Shetland Islands Council

Review of Council Spending

2003-2013

Securing the best for Shetland

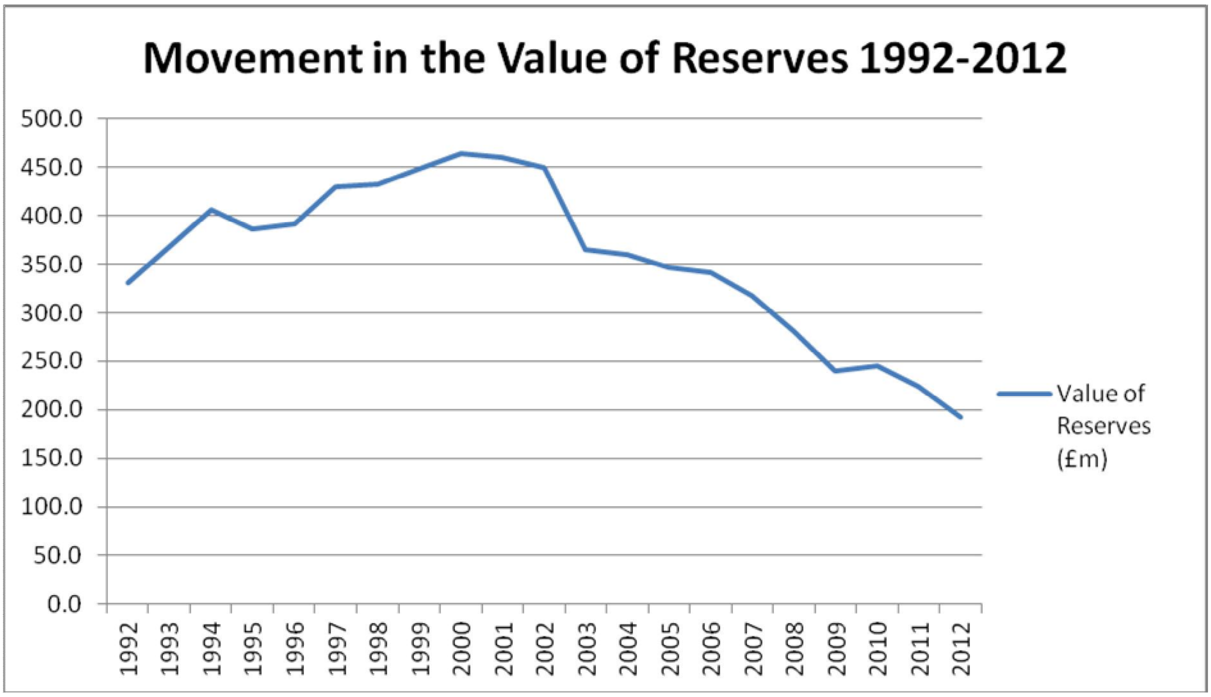
Contents

Background

1.01 In the Council's last published set of financial statements (2011-12) it was reported that the total draw on reserves required in the year to balance the budget was £35.8m. This equated to the Council overspending by almost £100,000 per day.

1.02 The most serious aspect of this was that of the £35.8m drawn from reserves, £32m was used to fund day to day Council services, meaning that there was a recurring year on year need to withdraw such a sum to keep the Council services operating at that level. It can therefore be said that the Council has a significant structural deficit which is unsustainable.

1.03 In addition, Members were presented with the graph below that shows the real value of the Council's investments over the previous 20 years. This showed that the reserves peaked at £465m (at today's prices) in 2000 and in the subsequent 12 years, reduced in value by 58% to £193m in 2012



1.04 As a result of the rapid decline in reserves and the structural deficit being operated by the Council, it was estimated that the Council's reserves would be fully depleted within 5 years without significant change to spending levels.

1.05 The Council's Medium Term Financial Plan (MTFP) was approved in September 2012 and sets out a 5-year roadmap towards achieving financial sustainability and stabilising the level of reserves at a level no lower than £125m.

1.06 Members of the Audit and Standards Committee sought an audit of income and expenditure levels over the past 10 years to understand how the structural deficit came about and to learn from this so that a similar situation does not arise in the future. This report seeks to address that request.

