

Reserves Strategy

Report by Gary Fairley, Head of Finance and Integrated Service Support

1 Purpose of Report

This report sets out a Reserves Strategy for consideration by Council.

The strategy provides an update to members on the financial reserves held by the Council and their purpose. Its aim is to ensure that the Council reserves position supports financial sustainability and provides clarity on the purpose and maintenance of useable reserves.

2 Background

At a national level the Accounts Commission, in its Local Government in Scotland: Financial Overview 207/18 report, highlighted that it is important that councillors are aware how usable reserves are being used each year, especially where the cumulative scale of this is potentially significant to financial sustainability.

The report also highlighted that in the previous year's report the Commission had highlighted the risk for some Councils plans to use significant amounts of their reserves to manage funding gaps and that for 2017/18 although overall reserves have continued to reduce, no Council was using its reserves at a level that risks their financial sustainability in the next two to three years.

The Commission also highlight that they will continue to have an interest in how Councils set their reserves policy and utilise reserves as funding pressures continue in the coming years. This statement indicates that the Accounts Commission recognises that the utilisation of reserves to meet ongoing expenditure pressures represents a significant risk to the financial sustainability of Councils.

Turning to the Midlothian position, the Council maintains the following reserves which for accounting purposes are described as useable reserves:-

The General Fund Reserve which represents the accumulated surplus on the General Fund and is split between earmarked and non earmarked reserves. The former being held at the yearend for a specific purpose or to meet an existing commitment.

The HRA Balance, represents the accumulated surplus on the Housing Revenue Account. Other than a small contingency of £2.000 million the remainder of the HRA balance is held to support the committed investment in new Council housing and in sustaining the quality of the existing housing stock.

The Capital Fund, is operated under the terms of Schedule 3 to the Local Government (Scotland) Act 1975. Capital Receipts are credited to the fund and the fund can be used for defraying any expenditure of the authority to which capital is properly applicable, or in providing money for repayment of the principal of loans.

The Repairs and Renewal Fund, is also operated under the terms of Schedule 3 to the Local Government (Scotland) Act 1975 and to be used for the purpose of defraying expenditure to be incurred from time to time in repairing, maintaining, replacing and renewing any buildings, works, plant, equipment or articles belonging to the authority. The resource held in the Fund relate to the need to comply with proper accounting practice in respect of existing PPP, PFI and NPDM schemes.

Appendix 1 sets out the latest projection for 31 March 2019 for each of the above reserves and details the committed and uncommitted elements.

For completeness members should note that the Council also has the following unusable reserves which are maintained to comply with proper accounting practice. As they are unusable they are not considered further in this report.

- Capital Adjustment Account
- Revaluation Reserve
- Pension Reserve
- Employee Statutory Adjustment Account
- Financial Instruments Adjustment Account
- Available for Sale Financial Instruments Reserve

3 Current Position

The Chief Internal Auditors report on “Revenue Financial Budget Monitoring”, presented to Audit Committee on 29 January 2019, highlighted that:-

“General Fund Reserves have fallen sharply and £3.984M remains uncommitted as at 31 March 2018 which is just below the minimum prudent level. In the last three financial years 2016/17, 2017/18 and 2018/19 to Q2 reduction in reserves so far stem from a combination of factors, primarily:

Members approved the utilisation of £11.091m of reserves (including £6.448M to balance budgets, £1.446M to fund additional expenditure, £1.184M to support transformation, and £3.139M to fund VSER costs). Members have been unwilling to take potentially unpopular decisions which are necessary to balance the books in times of extreme financial difficulty”.

The latest projection for the General Fund Reserve is set out in the Financial Monitoring 2018/19 – General Fund Revenue report also on today’s agenda and is as follows:-

Table 1 – Projected General Fund Reserve 31 March 2019

	£ million
General Fund Balance at 31 March 2019	3.995
<i>Less Earmarked /Committed for specific purposes</i>	
Budgets earmarked for Council Transformation	(0.897)
Enhancement to Reserves earmarked for training	(0.190)
Devolved School Management carry forward	(0.384)
General Reserve at 31 March 2019	2.524
Early Years Ring-fenced grant – approved enhancement in 2019/20	0.898
General Reserve at 1 April 2019	3.422

At £3.422 million the General Reserve equates to 1.66% of net expenditure and so provides limited capacity to deal with unplanned cost pressures.

