Shetland Islands Council

Agenda Item

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Meeting(s):	**Policy and Resources Committee** **Shetland Islands Council**	**7 March 2017** **8 March 2017**
Report Title:	**Long-Term Revenue & Capital Planning – Update**	
Reference Number:	**F-039-F**	
Author / Job Title:	**Jonathan Belford, Executive Manager – Finance** **Robert Sinclair, Executive Manager – Capital Programme**	

1.0 Decisions / Action required:

1.1 That the Policy and Resources Committee:

1.1.1 NOTES the progress made by the Executive Manager – Finance and Executive Manager – Capital Programme in reviewing the Council's Long Term Financial Plan (LTFP) and developing a Long Term Asset Investment Plan (LTAIP); and

1.1.2 RECOMMEND that the Council RESOLVES to adopt the recommendations, as set out in section 2.16.

2.0 High Level Summary:

2.1 This report provides an update on the work that has taken place to review the Council's LTFP, which was last reported to Council on 3 December 2014, and incorporates the LTAIP position that has been refreshed following the last report, on 7 December 2015.

2.2 The implications of cuts to Local Government funding in the interim highlights the challenges that Local Government faces which means that maintaining services at current levels becomes impossible due to the financial constraints.

2.3 Reviewing the LTFP assumptions concludes that they remain sound. The resulting recommendations are now incorporated and approved as part of the Medium Term Financial Plan (MTFP), namely the need to fully consider the impact of the changing demographics in Shetland over time; and that the Council's investments should be treated as a fund from which regular, index linked, returns can be drawn to support the cost of delivering Council Services to mitigate as far as possible the negative impact of cuts in funding from the Scottish Government.

2.4 The Council has an agreed Capital Expenditure Policy that has no growth in the asset base and that capital expenditure is focussed on maintaining the existing assets. The approved Capital Funding Policy recognises the cost of capital and that in line with the Borrowing Policy, where grant funding and capital receipts are exhausted the Council will borrow externally to fund capital investment.

2.5 This places restrictions on capital expenditure and has specific revenue implications for funding capital expenditure.

2.6 There is clearly a revenue impact if capital investment is increased and because the Medium Term Financial Plan presents a forecast for 2016 to 2021 that requires recurring savings of 4.5% (or c. £5m) per annum it is difficult to see where additional funding could come from to further increase capital expenditure.

2.7 In order to assess the capital position that the Council may face in the future and to consider the overall impact of operating with the asset base that it has, a number of scenarios have been considered in relation to the Long-Term Asset Investment Plan (LTAIP).

Scenario 1: Only committed projects and maintenance of existing assets funded by the Council – Ferry and Terminal replacement programme funded by Scottish Government.

Scenario 2: Only committed projects and maintenance of existing assets funded by the Council – Ferry and Terminal replacement programme funded by the Council.

Scenario 3: Committed projects, maintenance of existing assets and provision for some replacement assets funded by the Council – Ferry and Terminal replacement programme funded by Scottish Government.

Scenario 4: Committed projects, maintenance of existing assets, provision for some replacement assets and Ferry and Terminal replacement programme funded by the Council.

2.8 Scenarios 1 and 3 rely upon Scottish Government funding to mitigate the impact on the Council's financial position.

2.9 A significant part of the anticipated capital investment is in Ferries and associated Terminals, the funding of which is still under discussion with Transport Scotland in the context of the Scottish Government's commitment to fair funding for the inter-island transport services.

2.10 Should this commitment not be honoured and no funding made available then the Council approach to funding expenditure would be through borrowing, as per the approved Borrowing Policy.

2.11 Scenario 3 takes into account that there may be a level of investment required to replace or renew some Council assets over time. This has been estimated based on a modest sum of £3m per annum.

2.12 Scenarios 2 and 4 place the funding burden on the Council in respect of Ferries and Terminals replacement, creating the greatest financial impact.

2.13 With the exception of Scenario 1, which remains affordable over the life of the long-term plan, the other scenarios clearly demonstrate costs that will impact adversely on the revenue budget and MTFP.

