position involving significant savings targets increases the risk of over spending, together with demand led spending pressures during a recession and potentially higher inflation than assumed. Funding beyond 2012/13 is uncertain as the Government is proposing a full review of the distribution of public sector funding. Budget plans for 2013/14 and beyond must be treated with caution at this stage.

This formal report is part of a continuum of professional advice and is the culmination of a budget process in which lots of detailed work has already taken place with Executive Directors, Senior Managers and their teams and Members.

The CFO considers that the budget proposals recommended by the Cabinet are robust and sustainable. However, there are risks associated with the achievement of efficiencies and service reductions and robust monitoring arrangements must continue to ensure savings are delivered within the required timescale. The level of general and specific reserves together with the contingency sum of £400,000 and the provisions held within the Risk Fund are sufficient to meet the known risks within the budget, taking account of the robust financial management framework which the Council has in place. Overall therefore whilst it is recognised that this budget has elements of risk not experienced before, it is felt that sufficient mitigating actions are already in place to accept and to manage those risks.