The latest projection for the HRA Balance is set out in the Housing Revenue Account Revenue Budget 2018/19 - 2019/20 and Capital Plan 2018/19 - 2023/24 report also on today's agenda. At 31 March 2019 the balance is expected to be £38.659 million with the majority held to support the committed investment in new Council housing and in sustaining the quality of the existing housing stock. Future year projections indicate that in the region of £2.000 million is uncommitted and represents a contingency for unforeseen costs etc.

In respect of the Capital Fund the projected balance at 31 March 2019 is £22.059 million. The strategy for the Capital Fund was set out in the Capital Strategy approved by Council on 13 November 2018. This provides for the planned utilisation of the Capital Fund and future capital receipts to support investment with the retention of a minimum balance for the Capital Fund of £5.000 million to provide for unforeseen capital investment needs. Members will also recollect that a recommendation of the November 2018 report was to “note *that there remains an affordability gap for general fund services over the ten year life of the plan and that work will continue to find ways to address this*”.

The Repairs and Renewal Fund balance at 31 March 2018 was £2.889 million. This will be updated as part of the year end accounting for PPP etc. assets.

4 Issues Considered

As indicated the HRA balance is held to support the cost of committed investment in new social housing and maintaining the quality of the existing housing stock. It provides a small contingency for unplanned costs. The HRA investment plans are supported by a longer term financial model which projects the impact of Capital Investment, movement in other costs and the future years rent levels required to maintain the financial stability of the Housing Revenue Account. Accordingly the strategy for the HRA balance is to continue the current approach with no change required.

There are however a number of issues in respect of the General Fund reserve position which need to be considered:

- The need to maintain an adequate level of General Reserve to provide a contingency for unforeseen or unplanned costs and what might be considered a prudent level in the current financial context;
- The implications arising from the Integration of Health and Social Care. At 31 March 2018 the Midlothian Integration Joint Board held its own reserves of £0.900 million of which £0.656 million was classified as a general reserve;
- With an already low general reserve an alternative source of funding will be required to meet the expected one off costs associated with further service transformation and to meet the costs of severance for employees and the workforce changes.

As indicated above the Capital Strategy provided for the continuation of the current practice of crediting capital receipts into the Capital Fund and for their subsequent release to the capital account to defray capital expenditure, whilst maintaining a minimum balance of £5.000 million. The latest projections indicate that a further £5.265 million of capital receipts will be credited to the Capital Fund over the short term with a further £9.630 million over the remainder of the period covered by the Capital Strategy with in total £32.704 million planned to be utilised to fund capital expenditure.

On 10 December 2018 the Cabinet Secretary for Finance, Economy and Fair Work offered enhanced financial flexibility to that previously offered in relation to capital receipts. A copy of the letter confirming the scheme as included is appendix 2. The enhanced flexibility is not limited to severance costs, but also enables Councils to use capital receipts to fund the cost of projects designed to transform service delivery to reduce costs and/or reduce demand for services in future years.

The proposed new scheme will:-

- Permit capital receipts received in the years in which this flexibility is offered to be used to fund qualifying expenditure;
- Define qualifying expenditure as expenditure on any project that is designed to transform service delivery to reduce costs and/or transform service delivery in a way that reduces costs or demand for services in future years;
- Permit set up and implementation costs of any new processes or arrangements to be classified as qualifying expenditure. The ongoing revenue costs of the new processes or arrangements will not be classified as qualifying expenditure;
- Continue to exclude the use of capital receipts to fund teacher severance costs;
- Require accountability and transparency in the use of capital receipts. A council will be required to present the projects that will be funded or part funded through the capital receipts to full Council and to publish their approved plans on their website. A council will also be required to report on projects approved in previous years, including a commentary on whether the planned savings or service transformation have been/are being realised in line with the initial analysis.