Overview of Council Spending 2003-2013

2.01 Between 1 April 2003 and 31 March 2013, the Council's expenditure has been over £300m higher than its income. This has been funded by using all the surpluses that the Council has made from the Harbour activities over this time, as well as taking well in excess of a quarter of a billion pounds from the reserves.

2.02 This 10 year period can be split into 4 clearly defined segments which share many of the same characteristics. These are -

- **2003-04 to 2005-06** – during this period revenue expenditure was broadly sustainable, but capital expenditure was high, meaning overall the draw on reserves was well in excess than the income generated on the reserves.

- **2006-07 to 2008-09** – during this period there was a large increase in revenue funding from Scottish Government which meant that the large increases in revenue expenditure were sustainable. Capital expenditure remained high, but not as high as the previous 3 years.

- **2009-10 to 2011-12** – during this period revenue expenditure increased by 22% whilst revenue income increased by only 3% which meant that revenue spending reached unsustainable levels. Capital expenditure reduced during the period, but overall the draws on reserves remained unsustainable.

- **2012-13** – The final outturn is not complete as yet but during last year the revenue deficit decreased as a result of the reduction in expenditure being larger than the reduction in income. Capital expenditure also decreased. The result was that the draw on reserves in real terms will be at the lowest level that they have been during the decade covered in this report. However, the draw on reserves remains unsustainably high.

2.03 Therefore to summarise, the draw on reserves has been at an unsustainable level for each of the last 10 years. However, there has been a move away from sustainable revenue (recurring) deficits and one-off capital deficits which in total represented an unsustainable draw on reserves, to large unsustainable revenue (recurring) deficits and smaller capital deficits.

2.04 What this means is that during the past 10 years the nature of the unsustainable draw on reserves has changed from being a more manageable capital overspending nature, to a structural deficit on the council's revenue spending which is far more challenging to address.

2.05 The most significant area of the Council's increase in general fund revenue expenditure has been in staff costs which have increased by 72% over the period 2003 to 2012 (not adjusted for inflation) from £54.1m to £93.3m.

2.06 Increases in staffing numbers in education and social care accounted for most of the increases in the Council.

2.07 The large increases in revenue expenditure were not matched by corresponding increases in revenue income and as a result a “budget gap” developed which was filled by a draw on reserves. This reached a level of £31.8m in 2011-12 which meant that the Council’s revenue spending bore little resemblance to its income levels. It can therefore be described as a structural deficit.

2.08 Therefore the overwhelming reason that the Council is in its current financial difficulty is because of the overspending on day to day services which is a drain on the reserves year after year, rather than because of one off expenditure items such as the Norrona or Bressay Bridge projects despite them being ill-fated.

2.09 It was not immediately obvious that this was happening because the financial information that was available did not explicitly set out the overall financial position. Instead it took individual strands of Council spending and reported these separately so that there wasn’t a single place where the overall draw on reserves for the year was reported. This went some way to masking the scale of the overspending that was developing (***See Learning Point 1***).

2.10 In addition, there did not appear to be a clear financial strategy to respond to the global financial crisis. The level of revenue spending in 2009-10 was 16.5% higher than the previous year despite the onset of a global financial crisis that has been deeper and more protracted than the great depression of the 1930s. As levels of income started to decrease rapidly in 2010-11, following a year of a real terms freeze in 2009-10, revenue expenditure continued to increase (***See Learning Point 2***).

2.11 Following many years of annual increases in funding it appears as though the Council was unable to respond to reductions in funding and this very quickly led to the revenue deficit tripling in 3 years from £10.4m in 2009 to £31.8m in 2012.