2.14 There is scope within Scenario 1 to accommodate rising costs and a degree of investment in future years, however this is modest in comparison to what is identified as required.

2.15 In considering these updated scenarios, based on the data gathered to support a long-term projection of costs, the capital grant limitations and the revenue constraints in relation to paying for the cost of capital only Scenario 1 can be recommended for long-term planning purposes.

2.16 In line with the MTFP the LTFP and LTAIP recommendations are:

- Base long term asset investment planning on £6.5m per annum as affordable to the Council, placing no additional burden on the revenue budget from borrowing (based on Scenario 1). To reinforce the decision to consider capital investment in line with the approved Gateway Process for the Management of Capital Projects.

- Instruct Executive Managers to develop, in conjunction with the Executive Manager - Capital Programme, long term asset investment plans for their individual Services that are regularly reviewed to maintain their integrity and relevance.

- The Council review its Employer discretions in relation to the Pension Fund to determine how future costs can be reduced through making changes to the discretionary awards that can apply when an employee leaves the Council through, for example early retirement.

- The Council's Investments continue to be used, as per the MTFP, to support the delivery of revenue Services, and that this is done in line with the Investment Withdrawal Policy defined in the MTFP.

- Resource allocation and financial planning should take into account the demographic changes that are projected to occur over the life of the LTFP and to consider the evidence of population changes in making strategic decisions about Service outcomes and setting priorities.

3.0 Corporate Priorities and Joint Working:

3.1 This report supports the Council's Financial Strategy, Reserves Policy and Budget Strategy. 'Our Plan 2016 to 2020' states that "Excellent financial-management arrangements will make sure we are continuing to keep to a balanced and sustainable budget, and are living within our means" and that "We will have prioritised spending on building and maintaining assets and be clear on the whole-of-life costs of those activities, to make sure funding is being targeted in the best way to help achieve the outcomes set out in this plan and the community plan".

4.0 Key Issues:

4.1 The Council has had a 5-year Asset Investment Plan (Capital Programme) since October 2010. This has been reviewed and updated since then as part of the annual budget setting process. This Asset Investment Plan (AIP) has been reduced in scale as the Council has progressed towards reducing its draw on reserves to a sustainable level and since 2013/14 it has been funded without drawing on reserves other than for Spend to Save Projects and the new Anderson High School.

4.2 Now that the 5-year AIP is funded on a sustainable basis, it does not change dramatically at each annual review. This has benefits in planning and programming both works and cash flow.

4.3 This has highlighted the benefits that could come from an AIP that extends further into the future. A timeline of 35 years was decided initially and on 3 December 2014 the Council agreed to the recommendations in a Long Term Financial Plan (Min Ref: 99/14), prepared by the Executive Manager – Finance, which described the financial backdrop of falling Government funding and rising costs and the financial constraints relating to the LTAIP.

4.4 The Long Term Financial Plan (LTFP) explored predicted capital spend into the future, from estimates by Council officers and from historical trends. Based on that information, it was estimated that the Council would need to spend £17.2m per year on capital in order to maintain the existing asset base. This figure makes no allowance for 'growth' projects that would increase the asset base. When set against predicted total core capital income of £6.3m (from Capital Grant and Capital Receipts), this leaves an annual shortfall of £10.9m.

4.5 The LTFP then explored a number of financial modelling options, which looked at borrowing to fund this shortfall. It compared different levels of borrowing to support capital spend as well as assessing historic interest rates and concluded that a sustainable level of spending on capital (at 2014 prices) would be £10-£11m per annum.

4.6 Any Asset Investment Plan relies heavily on service planning across the Council and in particular any predictions relating to future levels of service. On 7 December 2015, the Executive Manager – Capital Programme presented Members with an indicative LTAIP (Min Ref: 91/15). It was provided in order to give a sense of scale only, based on the assumptions and information set out below.

