APPENDIX 12

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

Section 151 of the Local Government Act 1972 requires local authorities to make arrangements for "the proper administration of their financial affairs' and appoint a CFO to have responsibility for those affairs. The CFO must exercise a professional responsibility to intervene in spending plans in order to maintain the balance of resources so that the authority remains in sound financial health.

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 2013/14 budget process in the context of the exceptional financial circumstances that Local Government finds itself in.

Since the start of the current CSR period, the Council has made significant savings totalling £40M. For the 2013/14 financial year the budget shortfall as published in this report is £16.0M rising by a further £36.6M over 2014/15 and 2015/16 and therefore presents a significant and ongoing challenge to the Authority.

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 budget savings required in the medium term is in preparation and is absolutely essential.

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 2013/14 and beyond.

The level of one off funding already included in the ‘base position’ totals almost £6.1M, (as set out in paragraph 67), and is effectively contributing in the order of 25% of the savings required to close the gap and balance the budget position in 2013/14. This is clearly not a sustainable position. The Council’s reserves are at the minimum level recommended by the CFO and given the ever tightening financial position, the increasing pressures on spend (in particular in social care) and the significant savings to be made in future years, it is difficult to foresee that significant sums of one-off funding will be available in future years to support the budget position.

In addition, there are significant shortfalls in future years as set out in Appendix 10. Therefore, Members must not lose sight of the need to ensure that work is ongoing to develop sustainable savings proposals for future years and must be mindful of the need to carefully consider the extent to which one off funding is utilised in order to deliver a balanced budget in any one year.

There are a number of specific risks, some of which are new for 2013/14, 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 Council Tax freeze grant for 2013/14, which will fund the equivalent of the difference between a zero percent and a 2.0% council tax increase but will be paid over 2013/14 and 2014/15. The grant receivable will represent additional funding equivalent to increasing Council Tax by 1.0%, which for Southampton City Council is approximately £0.8M. However, based on the level of grant payable in 2013/14 and 2014/15 if the decision was taken to freeze Council Tax and accept the grant this would increase the current budget gap in each of these years by £0.8M due to the difference between the Council Tax income that has been assumed and the level of funding being offered by the Government. This increase in the forecast gap would grow to £1.6M in 2015/16 and beyond when the grant income is also lost. The advice I have given to all four political groups is that it would not be in the Council's long term financial interest to accept the freeze grant. The Executive's budget proposal does not include an acceptance of this grant.

ii) **Council Tax Referendum** – The introduction of a Council Tax referendum for Council Tax increases in excess of 2.0% 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 Council Tax increases would be capped at a maximum increase of 2.0% which would limit the ability to use Council Tax increases in future as a way to address the ongoing funding shortfall. The Executive's budget proposes a Council Tax increase of 1.9%, and thus does not trigger a referendum.

iii) **Local Government Settlement** – The Comprehensive Spending review (CSR) was for the 4 year period 2011//12 to 2014/15 and in December the provisional settlement set out funding for Local Government for the final two year period of the CSR; (2013/14 and 2014/15). This settlement reflected the changes resulting from the Local Government Resource Review into the way that Local Government is financed. Whilst the settlement announcement gives a degree of certainty these changes which include a system of locally retained business rate income introduce new risks.

iv) **Business Rate Retention (BRR) Scheme** – From 2013/14 onwards the previous formula grant system is to be replaced by a new regime which is based on business rates retention. Under the new BRR Scheme the Council will retain 48% of business rate income with a series of "tariffs", "top-ups", "levies" and "safety nets" to reflect the current difference between what individual local authorities actually collect compared with what they get under the current formula driven mechanism. The new BRR Scheme means that the Council's income during the year will be subject to greater volatility. Previously the funding from business rates was by way of a fixed annual government grant but in the future it will be dependent on our ability to collect, retain and grow business rate income, and in part this will depend on the local economic situation. It should be therefore be noted that the new system introduces significant new risks which the Council will need to be aware of:

The Authority is required to estimate the likely level of business rates to be retained, and this income level is then built into the Authority's budget. If the actual income collected is less than the amount included in the budget, then, all other things being equal, this will have a direct negative impact on the Council's financial position.