2.12 The table on the next page sets out all Council spending for the financial years 2003-04 to 2011-12 inclusive.

Line	General Fund Expenditure	Line calculation	2003-04 £000s	2004-05 £000s	2005-06 £000s	2006-07 £000s	2007-08 £000s	2008-09 £000s	2009-10 £000s	2010-11 £000s	2011-12 £000s
1	Staff costs	1	54,134	58,573	66,192	71,272	73,619	80,675	85,485	92,313	93,304
2	Operating costs	2	39,429	41,367	44,309	48,802	50,420	53,143	59,534	58,910	58,466
3	Capital financing costs	3	929	889	3,580	573	805	1,547	1,497	2,303	41
4	Transfer payments	4	13,059	38,665	14,188	16,443	14,597	14,821	22,514	21,368	14,802
5	Income	5	-16,741	-18,155	-23,822	-28,348	-27,642	-29,916	-30,845	-29,182	-29,577
6	Net recharges	6	-7,541	-7,492	-8,800	-8,236	-8,711	-11,379	-11,308	-14,183	-3,967
7	**General Fund Expenditure**	**Equals 1 to 6**	**83,269**	**113,847**	**95,647**	**100,506**	**103,088**	**108,891**	**126,877**	**131,529**	**133,069**
	Income										
8	RSG/NNDR	8	-68,364	-72,394	-75,686	-75,679	-79,873	-89,918	-93,563	-95,566	-91,866
9	Council Tax	9	-6,478	-7,008	-7,580	-7,894	-8,093	-8,263	-8,547	-8,647	-8,752
10	Trading/DLO	10	-1,275	-1,051	-1,025	-1,223	-776	-264	-896	-830	-647
11	Other	11	-2	-88	0	0	0	-5	0	0	0
12	**Total General Fund Income**	**Equals 8 to11**	**-76,119**	**-80,541**	**-84,291**	**-84,796**	**-88,742**	**-98,450**	**-103,006**	**-105,043**	**-101,265**
13	**General Fund draw on reserves**	**Equals 7+12**	**7,150**	**33,306**	**11,356**	**15,710**	**14,346**	**10,441**	**23,871**	**26,486**	**31,804**
	HRA										
14	**HRA Draw on Reserves**	**14**	**49**	**577**	**-4,391**	**952**	**1,741**	**1,770**	**310**	**459**	**7**
	Capital										
15	**Capital draw for capital**	**15**	**26,641**	**4,932**	**34,988**	**14,188**	**12,459**	**12,649**	**6,583**	**7,930**	**5,945**
16	**TOTAL LEVEL OF DEFICIT**	**Equals 13+14+15**	**33,840**	**38,815**	**41,953**	**30,850**	**28,546**	**24,860**	**30,764**	**34,875**	**37,756**
17	Harbour Account contribution		-3,074	-2,590	-2,141	-4,352	-4,549	-3,227	-2,534	-2,357	-2,185
18	**NET DRAW ON RESERVES**	**Equals 16+17**	**30,766**	**36,225**	**39,812**	**26,498**	**23,997**	**21,633**	**28,230**	**32,518**	**35,571**

Some Key Statistics

29.8% The real terms increase in spending on day to day services (general fund revenue) between 2003 and 2012.	**3.02%** The real terms increase in income to fund day to day services between 2003 and 2012
£24.6m The increase in the size of the general fund revenue deficit from £7.2m in 2003-04 to £31.8m in 2011-12.	