Examples of qualifying expenditure projects, will include, but are not limited to:

- Investment in service reform feasibility work, e.g. setting up pilot schemes;
- Service reconfiguration, restructuring or rationalisation;

- Expanding the use of digital approaches to the delivery of services or interactions between a local authority and the public; and
- Improving systems or processes.

Recognising local authorities need to plan for service transformation and include these in their medium term financial plans the Cabinet Secretary has made this financial flexibility available for four financial years, 2018/19 to 2021/22.

This scheme, together with the flexibility to meet non enhanced severance costs provides the Council with an alternative means to fund these costs, which in the absence of available reserves, would have needed to be met from the revenue budget of the year in question and as a consequence would have required further revenue budget reductions. Adopting this flexibility would also allow the uncommitted element, currently estimated to be £0.305 million, to be released back to the General Reserve so leaving £0.592 million to meet existing commitments for Council transformation.

By using the capital receipts flexibility in this way it is recognised that there will be less resources to support the capital investment plans set out in the Capital Strategy. It will result in the utilisation of the planned £5.000 million Capital Fund contingency and is reliant on the Council continuing to generate capital receipts. If severance and transformation costs exceed the available capital receipts received in any one year then this can be mitigated by making a transfer from the Capital Fund to meet the repayment of the principal of loans which is currently provided for in the Revenue Budget.

In respect of severance costs the flexibility offered by the Cabinet Secretary does not extend to the enhancement of any severance payments. The amendment approved by Council on 18 December 2018 in respect of VS/ER provides for a VS/ER scheme for which severance payments would be based on the statutory redundancy calculator so these would in the main qualify to be met from the capital receipts flexibility. However the Council's existing VS/ER policy still provides for an enhanced severance package where employees are undergoing a service review and are at risk of redundancy. These costs could not be met from the flexibility outlined above and in the absence of an adequate General Fund Reserve would fall to be met from the Revenue Account in year which given the severity of the 2019/20 grant settlement would require further budget saving measures to offset these costs. Accordingly a revised VS/ER policy in which severance payments are based on the statutory redundancy calculator is set out at appendix 3 for approval. The opportunity has also been taken to ensure that the revised VS/ER policy supports the delivery of the measures which require changes in the staffing establishment set out in the Financial Strategy report.

5 General Reserve Balance

The General Reserve balance, or contingency, is the level of reserve the Council should hold to meet unforeseen or unplanned costs. Historically a level of between 2% to 4% of next expenditure has been considered prudent. The projected General Reserve balance is currently projected to be £3.422 million at 31 March 2019 which equates to 1.66% of total net expenditure.

A survey carried out by the Directors of Finance section in the autumn of 2018 provided an insight into the level of reserves held across Scotland at that point in time and the extent to which these were held as a contingency. Of the 27 mainland Councils who responded 15 indicated an unallocated general fund balance of less than or equal to 2%, 9 were greater than 2% but less than or equal to 3%. Three held an unallocated General Reserve over 3%. The lowest level reported was 0.49%, the highest 4%. 6 Councils indicated an unallocated general fund balance in percentage term less or equal than that of Midlothian at that time.

Taking cognisance of the financial outlook, the messages in the Accounts Commission report and the insight into the reserves position of other Councils it is proposed to continue to adopt 2% of net expenditure as a prudent minimum General Reserve or contingency.

Traditionally net expenditure has been classified as the total net service expenditure met from government grant and Council Tax. This includes funding provided to the Midlothian Integrated Joint Board which as it now holds its own reserves leads to a degree of duplication. Accordingly it is recommended to exclude the resources allocated to the IJB when arriving at the value of the 2% of net expenditure to be held as a minimum reserve.

To provide ongoing financial resilience Council should not allow the General Reserve to fall below the agreed minimum. Accordingly where projections indicate that the minimum General Reserve balance will be breached an immediate recovery plan will need to be implemented to recover the position failing which the next available budget would also need to provide for the restatement of reserve position.

6 Overall Impact

Adopting the measures set out above as part of the Reserve Strategy would result in the following revised position at year end for General Fund.

