

Agenda Item	9
Report No	HC/16/17

HIGHLAND COUNCIL

Committee: Highland Council

Date: 29 June 2017

Report Title: **Financial Outlook 2018 - 2023**

Report By: Director of Finance

1. Purpose/Executive Summary

- 1.1 The report sets out the financial risk analysis and modelling of various planning assumptions in respect of the next five financial years, covering both Revenue and Capital Budgets (excluding Housing).
- 1.2 Longer term financial planning is a key management tool to enable politicians and officers to develop and implement policy priorities within the financial resources available to the Council.

2. Recommendations

- 2.1 Members are asked to:
 - i. Consider the financial modelling assumptions
 - ii. Note the scale of financial challenge facing the Council over the next five years with a modelled financial gap in the Revenue Budget of between £129.7m and £186.9m
 - iii. Note the implications for capital expenditure and the need to review the Capital Plan in light of the revenue budget implications and its affordability
 - iv. Agree the need to develop a five year financial strategy linked to the priorities of the Council

3. Background

- 3.1 One of the main challenges facing the Council over the next five years will be a lack of financial resources. The purpose of this report is to outline the challenges and uncertainties facing local government over this period, and to assist in the prioritisation of services within that funding framework.
- 3.2 Financial modelling is not an exact science. It requires assumptions to be made around pay and price inflation, demographic and other changes in the demand for services, growth in the council tax base, and the implementation of government policies at a national and local level. One material factor is an evaluation of levels of Scottish Government Grant over this period, given that this currently accounts for around 78% of the Council's net funding, with only 22% funded by council tax.
- 3.3 A key element of any financial model has to be an assessment and approach to risk. It is not possible to eliminate all risk. However it is important to evaluate risk and assess the implications should the risk materialise.
- 3.4 The financial model will therefore not deliver an exact total funding requirement, but will provide a range of potential scenarios and the financial implications. This will enable the Council to plan ahead to prioritise services and plan how it will address and manage risk in this environment.
- 3.5 Audit Scotland has produced a report in December 2016 outlining their overview of local government finances in Scotland. A follow up report was released in March 2017. Both these reports make a major play on the need for councils to have long term financial plans that are linked to the strategic plans of the Council.
- 3.6 Whilst the financial environment for local government is extremely challenging and uncertain, especially with single year grant settlements, this actually strengthens the argument for developing a five year financial plan, and modelling various scenarios, in order to enable councillors to plan and prioritise accordingly.
- 3.7 This report, whilst focussing principally on the Revenue Budget, makes a direct link to the affordability of the current Capital Plan. There is a direct correlation between borrowing for capital investment and the ability to repay it, including interest payments and the impact on the revenue budget. Although actual costs vary, approximately every £10m borrowed incurs additional annual revenue costs of £1m (principal and interest repayments).

4. Financial Modelling Assumptions

- 4.1 An initial starting point for any financial model is the current cost of services. At the core of the model is an assessment of the cost of maintaining services at their current level. The baseline is therefore the net Revenue Budget for 2017/18 of £567.921m as agreed by Highland Council on 16 February 2017. This includes the 3% Council Tax increase.

4.2 *Inflation*

- 4.2.1 There are two main elements to this, namely pay inflation and price inflation.

- 4.2.2 Pay inflation is the subject of national pay bargaining. At the time of writing negotiations are ongoing around a pay settlement for all pay groups around an uplift of 1.2% for 2017/18, and this is reflected in the current year's budget.
- 4.2.3 National public sector pay policy is currently set at 1% per annum over the next few years. This may however come under pressure as cost of living may increase more generally over the period (see below).
- 4.2.4 The financial model therefore considers options of 1%; 1.5%; and 2%. The model will use, for planning purposes, a figure of **1.5%** as the main assumption. This reflects an upward pressure balanced against affordability over the period in a context of reducing budgets and risk of job reductions. It should be stressed that this assumption is for the purposes of the financial model, and does not prejudice future pay negotiations. Nor does it reflect affordability.
- 4.2.5 The Council meets its requirement to pay (at least) the Living Wage to all staff. For the purposes of this model, equal pay risk is acknowledged but it is assumed that any potential future issues will be addressed without impact on current pay cost assumptions.
- 4.2.6 Non pay inflation is an area where the Council has not made specific budget provision for a number of years. Any material pressure has either been addressed within the service concerned, or through a budget feed in the current or future year's budget. The only exception has been where the Council has entered into contracts that make provision for annual inflation uplifts. Such examples are around ICT, Schools PFI/PPP, and transport.
- 4.2.7 Latest inflation figures for the UK show the Consumer Price Index (CPI) rising to 2.7% in April 2017, the highest since September 2013. There are significant pressures around catering and transport which can be attributed to the falling value of sterling against the euro and the dollar. Given the ongoing uncertainty regarding the timing and negotiation around the UK's exit from the European Union (Brexit), this situation is likely to continue for the next 2-3 years. Beyond Brexit there will be significant uncertainty regarding the value of sterling and this may continue for the foreseeable future.
- 4.2.8 Over the life of this financial plan a general provision for inflation has been made. This will allow the Council to direct resources at specific commodities and contracts where there are financial pressures and commitments. An allowance of **1%** has been made. Key to mitigating this risk will be the Shared Commercial and Procurement Service with Aberdeen City and Aberdeenshire Councils.