£325m

The approximate draw in reserves between 2003 and 2013

The reduction in the real value of reserves since 2000

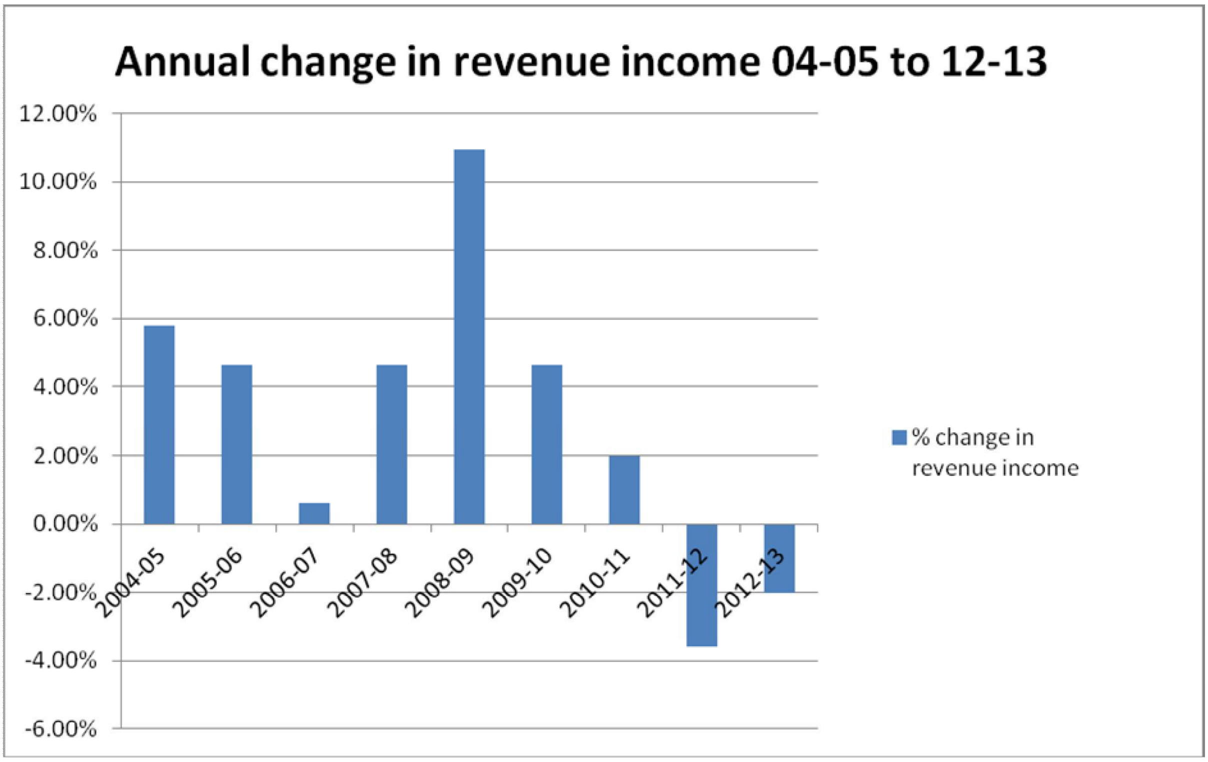
59%

Income

3.01 The Council has the following core sources of revenue income:

- Core Revenue Grant from the Scottish Government which is made up of a Revenue Support Grant (now called General Revenue Grant) and National Non-Domestic Rates (NNDR) income. This generated £91.9m in 2011-12.
- Council Tax which is a property tax levied on all properties in Shetland. This generated £8.8m in 2011-12.
- Trading account income which is a mixture of work undertaken externally to the Council as well as internal work for which the account seeks to break-even. This generated £0.6m in 2011-12.

3.02 The table below shows the annual cash percentage changes (i.e. not taking into account inflation)in these income streams over the period:



3.04 The table shows that after a period of annual increases in core income this pattern reversed with decreases in income in 2011-12 and 2012-13. However, when inflation is taken into account, the 2009-10 income was static in real terms and there have been sharp decreases in revenue funding in each of the subsequent financial years.

3.05 It is anticipated that the Council will continue to face overall annual decreases in income over the medium term as a result of reducing Scottish Government core grant and NNDR income. It may be the end of the decade before real terms increases in funding are seen.

3.06 There was an 11% increase in core revenue income during the 2008-09 financial year. This was as a result of a £10m increase in the Scottish Government General Revenue Grant/NNDR income following a redetermination of GAE levels following a spending review.

3.07 The GAE formulae used to determine how much revenue core funding that a local authority receives from Scottish Government is complicated and relies on data provided by the Council annually on service and spending levels across the organisation. Broadly speaking, the more a local authority spends and the more service it provides, the more core funding that it will attract.

3.08 Therefore, broadly speaking the £10m increase in core funding received by the Council in 2008-09 can be largely attributed to the increases in spending and service provision approved by the Council. It is therefore important that the Council fully considers the impact that spending cuts and reductions in service levels will have on the future amounts of core funding that the Council will attract from Scottish Government (***See Learning Point 3***).

Fees and Charges

3.09 The Council generates a significant amount of income by levying fees and charges for particular services such as ferry fares. This income is not shown as core general funding for revenue services because it is retained by the Council services that levy the charges. However, this income contributes to the running costs of individual services, which means that the net expenditure of the service is lower than it would be if fees and charges were not levied.

3.10 In 2011-12 this income stream amounted to £29.8m which is almost 3.5 times more than is raised through Council Tax representing a significant amount of income to the Council. It is therefore important that the Council recognises the importance of fees and charges and its ability to reduce budget gaps in future years through the introduction of new charges and changes in current practices (***See Learning Point 4***).

