Appendix 1

Shetland Islands Council

Medium Term Financial Plan

2014-2019

Securing the Best for Shetland

Contents

Purpose

1.1 The purpose of this Medium Term Financial Plan (the Plan) is to set out the roadmap for Shetland Islands Council to achieve financial sustainability in the next financial year (2015-16) and then maintain this through the remainder of the life of the current Council. In addition, the plan clearly differentiates the savings requirements between directorates to ensure that insofar as possible, resources are aligned to the priorities of Members, as set out in the Corporate Plan.

1.2 The Plan combines all of the resources available to the Council relating to the General Fund, Harbour Account and Housing Revenue Account for both revenue and capital expenditure.

1.3 This document therefore acts as a tool for financial planning; setting out the financial resources available to the Council, describing the cost pressures over the period and therefore setting out the level of expenditure that the Council can reasonably afford on an annual basis.

1.4 In addition, the document is an integrated budget strategy and reserves strategy for the life of the current Council and beyond, ensuring that there is a clear understanding between the level of expenditure agreed for each year and the impact that this will have on the Council's reserves.

1.5 It is important to recognise that the Plan is a live document and will therefore be updated annually to reflect any changes in policy and/or changes in the level of funding available to the Council.

Benefits of the Plan

1.6 By taking a longer term view of the Council's finances over a period of five years it allows Members to understand the role that each annual budget setting exercise contributes to the overall strategy of securing a financial sustainable Council.

1.7 It improves financial planning and financial management of the Council's revenue and capital resources. This means that Members and Directors have a longer timescale to plan for future changes in budget levels, as they can see what is going to happen to directorate budgets for the next 5 years.

1.8 It allows for the clear alignment of resources to the Council's spending priorities. The priorities of the Council will feed into the allocation of revenue and capital resources for each directorate over the period of the Plan and will be focused on the Council priorities set out in the Corporate Plan.

1.9 Ensuring that resources are aligned to priorities will ensure that the Council maximises the use of resources at its disposal.

1.10 Finally, this integrated Plan will help to ensure the delivery of the Council's Reserves Policy by clearly limiting expenditure to levels that comply with the decisions that Members take with regard to the future direction of reserves.

Principles

2.1 The Plan is to be based on the following principles:

- The Council will determine an option for the future direction of reserve levels – either to deplete, maintain or increase them – and this will drive the maximum contribution that can be made from the reserves each year.
- If the Council wishes to continue to fulfil its Corporate Plan objective of becoming financially sustainable and living within its means, it will need to agree to either maintain or increase reserve levels into the future.
- The approach to reserves will allow the Executive Manager – Finance to forecast the level of incoming available resources for each of the next 5 financial years.
- Members will set the maximum level of capital expenditure that can be incurred each year, recognising that any expenditure over and above what can be funded from Capital Grant and receipts will need to be financed through borrowing.
- Borrowing will create an ongoing revenue cost pressure as a result of the arising capital charges (interest payments and principal repayment of debt), which will reduce the resources available for service delivery.
- The Executive Manager – Finance will determine the level of funding required to manage significant cost pressures such as pay awards. A central allocation of funding will be set aside for cost pressures and will be allocated to directorates as required.
- These decisions will determine the level of expenditure that can be sustainably incurred on services for each of the next five years.
- Members will then be required to determine the level of resources available to each directorate for the next five years based on Council priorities.

2.2 Each directorate will know its target operating budget for 2015-16 and for the following four years.

2.3 Directors, working with their relevant Council Committee, are required to develop resourced directorate and service plans based on the target operating budgets across the Plan's timeframe.

2.4 Members will have the opportunity to review the spending proposals and options for each directorate as part of the budget setting process during Autumn 2014, and through a process of continuous assessment be able to adjust budgets at the margins to ensure that Council priorities are properly reflected.

2.5 A budget will be presented to Council in December 2014 which sets out detailed directorate budgets for 2015-16 and indicative budgets for a further four years within the parameters in the Plan.

2.6 The Plan will subsequently be updated to reflect the approved 2015-16 budget and refreshed annually by Members during May/June each year to accommodate any shifts in Council priorities.

Assumptions

2.7 The starting point for setting a directorate's target operating budget for the year is the prior year budget. In practice what this means is that –

- If a directorate is under spent against its budget in a financial year, it will not be penalised by having the budget reduced by this amount in the next financial year.
- If a directorate achieves a higher level of recurring savings than budgeted through increased efficiency, these will be applied to the following year's target, thus giving that directorate a head start in the following year and embedding a culture of continuous improvement in service delivery.
- Similarly, if a directorate overspends against its budget, for the purposes of planning it will be assumed that the starting point for the next year was the prior year budget and not the actual spend. This will in effect mean that a directorate in this position will still be required to make the recurring savings it failed to deliver in the previous year, along with the new savings required for the new financial year.
- All savings targets to be delivered by each directorate are required to be recurring savings.