Table 2 – Amended General Fund Reserve Position

	£ million
General Fund Balance at 31 March 2019	3.995
<i>Earmarked for specific purposes</i>	
Enhancement to Reserves earmarked for training	(0.190)
Devolved School Management carry forward	(0.384)
Committed Transformation Funds	(0.592)
Amended General Reserve at 31 March 2019	2.829
Early Years Ring-fenced grant – approved enhancement in 2019/20	0.898
General Reserve at 1 April 2019	3.727

The indicative budgeted net expenditure for 2019/20 is currently estimated to be £206 million of which £42.6 million is delegated to the IJB. Accordingly the minimum prudent level of reserves would equate to 2% of £163.4 million or £3.3

million. As the table indicates the projected level, reflecting the proposals in this report, would be slightly above the minimum.

7 Investment of Reserves

The Accounts Commission report referenced in section 2 of this report highlighted that Councils don't always have cash to support reserves and might need to borrow further.

At 31 March 2019, 13 Councils had significant cash or investments that could be used to support the reserves position and the Commission noted that spending reserves would reduce the cash or investments held. However the report also highlights that other Councils have chosen in the past to use their cash or investments to fund capital spending rather than take on further borrowing. This means that some Councils would need to borrow further over the longer term to provide the cash to spend on commitments identified in their reserves. This borrowing would increase their 'underlying' debt position.

The Treasury Management and Investment Strategy which is also on today's agenda sets out the proposed arrangement for Midlothian for the effective management of the funds held in reserves. The proposed strategy aims to cash back the reserves by using the investment vehicles permitted in the investment strategy. This approach allows the Council to secure a return on the value of these reserves which in turn benefits the Revenue Account and reduces the longer term risk to the financing of capital expenditure.

As identified in the Treasury report limiting investments to the Debt Management Office (the most secure investment) would limit returns and have an adverse impact on the Revenue Account.

8 Report Implications

8.1 Resources

Whilst this report deals with financial issues there are no financial implications arising directly from it.

8.2 Risk

Within any financial projections, there are a number of inherent assumptions in arriving at figures and budget provisions and therefore risks that may be faced if costs change or new pressures emerge.

Financial risks can be mitigated by having an effective Reserves Strategy that can minimise the financial shock of unplanned or unforeseen events and costs. The proposed Reserves Strategy and the adoption of the capital receipts flexibility scheme also provides resources to meet the costs associated with securing change in service provision and in the workforce.

The risk of limited capital receipts in any one year can be mitigated by approving the transfer of funds from the Capital Fund to repay loans and repayments so releasing the existing budget for these repayments to meet transformation costs.

The stringent requirements of the capital receipts scheme mitigate against the risk of limited resources being expended on projects that do not deliver the stated benefits.

The proposed changes to the VS/ER policy avoid the risk of incurring severance costs which would fall to be met from the already limited General Fund reserve. The changes also ensure all severance, whether through the 2019 VS/ER Scheme or through service reviews are offered on the same terms.

8.3 Single Midlothian Plan and Business Transformation

Themes addressed in this report:

- Community safety
- Adult health, care and housing
- Getting it right for every Midlothian child
- Improving opportunities in Midlothian
- Sustainable growth
- Business transformation and Best Value
- None of the above

8.4 Impact on Performance and Outcomes

The Reserves Strategy is aimed at providing greater financial resilience and financial sustainability whilst still ensuring there are resources available to support the cost of delivering change in services and the workforce.

8.5 Adopting a Preventative Approach

Whilst the proposals in this report do not directly impact on the adoption of a preventative approach, an effective Reserves Strategy in turn allows resources to be prioritised.

8.6 Involving Communities and Other Stakeholders

Consultation, albeit limited given the time available, has taken place with Senior Officers and Trade Union representatives, mainly in relation to the revised VS/ER scheme.

Whilst understanding the changes proposed the Trade Unions representing the Local Government workforce have made representation that the existing VS/ER policy and the enhanced terms it provides for should be maintained for the foreseeable future.