Harbour Account Income

3.11 The Harbour Account has been a source of income to the Council for over 30 years. The surpluses generated are transferred to the Reserve Fund and this lessens the impact on the draw on reserves required each year to cover the Council's overspending.

3.12 However, over the period 2003-2013 the surplus generated by the Harbour Account has averaged at less than £3m per year which is significantly lower than earlier years. It is anticipated that over the next 3 years the surpluses generated will be close to zero as a result of reduced throughput levels and the cost of meeting the towage staffs' pension liabilities.

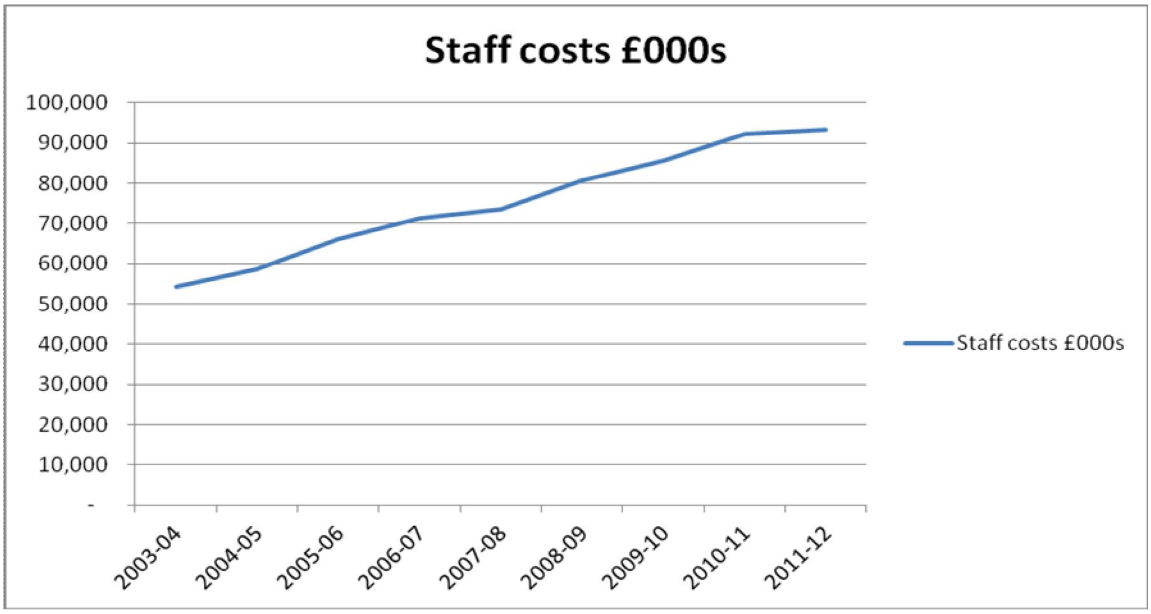
3.13 Therefore it can no longer be said that the current direct financial benefit to the Council from the oil industry is significant. However, there is scope for this to change in the future with the new Shetland Gas Plant.