4.3 ***Cost of Borrowing***

- 4.3.1 Cost of borrowing contains a core assumption that the Council needs to spend an additional £2.5m per annum to support the existing capital plan. This is factored into the financial model at present. There is a significant risk of increasing interest rates, particularly after Brexit. Any upward pressure may mean that the Council cannot sustain existing capital expenditure plans, although this risk can be mitigated by reviewing the period over which loans are taken. This mitigating risk, whilst delivering a short term benefit, may carry

a longer term financial risk around debt refinancing.

4.3.2 The current practice of using short term borrowing for any financing requirements is at a level that may be unsustainable in the longer term.

4.3.3 This is a material issue regarding affordability, and meeting any Budget Gap, and the issues around this are developed in Section 8 of this report.

4.4 ***Demographic Changes and General pressures***

4.4.1 The Council faces a number of upward pressures and increasing demand for services. Some are caused by demographic changes, including:-

- A growing population;
- A growing population of older people and adults in need of health and social care, including adults with learning difficulties;
- An increase in the number of children born and surviving with complex care needs, and in need of additional support for learning (some 36.6% of school age children receive some form of additional support. Around 2000 (6%) children and young people have the highest levels of need and 140 attend special schools);
- Growth in the number of households with domestic properties expected to increase over the next five years, particularly in the Inverness and Lochaber areas, and this will cause pressures on school rolls, school accommodation, and will lead to additional pressure on infrastructure and waste collection and disposal.

4.4.2 Linked to this there will be a corresponding increase in the Council tax base over the same period. This may generate additional revenue of £0.6m per annum. In addition the Council will have the option to increase council tax rates annually, assuming that there is no change in Scottish Government policy. For the purposes of this model no increase in Council Tax has been assumed. This will be an issue for the Council to determine in due course. In 2017/18 the Scottish Government placed a cap of 3% on any tax increase.

4.4.3 The future of council tax as a tax is uncertain. Most political parties wish to see a replacement tax system introduced, although there is no clarity as to what any final proposals may look like. For the purposes of this model no changes to the current tax system are anticipated. Any change would take a minimum of two years to implement.

4.4.4 An annual provision of £7.5m for demographic changes and general pressures has been made in the model, based on historical experience.

4.5 ***Scottish Government Grant Funding***

4.5.1 As stated above, this is the largest element of uncertainty, and the largest element of council funding. In 2016/17 and 2017/18 the Council has seen a reduction in its core funding of around 4.3% and 2.47% respectively in each year. This is unprecedented.

4.5.2 In 2016/17 the Council required to deliver some £35m of savings, with a further £16m required to be found in 2017/18. Ongoing savings of this scale make it harder to find savings without further impacting on service delivery.

- 4.5.3 In modelling future scenarios it is important to consider current stated government policy at both a UK and Scottish Government, and assess what this means for the Council.
- 4.5.4 The Fraser of Allander Institute has modelled the Scottish Block Grant from Treasury for 2018/19 and 2019/20. This indicates a cash reduction of 1.9% and 1.4% respectively, as opposed to a small cash uplift in 2017/18.
- 4.5.5 The Scottish Government has indicated its policy intention to protect NHS funding by £0.5bn above the rate of inflation over the life of the Scottish Parliament. Whilst the Scottish Government has indicated a small shift in tax policy for 2017/18 this will not make a material difference to Government finances.
- 4.5.6 Given this scenario, further real reductions in Scottish Government Grant funding can be anticipated over the immediate future. For planning purposes, this model assumes cash reductions of 2%, 3.5% and 5% over each of the next 5 years.