As set out earlier the continuation of a policy which uses the enhanced redundancy calculator would prohibit the use of the capital receipts scheme to fund these costs, It is expected that the Local Government Trade Unions will make representations on the VS/ER Policy at the Joint Consultative Group meeting on 5 February 2019.

8.7 Ensuring Equalities

The Reserves Strategy is aimed at supporting financial sustainability and has been developed within the context of the Midlothian Single Plan, ensuring that resources are directed towards the key priorities of reducing the gap in learning, health and economic circumstance outcomes.

The Reserves Strategy together with the emerging proposals in the Financial Strategy will continue to reflect Midlothian Council's commitment to the ethos of the Equality Act 2010 with careful consideration of the interests of the most vulnerable in our communities through the preparation of equality impact assessments (EqIA) for all proposals.

A separate assessments has been published for the new VS/ER policy and EqIA for the strategy itself has been published alongside this report on the Committee Management System (CMIS) section of the Council website. The later demonstrates the Council's importance of having a Reserves Strategy to ensure the effective use and prioritisation of resources.

8.8 Supporting Sustainable Development

There are no direct sustainability issues arising from this report.

8.9 Digital Issues

There are no direct digital implications arising from this report.

9 Summary

This report sets out a Reserves Strategy for consideration by Council. The strategy provides an update to members on the financial reserves held by the Council. Its aim is to ensure that the Council's reserves position supports financial sustainability by ensuring clarity on the purpose and maintenance of reserves. The reserves position reflecting the recommendations in this report is also set out in Appendix 1.

10 Recommendations

Council is recommended to:-

- a) Note the need to maintain an adequate level of General Reserve to provide a contingency for unforeseen or unplanned costs and that in the current financial context approve the adoption of 2% of net expenditure (excluding resources delegated to the IJB) to be considered a minimum. This equates to £3.3 million;
- b) Agree that where projections indicate that the 2% minimum General Reserve balance will be breached an immediate recovery plan be implemented to recover the position, failing which the next available budget would need to provide for the restatement of reserve position;
- c) Agree that the capital receipts flexibility scheme be utilised as an alternative source of funding to meet the expected one off costs associated with further service transformation and to meet the costs of severance for employees;
- d) Agree that the £0.305 million which is the uncommitted element of funds earmarked for Council Transformation General Reserve and note the updated projection of available General Fund reserve is £3.727 million;
- e) Agree that if severance and transformation costs exceed the available capital receipts received in any one year then this can be mitigated by making a transfer from the Capital Fund to meet the repayment of the principal of loans

and delegate authority to action such a transfer to the Head of Finance and Integrated Service Support to action;

- f) Approve the revised VSER policy, in which severance payments are based on the statutory redundancy calculator, as set out in appendix 3;
- g) Otherwise note the contents of the report.

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Appendix 1 – Current projected reserves position for 31 March 2019

Appendix 2 - Cabinet Secretary's letter regarding Capital Receipts Scheme

Appendix 3 - Revised VS/ER Policy

A: Existing Projected Useable Reserves 31 March 2019

	Total Reserve	Committed	Year End Flexibility	Uncommitted/Contingency Reserve
	£m	£m	£m	£m
General Fund Reserve	3.995	(1.087)	0.514	3.422
HRA Balance	38.659	(36.659)	0	2.000
Capital Fund	22.059	(17.059)	0	5.000
Repairs and Renewals Fund	2.889	(2.889)	0	0
Total Usable Reserves	67.602	(57.694)	0.514	10.422

B: Existing Projected Useable Reserves 31 March 2019

	Total Reserve	Committed	Year End Flexibility	Utilisation to fund change costs (a)	Uncommitted/Contingency Reserve
	£m	£m	£m	£m	£m
General Fund Reserve	3.995	(0.782)	0.514		3.727
HRA Balance	38.659	(36.659)	0		2.000
Capital Fund	22.059	(17.059)	0	(5.000)	0
Repairs and Renewals Fund	2.889	(2.889)	0		0
Total Usable Reserves	67.602	(57.389)	0.514	(5.000)	5.727

(a) Assumes full £5m is utilised.