Expenditure

General Fund Revenue Expenditure

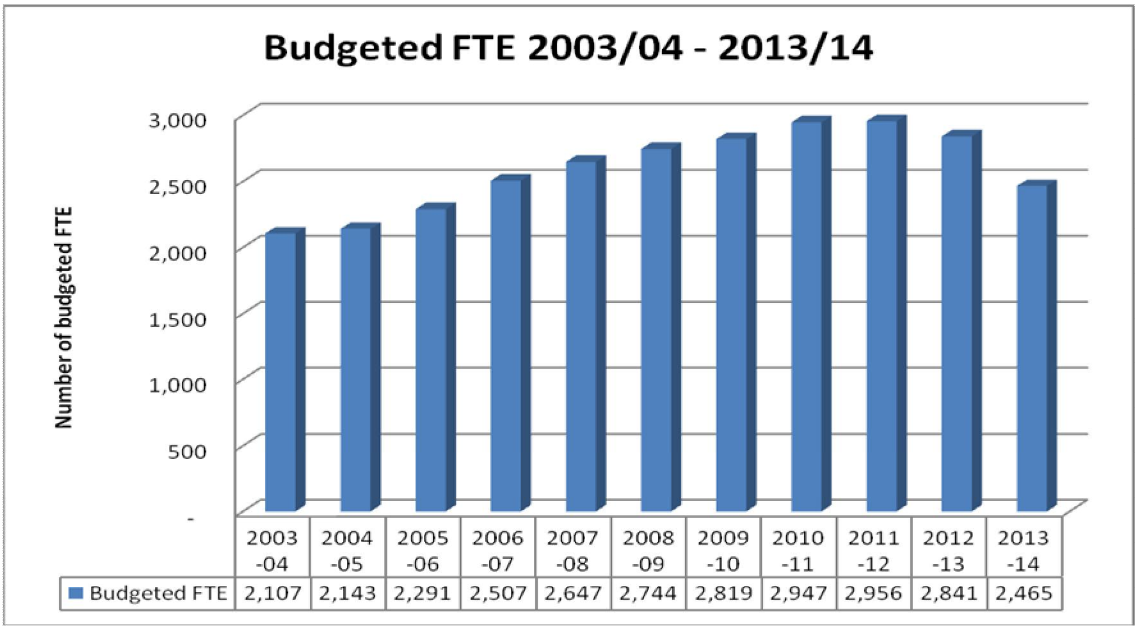
4.01 There was a 29.8% increase in general fund revenue expenditure between 2003 and 2012. The largest increase was in relation to staff costs which were £54.1m in 2003 and £93.3m in 2012.

4.02 The table below shows the level of staff costs in each of the years:



4.03 It can be seen that staff costs rose fairly consistently and rapidly throughout the period suggesting that increases in staffing numbers was the main driver as opposed to it being pay awards or the effect of implementing single status costs.

4.04 The table below shows the number of budgeted FTEs in the approved budgets from 2003-04 to 2013-14:



4.05 Due to changes in management structures in the Council during the period it is not easy to compare FTEs each year on a service by service basis. However, broadly speaking it is possible to say that almost all of the growth in FTE numbers between 2003-04 and 2011-12 came in the education and social care area, but social care in particular. In 2003-04 there were 326FTE budgeted for in what was the Social Work service and in 2011-12 there were 968FTE budgeted posts between Community Care and Children's Social Work.

4.06 There was very little change in the numbers of staff in Infrastructure, Development and Corporate services during the period of growth in staffing numbers.

4.07 The 2012-13 and 2013-14 budgets have reversed the growth trend in staffing numbers with the number of posts budgeted for in the current financial year being similar to the levels last seen in 2006-07.

4.08 Some other notable highlights in the general fund expenditure headings during the period are as follows –

- In 2004-05 Transfer Payments expenditure was significantly increased as a result of a one-off grant of £24m to Shetland Development Trust;
- From 2009-10 Operating Costs increased by approximately £6m each year as repairs and maintenance that had previously been classified as capital expenditure was reclassified as revenue expenditure;
- In 2009-10 and 2010-11 Transfer Payments were temporarily increased by about £7m each year largely as a result of grants to NAFC and to SADA for the building of Mareel.

4.09 The approach to budgeting for cost pressures during the period did not lend itself to managing increases in expenditure downwards. There was a practice of inviting services to identify their own cost pressures and have these included in the budget without appropriate independent scrutiny. As a result there was over £8m of cost pressures in the 2012-13 revenue budget, which given there was a pay freeze on staff costs, meant that there was an effective rate of 20% inflation on the £40m of non-staff costs in the budget. This meant that the first £8m of savings out of the target £15m in the 2012-13 budget were in effect to stop overall expenditure levels rising, meaning that overall revenue expenditure would only reduce by £7m if all of the £15m of savings were delivered.

4.10 As the Council faces significant challenges to deliver savings that will impact upon service levels it is more important than ever before that cost pressures are managed tightly and controlled by the independent finance service in order to put downward pressure upon them (***See Learning Point 5***).

Capital Expenditure

4.11 Over the past decade the Council's capital programme has reduced and the corresponding draw on reserves to fund the capital programme has similarly decreased. However, over the past decade the Council has spent over £125m from reserves to fund the capital programme. It is anticipated that in the future the draws on reserves for capital expenditure will continue to decrease in the medium term, with the reserves only be used for specific council priority projects.