5. Financial Models

- 5.1 Appendix 1 shows the core model reflecting the factors outlined in Section 4 above. This therefore represents an estimate of the status quo i.e. the cost of maintaining all services in their existing form. Service redesign, efficiency savings, additional income, and cuts in services will all be key elements that will change the model and deliver a balanced budget. All these options will however have staffing implications, and the Financial Strategy needs to be aligned with a Workforce Strategy to enable the Council to downsize where necessary without incurring significant cost.
- 5.2 The analysis therefore indicates that the range of **Budget Gap** is between **£129.7m and £186.9m** over the five year period.
- 5.3 Clearly this represents a significant financial gap, and does not necessarily represent the worst case scenario. Whilst this is not an absolute position it does demonstrate a significant and worsening financial position. However this indicates that the Council will likely have a net budget of around £0.5bn, and its challenge will be to make the best and most effective use of the resource available.

6. “Protected Services”

- 6.1 The Scottish Government has to date continued its policy of protecting absolute teacher numbers.
- 6.2 The Council itself has a number of funding, or contractual commitments, over which it has very little control in absolute terms. Principally these relate to Loan Charges (repayment of historical borrowing), ICT and Transport Contracts, and PFI/PPP/SFT school costs. Some contracts could however be reviewed with a corresponding reduction in service e.g. transport (the redesign review has already identified that a different approach is needed).

- 6.3 The table below details the type and extent of “protected budgets”, accounting for 42% of the Council’s total net budget:-

	Budget £m
Teacher Salaries	130
Loan Charges	55
ICT and Transport Contracts	23
PFI/PPP/SFT	<u>30</u>
	<u>238</u>

- 6.4 If the Overall Budget for 2017/18 is £568m then savings will have to be found from the £330m (58%) of “unprotected” budgets.
- 6.5 In the last two years the Council’s previous Administration has also indicated a desire to protect Roads and Winter Maintenance budgets. This has effectively “protected” a further £20m of budget from savings.
- 6.6 The model therefore shows that the scale of savings required from these “unprotected” budgets is substantial over the next few years.
- 6.7 The Council has also protected “front line services” in the last few years at the expense of professional, technical, and administrative services. Whilst this policy has been managed to date it is not sustainable, and there is a significant risk to service delivery, governance, financial stewardship, and legal and employee management.
- 6.8 Any financial strategy needs to be linked with a workforce strategy that plans an overall reduction in the workforce linked to the Council’s priorities.

7. Reserves

- 7.1 The Council’s non earmarked balances are forecast to be around £9.72m at 31 March 2017, as reported to Resources Committee on 14 June. At 1.73% they are below the Council’s own policy of maintaining balances at a minimum of 2% of net revenue budget. Audit Scotland has suggested that reserves should be maintained at a level of 2-4%.
- 7.2 Whilst manageable in the short term, the Council is exposed to a greater degree of financial risk. It is also restricted in its ability to finance service redesign and restructuring.
- 7.3 Any financial strategy therefore has to attempt to build up balances again, and it is suggested that a minimum sum of £0.5m per annum is provided to enable this to happen over the period of this plan. This is included in the financial gap, but by creating a budget surplus each year of £0.5m this would allow balances to be restored over the 5 year period to get back to a 2% minimum balance.

There is however a risk that balances will require to be used over this period, and a higher sum to restore balances may be prudent.

8. Capital

- 8.1 The Council considered an update report on the Capital Plan at its meeting on 15 December 2016 but deferred taking any action to allow the incoming Council to review its priorities.
- 8.2 However at that meeting, particularly given pressures on the Revenue Budget, members were advised that the existing Capital Plan was no longer affordable. The need to increase loan repayments by £2.5m annually is arguably not sustainable in a time of real reductions in revenue grant.
- 8.3 The Council is facing significant pressures around its schools estate and has a significant backlog of roads structural maintenance.
- 8.4 The Council therefore needs to review capital expenditure proposals and prioritise these within a funding umbrella that is affordable and recognises the real reductions in revenue funding to pay for borrowing. In considering options the Council is required to meet the requirements of the Prudential Code that at its core requires capital plans to be prudent, sustainable and affordable.
- 8.5 Affordable means that the borrowing must be capable of being funded from within the revenue budget, not just in the first year but over the life of the loan. At a time when revenue grant funding is predicted to fall, increasing expenditure to meet the cost of borrowing will place significant additional pressure on service budgets and require additional savings i.e. cuts in service.
- 8.6 In terms of affordability of capital expenditure, the Council currently receives Capital Grant annually of around £30-35m from the Scottish Government. It is anticipated that this will continue at this level. In addition maturing debt allows the Council to replace that maturing debt with new borrowing without impacting on the existing Loans Fund revenue budget. This will give additional spending capacity of around £20m per annum.
- 8.7 In total therefore the Council needs to consider the implications of reducing its current annual capital spend from around £100m to £55m in order to avoid further pressure on the Revenue Budget. This would make a significant contribution towards closing the funding gap highlighted in Section 5 by removing additional costs of £2.5m per annum from the model.
- 8.8 During the course of the next few months members therefore need to consider the competing pressures of both capital and revenue in order to address the financial challenges outlined in this paper. In short, any capital expenditure above £55m will place greater pressure on the revenue budget, and require a higher level of budget reductions.
- 8.9 It is strongly recommended that Capital Expenditure is set at a maximum level of £55m per annum to address the financing challenge of the Revenue Budget. However any review has also to consider the implications of a decline in the existing asset base through lack of investment that may result in further revenue budget pressures.