4.6.1 It was recognised that ferry related projects accounted for 45% of spend over the first 18 years or so. Whilst work had been commissioned by Transport Planning to examine the future of transport links of all types across Shetland, both in terms of level of service and in terms of management and funding, the outcome of that work was, and remains, uncertain. The cost of ferry and terminal replacement was therefore included in the indicative plan.

4.6.2 No allowance was made for new buildings, even where they would be on a 'like-for-like' basis. The LTFP made an allowance of £3m per annum for this type of project. The capital building maintenance allowance was also reduced from £2.1m to £1m per annum.

4.6.3 Similarly, the allowance of £4.5m per annum for new roads in the LTFP was reduced.

4.6.4 This indicative plan sought to balance service needs with the identified sustainable level of capital spend identified in the LTFP. The capital spending predictions used in the LTFP were all re-examined. Most were reduced or re-profiled to reduce annual spend.

4.6.5 Housing Revenue Account projects, Spend to Save projects and the new Anderson High School were not included in this plan.

4.7 This indicative LTAIP demonstrated that balancing capital spend with sustainable levels of funding would be a challenge well into the future. It showed that until 2031 the predicted average spend per annum was still unaffordable at over £12m per annum. The predicted spend figures in later years suggested that the situation would be less challenging, but highlighted that it would be unrealistic to think that new aspirations will not emerge by that time. It indicated that the future model of inter-island transport links might change the indicative plan significantly and therefore indicated that Members would be provided with an update, expected in late 2016. This report seeks to provide that update

4.8 As Members will be aware, discussion with the Scottish Government have not yet confirmed the financial package to support Ministers commitment to fair funding for inter-island transport in Shetland. The investment required to the infrastructure underpinning those services represents such a significant proportion of the Council's predicted capital spend (over £23m over the next 5 years and over £90m in 18 years) that it makes a fundamental difference to the affordability of capital expenditure in the future.

4.9 In an effort to refresh the LTAIP forecasts and determine what impact there might be in the future, the indicative LTAIP has been updated in line with the 5-year Asset Investment Plan, approved by the Council on 15 February 2017, and four scenarios have been prepared. These scenarios are attached as Appendices A to D, namely;

4.9.1 Appendix A – Scenario 1: Only committed projects and maintenance of existing assets funded by the Council – Ferry and Terminal replacement programme funded by Scottish Government.

4.9.2 Appendix B – Scenario 2: Only committed projects and maintenance of existing assets funded by the Council – Ferry and Terminal replacement programme funded by the Council

4.9.3 Appendix C – Scenario 3: Committed projects, maintenance of existing assets and provision for some replacement assets funded by the Council – Ferry and Terminal replacement programme funded by Scottish Government.

4.9.4 Appendix D – Scenario 4: Committed projects, maintenance of existing assets, provision for some replacement assets and Ferry and Terminal replacement programme funded by the Council

4.10 In all the scenarios the basis for forecasting has been the approved AIP for 2017/18 to 2021/22. The ongoing commitment to maintain current properties has been updated to reflect current condition information at a high level. The Housing Revenue Account has been included to reflect the investment profile as per the 30 year financial plan that supports the HRA Business Plan – this is fully funded by the HRA. Ferry and Terminal replacements programme is based on the existing programme, updated to reflect 2017/18 being the initial year in an 18 year programme.

4.11 In Scenarios 2 and 4, where recognition of the potential for capital expenditure is likely to be required during the life of the programme, this has been valued at £3m per annum from 2019/20 onwards. This does not necessarily reflect building projects, as the Council's approved Gateway Process for the Management of Capital Projects will be used to define the detail of future projects.

4.12 In Scenarios 1 and 3 the assumption is that the Ferry and Terminal Replacement programme would be funded in full. The costs of some limited life extension work as incorporated into the approved AIP has been included as a charge that the Council will have to fund. This is a prudent assumption.