4.12 The most notable spending over this period was in the 2003-04 to 2005-06 period when over £37m was spent on the Yell Sound ferries project.

4.13 One consequence of the large capital investment in the early years of the last decade was the impact that this had on pushing up revenue costs in relation to repairs and maintenance. Whereas it can be economical to replace existing assets as it can result in lower repairs and maintenance costs, the creation of new assets or enhanced assets has the effect of creating an ongoing revenue cost pressure. This phenomenon was experienced during the 2003-2013 period with the creation of new and enhanced assets resulting in the Council's operating costs increasing significantly throughout the period. It is therefore important that the full ongoing revenue costs are fully considered as part of the decision making process around the prioritisation of the Asset Investment Programme (***See Learning Point 6***).

Reserves

5.01 The Council has spent approximately £325m from its reserves between 2003 and 2013. The annual draw on reserves has been unsustainable in each of the past 10 years and this has resulted in the real value of the reserves dropping by 59% since 2000.

5.02 There is no evidence to suggest that appropriate consideration has been given to what could be sustainably taken from the reserves each year in order to maintain the real value (i.e. inflation proof) of the reserves. As a result the Council's previous policy of retaining a reserves floor of £250m was breached and the level of reliance on the reserves meant that they were on course to be fully depleted by 2017. If the Council wishes to retain a level of reserves for the future, it is vital that there is a recognition of what can affordably be taken from reserves each year to supplement spending on services ***(See Learning Point 7)***.

5.03 The diagram below sets out a rationale for determining that a sustainable draw on reserves for 2012-13 would have been £5.8m:

<table>
<tr><td rowspan="2">5.75%
Average return on Reserves 1992-2012</td><td>2.75% set aside to protect against inflation</td></tr>
<tr><td>3% as a sustainable draw on the reserves to spend on Council services</td></tr>
<tr><td colspan="2">£5.8m
A sustainable draw on reserves in 2012-13 based on 3% of a Reserves value of £193m</td></tr>
</table>

5.04 In the past there have been significant fluctuations in the returns that have been recorded on the reserves each year. This is because 75% of the reserves are held in equities which are volatile and the result has been that it has skewed financial planning. When there has been a large return in the past, this has led to a view in certain quarters that it justifies a large level of spending from the reserves. However, the Council has suffered years of large losses too.

5.05 What we know for certain from history is that over the past 20 years the reserves have generated an average return of 5.75%. During that time inflation has averaged at 2.75%. What this means is that for 20 years a sustainable draw on reserves for each year has been 3% of the reserves balance. It is important for the Council to recognise this fact and not be pushed off a course of sound financial planning because of annual fluctuations in the returns from the reserves ***(See Learning Point 8)***.

5.06 Had the Council adhered to a policy of a sustainable draw on reserves since they peaked in 2000, it would mean that the Council would have over £8m per year more to spend each year on services in perpetuity. This could have meant that no savings would now be required from schools or ferries.

Learning Points

Reference	Learning Point	Action	Implementation Date	Responsible Officer
Para 2.09	***1. Clear Reporting of Financial Performance*** It is important that Members and managers are provided with clear and regular management information on progress against the budget both at departmental level and council-wide level. In addition the final outturn report should clearly show the impact that the annual spending has had on the level of the draw on reserves required to balance the budget.	Members provided with quarterly revenue management accounts for each committee area. An overall revenue management accounts report and a capital management accounts report presented to Executive Committee every quarter. The annual outturn report sets out the global council position and the total draw on reserves that was required to balance the budget.	**Implemented**	**Executive Manager – Finance**
Para 2.10	***2. Financial Planning*** Over the past decade increases in expenditure far exceeded increases in income which led to a structural deficit which is an unsustainable drain on reserves and extremely challenging to address. A clear and well constructed 5 year financial strategy incorporating all Council spending is the most effective way to set parameters on spending so that it is in line with income levels.	Development of a 5 year Medium Term Financial Plan which sets out expected funding levels and cost pressures in order to inform the level of expenditure that is sustainable. The plan will require to be fully updated each year to ensure that the most up to date information is used in the future financial modelling.	**Implemented**	**Executive Manager – Finance**