9. Implications

9.1 Resource – the resource implications for both revenue and capital are outlined in the report.

Legal – there are no specific implications to highlight at this stage. However legal commitments place further pressure on revenue budgets.

Community (Equality, Poverty and Rural) – whilst the report doesn't highlight any specific issues, there is no doubt that the scale of the financial challenge will impact on all areas of the Highlands and will have significant impact on the range and scale of local services.

Climate Change/Carbon Clever – there are no specific implications to highlight at this stage.

Risk – the report highlights a number of financial risks and uncertainties which form part of the financial model.

Gaelic – there are no specific issues to highlight at this stage.

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Background Papers:	Audit Scotland national reports Fraser of Allander Institute financial outlook

Scenario 1 – 2% annual reduction in grant

	2018/19	2019/20	2020/21	2021/22	2022/23	5 year total
	£m	£m	£m	£m	£m	£m
Roll forward budget	567.9	558.7	550.7	542.9	535.3	
Budget pressures	17.3	18.1	17.5	17.6	18.7	
Budget addition to rebuild balances	<u>0.5</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	
	<u>585.7</u>	<u>576.9</u>	<u>568.2</u>	<u>560.5</u>	<u>554.0</u>	
Council tax	128.0	128.7	129.3	129.9	130.5	
Grant funding	<u>430.7</u>	<u>422.1</u>	<u>413.6</u>	<u>405.4</u>	<u>397.3</u>	
	<u>558.7</u>	<u>550.7</u>	<u>542.9</u>	<u>535.3</u>	<u>527.8</u>	
Budget Gap	<u>26.9</u>	<u>26.1</u>	<u>25.3</u>	<u>25.2</u>	<u>26.2</u>	129.7

Scenario 2 – 3.5% annual reduction in grant

	2018/19	2019/20	2020/21	2021/22	2022/23	5 year total
	£m	£m	£m	£m	£m	£m
Roll forward budget	567.9	552.1	537.9	524.2	511.0	
Budget pressures	17.3	18.1	17.5	17.6	18.7	
Budget addition to rebuild balances	<u>0.5</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	
	<u>585.7</u>	<u>570.3</u>	<u>555.4</u>	<u>541.8</u>	<u>529.7</u>	
Council tax	128.0	128.7	129.3	129.9	130.5	
Grant funding	<u>424.1</u>	<u>409.3</u>	<u>394.9</u>	<u>381.1</u>	<u>367.8</u>	
	<u>552.1</u>	<u>537.9</u>	<u>524.2</u>	<u>511.0</u>	<u>498.3</u>	
Budget Gap	<u>33.5</u>	<u>32.4</u>	<u>31.2</u>	<u>30.8</u>	<u>31.4</u>	159.2

Scenario 3 – 5% annual reduction in grant

	2018/19	2019/20	2020/21	2021/22	2022/23	5 year total
	£m	£m	£m	£m	£m	£m
Scenario 3 – 5% annual reduction in grant						
Roll forward budget	567.9	545.6	525.3	506.1	487.9	
Budget pressures	17.3	18.1	17.5	17.6	18.7	
Budget addition to rebuild balances	<u>0.5</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	
	<u>585.7</u>	<u>563.7</u>	<u>542.7</u>	<u>523.6</u>	<u>506.6</u>	
Council tax	128.0	128.7	129.3	129.9	130.5	
Grant funding	<u>417.5</u>	<u>396.6</u>	<u>376.8</u>	<u>358.0</u>	<u>340.1</u>	
	<u>545.6</u>	<u>525.3</u>	<u>506.1</u>	<u>487.9</u>	<u>470.6</u>	
Budget Gap	<u>40.1</u>	<u>38.4</u>	<u>36.7</u>	<u>35.8</u>	<u>36.0</u>	186.9