The Authority's estimate of the level of Business Rates to be retained can be impacted by two key issues:

a) Economic Growth – If the economy grows within the City, then it is likely to have a positive impact, leading to growth in the level of business rate income. Conversely, every time a business closes, that will represent a real reduction in income to the Authority, and there are recent examples which illustrate this risk, for example Comet, Jessops and Ford.
b) Appeals – Under the new system, Local Authorities (LA's) will lose income each time the Valuation Office reduces a Rateable Value and hence the business rates payable following a successful appeal. Up until 2013/14, any successful appeals do not impact on LA's, but from 2013/14 onwards, LA's will lose income proportionately for each successful appeal, and in Southampton the proportionate share will be 48%. In estimating the level of retained Business Rates to include in the budget, an assessment has had to made of the level of appeals, and the figure included in the budget is net of this amount. There is a clear risk therefore that if appeals are higher than anticipated, income will be less than forecast and, all other things being equal, this will impact negatively on the Council's financial position.

These are new and significant risks to the Council.

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 has sought 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. However, there remains a risk of increased non collection and also the risk that the number of claimants will increase.

vi) **CSR 15** –The next CSR period starts in 2015 and is likely to contain another round of significant cuts to Local Authority funding. Various professional bodies and associations quote the potential loss of grant funding between 25% and 40%. The exact timings of these further reductions are unknown at present. 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.

For planning purposes, 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 central government grant of 9% in 2015/16. This reflects an ongoing reduction which has averaged 7% per annum and an additional 2% reduction continuing that announced by the Chancellor in the Autumn Statement for 2014/15. There is a risk that the actual reductions in government grant will be in excess of 9% for 2015/16.

vii) **Impact of Welfare Reform** –The Welfare Reform changes will affect residents of Southampton and may increase demand for services provided by the Housing, Adult Care and Support and Children Schools and Families services. Whilst it is impossible to calculate these impacts, the overall budget does include some funding specifically aimed at supporting the most vulnerable who are impacted by these reforms:

a) Social Fund – A sum of £654,200 has been included in the 2013/14 budget which can be awarded on a discretionary basis to the most vulnerable individuals who are in real financial difficulty.

b) Council Tax Reduction Scheme – A sum of £200,000 has been set aside as part of the scheme agreed by Full Council in the form of a discretionary Hardship Fund.

However, there remains an unquantifiable risk that an increase demand for services would impact on the Council's financial position, as no specific additional funding has been built into service budgets to account for any impact arising form the Welfare Reform changes.

viii) **Public Health Growth** –Public Health responsibilities transfer to the Council from April 2013 and at this stage it has been assumed that the associated funding will meet the cost of providing the transferred service and therefore will not have any impact on the Council's total net revenue budget requirement. Whilst unlikely, any shortfall arising will need to be addressed during the financial year as a matter of urgency and in future years there is a risk that growth in demand may place a financial pressure on the Council.

ix) **Academy Schools Transfer (Education Services Grant)** – The Education Services Grant (ESG – formerly known as Local Authority Central Spend Equivalent Grant - LACSEG) is currently paid to Academies to cover the cost of services that local authorities provide centrally to its own schools. These services include improving school attendance, financial support and asset management amongst others. This new grant will be allocated between the Council and Academies based largely on pupil numbers and will be reviewed on a quarterly basis. This will introduce an additional element of volatility and risk as schools transfer to Academy status and this will be exacerbated if the Council is not able to reduce its costs in line with reductions in funding.

x) **Interest Rate Risk** – The global financial position coupled with the current unresolved 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. 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.

xi) **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 2013/14 through the inclusion of significant sums within the Risk Fund to manage these budget pressures. Furthermore, additional funding is set out for approval in 2012/13 and sums have been allocated to add to service budgets in 2013/14 as known pressures.