Reference	Learning Point	Action	Implementation Date	Responsible Officer
Para 3.08	***3. Consideration of future Scottish Government Funding Levels*** Scottish Government core revenue funding to the Council is strongly linked to existing spending and service levels. Therefore it is important that the Council fully considers the impact that the agreed spending cuts and reductions in service levels will have on the future amounts of core funding that the Council will attract from Scottish Government.	An exercise will be undertaken to assess the anticipated impacts to GAE funding levels resulting from the savings delivered in 2012-13 and the approved savings for 2013-14 and seek to minimise impacts wherever possible. The future funding impacts will be factored into the Medium Term Financial Plan.	31 March 2014	**Executive Manager – Finance**
Para 3.10	***4. Maximising fees and charges income*** The Council raised £29.6m of income through fees and charges for services in 2011-12. It is therefore important that the Council recognises the importance of fees and charges and its ability to reduce budget gaps in future years through the introduction of new charges and changes in existing practices.	The Council's Charging Policy will be updated during 2013-14 and the importance of using fees and charges to bridge "budget gaps" will be reiterated to managers during the 2014-15 budget setting process.	31 October 2013	**Executive Manager – Finance**

Reference	Learning Point	Action	Implementation Date	Responsible Officer
Para 4.10	***5. Effective management of cost pressures*** For every £1 of cost pressures included in the budget, a saving of £1 has to be found somewhere else in order to stop overall expenditure levels increasing. As the Council faces significant challenges to deliver savings that will impact upon service levels it is more important than ever before that cost pressures are managed tightly and controlled by the independent finance service in order to put downward pressure upon them.	The Medium Term Financial Plan sets out a target maximum level of cost pressures for each of the next five financial years. This reflects expected pay awards and inflationary increases on non-pay costs. As part of each annual budget setting exercise services are invited to present a case to the finance service for cost pressures and these will be independently assessed by the finance service to ensure that they are genuine cost pressures and not budget growth items.	**Implemented**	**Executive Manager – Finance** **All Directors & Executive Managers**
Para 4.13	***6. Revenue consequences of Capital Expenditure*** One consequence of the large capital investment between the 2003-2013 period was creation of new and enhanced assets resulting in the Council's operating costs increasing significantly. It is therefore important that the full ongoing revenue costs are fully considered as part of the decision making process around the prioritisation of the Asset Investment Programme to assist with better financial planning.	The revenue consequences of all proposed capital expenditure projects should be given prominent consideration as part of the "gateway" process. Favour should be given to those projects that result in revenue savings (spend to save projects) over those that create a new ongoing cost pressure to the Council.	**31 March 2014**	**Executive Manager – Finance** **Executive Manager – Capital Programme**

Reference	Learning Point	Action	Implementation Date	Responsible Officer
Para 5.02	***7. Clarity over a sustainable level for using reserves*** There is no evidence to suggest that appropriate consideration has been given to what could be sustainably taken from the reserves each year in order to maintain the real value (i.e. inflation proof) of the reserves. As a result the Council's previous policy of retaining a reserves floor of £250m was breached and the level of reliance on the reserves meant that they were on course to be fully depleted by 2017. If the Council wishes to retain a level of reserves for the future, it is vital that there is a recognition of what can affordably be taken from reserves each year.	The Medium Term Financial Plan sets out a plan over 5 years to get to a position whereby there will be a sustainable draw on reserves, which ensures that the reserves will retain their real value (i.e. made inflation proof).	**Implemented**	**Executive Manager – Finance**
Para 5.05	***8. Managing fluctuations on the annual return on reserves*** The past 20 years has taught us that a sustainable draw on reserves for each year has been 3% and it is important for the Council to recognise this fact and not be pushed off a course of sound financial planning because of annual fluctuations in the returns from the reserves. That approach has been used in the past and has resulted in the reserves decreasing in value by 59% since 2000.	The updated Medium Term Financial Plan will attempt to address the issue of instability with regards to returns on reserves. It is important that annual fluctuations do not skew the medium term financial planning as these fluctuations will balance out in the long run.	**July 2013**	**Executive Manager – Finance**