4.13 The financial implications of the Scenarios are shown in detail in the appendices and summarised as follows:

General Fund Impact	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Balanced over 5 years	Yes	No	No	No
Shortfall over 5 years	-	£20.7m	£6.8m	£29.7m
Surplus over 5 years	£2.2m	-	-	-
Additional revenue financial implications over the long term	No	Yes	Yes	Yes
Capital Financing Requirement to 2050	Nil	£45.5m	£50.1m	£138.5m
Average annual revenue implication to 2050	Nil	£3.6m	£2.4m	£6.2m
Maximum annual revenue implication to 2050	Nil	£5.0m	£3.7m	£8.9m
Interest Rate for Borrowing (Pool Rate)	-	4.2%	4.2%	4.2%
Period of Borrowing	-	30 Years	30 Years	30 Years

4.14 Scenarios 2, 3 and 4 present an additional burden on revenue of between £3.7m and £8.9m per annum, which represents from 3.3% to 8.0% of the current revenue budget. Savings in the delivery of Services would require to increase from approximately 4.5% to between 7.8% and 12.5% per annum, recurring.

4.15 These Scenarios are unaffordable and to have to fund Ferry and Terminal Replacements or to continue spending at a rate of £3m per annum on creating or replacing other assets is beyond the Council at this time. Especially when any revenue implications of those additional spending projects have not been quantified or estimated.

4.16 It is clear from these appendices that based on current levels of Scottish Government funding the Council is only able to sustain a LTAIP consisting of the maintenance of existing assets. The introduction of either a programme of ferry and terminal replacements or any other asset replacement programme of significant scale would not be possible without an unsustainable level of draw on reserves or increased levels of borrowing, to the detriment of the delivery of core services.

4.17 Scenario 1, effectively the status quo, offers a future opportunity, subject to the funding of capital grant at £6m per annum that means the construction/price inflation can be absorbed so that in real terms the maintenance approach can be continued at current levels. Also, in following the Gateway Process for the Management of Capital Projects there may be scope to consider incorporating capital projects to the value of £1m per annum. This means that a recommended level of annual capital expenditure to be funded by the Council should be amended from the last LTFP (£10m) to be £6.5m per annum.

4.18 The Executive Manager – Finance has reviewed the LTFP in light of the changes in Local Government funding that have occurred since 2014 and any forecasts that can be made as to future funding. Fundamentally the underlying income for the Council reduced as a result of the Financial Settlements for financial years 2016/17 and 2017/18, when 9% of Scottish Government revenue funding was lost.

4.19 In light of this it is unsurprising that the statistical information underpinning the LTFP remains valid. The overall analysis and conclusions in terms of the financial context remain valid today and the Council continues to face a very challenging financial position as costs, predominantly employee related costs have risen substantially in recent years.

4.20 Pension costs over the long term are a feature of the current LTFP and the costs associated with early retirement/voluntary severance have added increased ongoing liabilities to the Council. The high costs of pension liabilities was demonstrated in the analysis carried out by Audit Scotland as at 31 March 2016 and published in their Financial Overview 2015/16 report in November 2016. This showed that Shetland Islands Council has the highest level of long-term pension liabilities in relation to its grant and Council Tax income of any Council (1.4 times the annual income). This not only signals the potential future costs that may be placed upon the Council as the primary Employer, it indicates that the cost of Pensions should be looked at in line with the recommendation made in 2014, and thereby mitigate increasing the future burden on the Council. The Council should carry out a review of its Employer discretions in relation to awarding pension enhancements.

4.21 Long term investment returns have for the last three years been assessed and utilised in line with the recommendations of the LTFP and this has been fully embedded into the MTFP approach to affordability for revenue budgets in the future. This means that retaining a consistent level of Usable Reserves on the Council Balance Sheet is an important means of protecting the underlying financial value of the investments and provides a solid basis upon which to assess the amount that can be used annually in support of Council Services.

4.22 The LTFP drew conclusions in relation to the Council's own resources, in particular the operations at Sella Ness. In light of the work that was done during 2015 to establish the Council's approach to the future of the Port, and the developing changes in relation to the ownership and operation of Sullom Voe Terminal, the recommendation from the LTFP regarding whether or not to retain the Port operations should now be removed. The Council should continue to actively engage in the changes that are planned for the Terminal and to secure the interests of the Council.