xii) **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 continue to be impacted in 2013/14 with the added risk of the impact on business rates which is now borne by the Council.

xiii) **Redundancy Provision** – Forecast future redundancy payments are based on information gathered during the previous budget process. We anticipate that we have set aside sufficient provision in the Organisational Development Reserve to finance the required one-off payments over the next three years. However the actual impact is only known when specific details come forward and changes in the overall level of savings required will influence the resulting level of redundancies in future years.

xiv) **Transformational Change** – There is still a considerable amount of transformational change that will need to occur at the same time as maintaining "business as usual" as the Council addresses the sustainable changes demanded in the next few years to ensure the long term viability of service provision. There is always a degree of risk associated with major change and due to the reduced resources at a senior managerial level there is a growing capacity issue which may impact on the ability to manage and support the wide ranging changes required whilst maintaining financial control and good governance of the Council. The Executive's budget proposes that an additional £1M is set aside to fund transformation activity in 2013/14.

xv) **Equal Pay** – The Council has received a number of Equal Pay claims. There remains the risk that further claims could be received.

The Council is required to have regard to this report in approving the budget and Council Tax. 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 2013 the Executive, (supported by the Management Board of Directors), developed a series of detailed budget proposals which were subsequently published in November. Whilst some figures were changed, proposals have been amended 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 1% pay award has been incorporated into the budget for 2013/14 and 2014/15, reflecting 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. Contributions from April 2014 will be reviewed as part of the next actuarial review and the impact will be built into future forecast which will be regularly updated.

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. 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 £16.5M.

Individual savings items have been approved by relevant 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 2011/12 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 2013/14.

iv) The current recommendation by the Cabinet retains a general contingency of £250,000 together with a risk based contingency sum of £5.8M 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. Additional 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 2013/14 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) <u>ADEQUACY OF PROPOSED FINANCIAL RESERVES</u>

Risk Mitigation – Mindful of the overall risks within the budget, some of which are specifically highlighted in points i) to xv) 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 reserves/balances.

The current recommended minimum General Fund reserves/balances is £5.0M, but based on a revised risk assessment I have recommended that the minimum level of balances be increased by £0.5M to £5.5M for the 2013/14 financial year.

In reviewing the minimum level of reserves, I have had regard to the significant new risks presented by the introduction of the new BRR Scheme and the new localised Council Tax Benefit Reduction scheme, together with the continuing reduction in Local Government funding and the consequent significant budget shortfalls the Council still faces in the medium term.

Cognisant of my advice and the issues set out above, the Executive are recommending to Full Council as part of their budget for 2013/14 that the minimum level of balances is increased to £5.5M.

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 £5.0M to a new minimum working balance of £5.5M. 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. Whilst this identifies the overall Capital Programme is fully funded this is based on a revised estimate of capital receipts. The level of capital receipts is volatile and therefore while the funding deficit is now closed from the level reported previously this remains an area to monitor as the deficit is based on estimated forecast receipts rather than receipts received.

Slippage in capital receipts could change the forecast of temporary borrowing that is required unless accompanied by equivalent slippage in spend. Non-receipt of any planned income will require a permanent draw from balances, additional borrowing 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.

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 2013/14 I have recommended that the level of this reserve should be maintained at £3.1M, 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 2014/15 is uncertain as this will signal the start of a new CSR and therefore budget plans for 2015/16 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 Directors, Senior Managers and their teams and Members.

The CFO considers that the budget proposals recommended by the Cabinet for 2013/14 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 £250,000 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 in 2013/14.

However, as CFO, I remain concerned about the Authority's medium term position, with circa £36M of savings to be found by 2015/16. Therefore, Members must not lose sight of the need to ensure that work is ongoing to develop sustainable savings proposals for future years and must be mindful of the need to carefully consider the extent to which one off funding is utilised in order to deliver a balanced budget in any one year.