4.23 Other recommendations in the LTFP should remain, namely:

4.23.1 All services should develop robust asset management plans for their asset class (e.g. vehicles, ICT, ferries etc.) that include information on condition, suitability, utilisation (against a policy target) lifespan and future investment requirement for those assets. This will ensure that there is robust information available to assist with the regular updating of the Long Term Asset Investment Plan.

4.23.2 Members should consider the impact of demographic changes in Shetland as part of the process for determining service priorities. Resources should be aligned to the areas where there is growing service demand, with resources taken away from areas with falling demand if the Council is to remain financially sustainable in the long term. This should be done in line with corporate outcome priorities and the statutory duties of the Council.

5.0 Exempt and/or confidential information:

5.1 None.

6.0 Implications :

6.1 Service Users, Patients and Communities:	Upon completion, the projects described in the appendices to this report will either enhance the quality and/ or condition of the assets available to the people of Shetland or add to them.
6.2 Human Resources and Organisational Development:	No implications arising directly from this report.
6.3 Equality, Diversity and Human Rights:	No implications arising directly from this report.
6.4 Legal:	No implications arising directly from this report.
6.5 Finance:	The Council faces an increasingly difficult financial climate, and has to seek the solutions to balance its budget annually, while delivering the services that it values most and must deliver to remain compliant with legislation. The LTFP and LTAIP have previously identified that there is no significant opportunity to increase capital investment as Council resources are targeted to support revenue expenditure. Following a review of the various plans this has not changed. An AIP to the value of £6.5m per annum, funded by the Council's Capital Grant and Capital Receipts should be the expectation of the Council in the long-term.

6.6 Assets and Property:	Upon completion, the projects described in the appendices to this report will either enhance the quality and/ or condition of the Council's existing asset base or add to it.	
6.7 ICT and new technologies:	No implications arising directly from this report.	
6.8 Environmental:	All maintenance and new-build projects seek to address climate change and carbon management for example by embedding energy saving measures and environmentally friendly materials in their design. Where possible, assets are repaired and maintained where this reduces the carbon footprint associated with new-build. Environmental Impact Assessments are carried out where the nature or scale of the project dictates. The only such project currently underway is the new AHS and associated Halls of Residence.	
6.9 Risk Management:	The main areas of risk are financial in terms of the uncertainty surrounding the funding for inter-island transport throughout Shetland and the difficulties this presents in planning capital spend into the future. If the funding commitment to fair funding made by Ministers is not honoured then the Council will face the prospect of having to borrow to fund that expenditure in order to continue inter-island transport services, or to fundamentally change the level of Service that is affordable. There is also the risk that building and asset creation will have a similar impact, increasing revenue costs as borrowing would have to be undertaken and paid for by the revenue budget. Neither of these scenarios are affordable to the Council in the current financial climate therefore the mitigation of these risks is to continue to place the responsibility for inter-island transport at the door of the Scottish Government and not to progress this until such time as the Government has confirmed funding. Avoiding entering into commitments to build and replace assets would assist in the management of Council finances.	
6.10 Policy and Delegated Authority:	Approval of the financial strategy and budget framework is a matter reserved for the Council having taken advice from the Policy and Resources Committee.	
6.11 Previously considered by:	Policy and Resources Committee	7 December 2015

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7 March 2017

Appendices:
Appendix A – Scenario 1: Only committed projects and maintenance of existing assets funded by the Council – Ferry and Terminal replacement programme funded by Scottish Government

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Appendix C – Scenario 3: Committed projects, maintenance of existing assets and provision for some replacement assets funded by the Council – Ferry and Terminal replacement programme funded by Scottish Government.

Appendix D – Scenario 4: Committed projects, maintenance of existing assets, provision for some replacement assets and Ferry and Terminal replacement programme funded by the Council

Background Documents:
Audit Scotland, Local Government in Scotland, Financial Overview 2015/16, November 2016.
http://www.audit-scotland.gov.uk/report/local-government-in-scotland-financial-overview-201516