2.8 The Council sets the target operating budget for each directorate for each year. Directorates are required to prepare their budgets within these parameters. Cost pressures are managed centrally and there is a presumption against growth in budgets, thereby removing the need for directorates to seek additional funding from Members during the budget setting exercise.

2.9 The amount of funding made available to each directorate is linked to the priorities of the Council.

2.10 If a cost pressure arises during the financial year, there is a presumption against providing that directorate with additional funding. In the first instance the directorate is required to identify a saving to compensate for the additional cost and report this to Council.

2.11 There is a presumption that there will be no growth in service cost in the medium term.

2.12 In order to ensure that the annual revenue budgets are delivered, contingency measures may need to be put in place.

Budget Carry Forward Scheme

2.13 The Plan makes provision for a budget carry forward scheme in order to offer an incentive to services to under spend against their budgets.

2.14 If a service achieves a one-off revenue under spend in a financial year, assuming it has delivered its budget in full, it will be permitted to carry 50% of this funding into the following financial year to support approved service priorities.

2.15 A 100% revenue carry-forward will be allowable if it relates to a specific contractually committed project that was not completed during the year due to slippage, or relates to ring-fenced funding.

2.16 A capital carry-forward is only allowable if it relates to a committed project that has not been completed. In these cases, 100% of the unspent budget can be carried forward if it is required to complete the project. There is no provision for the general carry-forward of capital under spends.

2.17 This carried forward funding will be applied to the following year's budget as a one off item and will only be available in line with approved Council service priorities.

2.18 The conditions around the scheme are:

- A service will only be granted a revenue carry forward if its directorate had delivered its budget. If a directorate was overspent no budget carry forward would be considered.
- The under spend will be carried forward as a non-recurring budget i.e. the service would benefit in the next financial year, but it will not receive the funding in future financial years.
- Services will be required to identify their under spends and make a request for a carry forward at a date to be specified by the Executive Manager – Finance, based on Period 9 information.
- A carry forward will have to be applied to approved Council service priorities.
- If a service achieves a higher actual under spend than it forecast at period 9, it will not be able to subsequently seek an increase in its carry-forward request. If a service fails to achieve the level of under spend that it forecast at period 9, it will have its carry-forward request reduced accordingly.
- A Service's carry-forward request will be reduced by a percentage which is double the percentage difference of period 9 forecast to the actual outturn position for the Directorate as a whole. For example, if at Period 9 the Directorate forecasts an under spend of 5% but the outturn is a 15% under spend, the 10% difference will result in there being a 20% reduction in the value of the carry-forward that was requested based on the

Period 9 data. This provides Services with a strong incentive to ensure that they forecast as accurately as possible at Period 9.

External Funding

2.19 Shetland Islands Council will seek all external funding opportunities where there is no additional financial commitment required by the Council.

2.20 Where an external funding opportunity is available to the Council, but it requires additional investment by the Council or an ongoing revenue commitment, the following criteria should be met in full –

- The project is consistent with the priorities of the Council; AND
- The project meets the criteria of a Spend to Save initiative; OR
- Savings will be identified elsewhere to ensure that the project is cost neutral to the Council.

2.21 If these criteria are not met the Council will recognise that by seeking the external funding it is diverting its own resources away from its priorities, and therefore will choose not to pursue the funding.

Spend to Save

2.22 The Council approved a Spend to Save scheme as part of recent budget setting exercises. The purpose of the Spend to Save scheme is to provide up front funding to a service in order to effect a change that will result in recurring savings in the future.

2.23 One of the key principles of the scheme is that any funding awarded has to be recouped within 3 years from the savings that the scheme generates.

2.24 Given the need to make further savings to address the structural deficit over the next 2 years the Plan will make sufficient provision of Spend to Save funds to facilitate the changes necessary to deliver these recurring savings. As a result the plan has made provision for £3m for spend to save projects between 2014-15 and the end of the structural savings programme in 2016-17

Investing Council reserves in Economic Development loans

2.25 The Plan is to continue to invest up to £3m per annum in local businesses. However it must be demonstrated that:

- The loan will generate for the Council, a rate of return at least equal to the markets; and
- Due diligence work has been undertaken to ensure that any loan granted is at an acceptable risk level to the Council.

Context

3.1 The UK economy is finally starting to show signs of a steady recovery, with the 2014 Q1 GDP figures showing 0.8% growth, which was the 5th successive quarter of economic growth.

3.2 However, the UK economy still remains smaller than it was 6 years ago in the spring of 2008. This represents the longest recovery in over a century, surpassing even the Great Depression of the 1930s.

3.3 Despite the relative strength of the Shetland economy in weathering the global and UK economic situation, Shetland Islands Council's financial situation continues to be adversely affected as a result of the reducing settlement that it is receiving from the Scottish Government each year.

3.4 The UK's Public Finances have not improved at the rate at which the UK Government had projected, and therefore any recovery in Local Government's financial settlement will be well beyond the term of the current Council. When this is coupled with the continuous cost pressures facing the Council, it is clear that further action is required to address the increasing natural drift between expenditure levels and available resources.

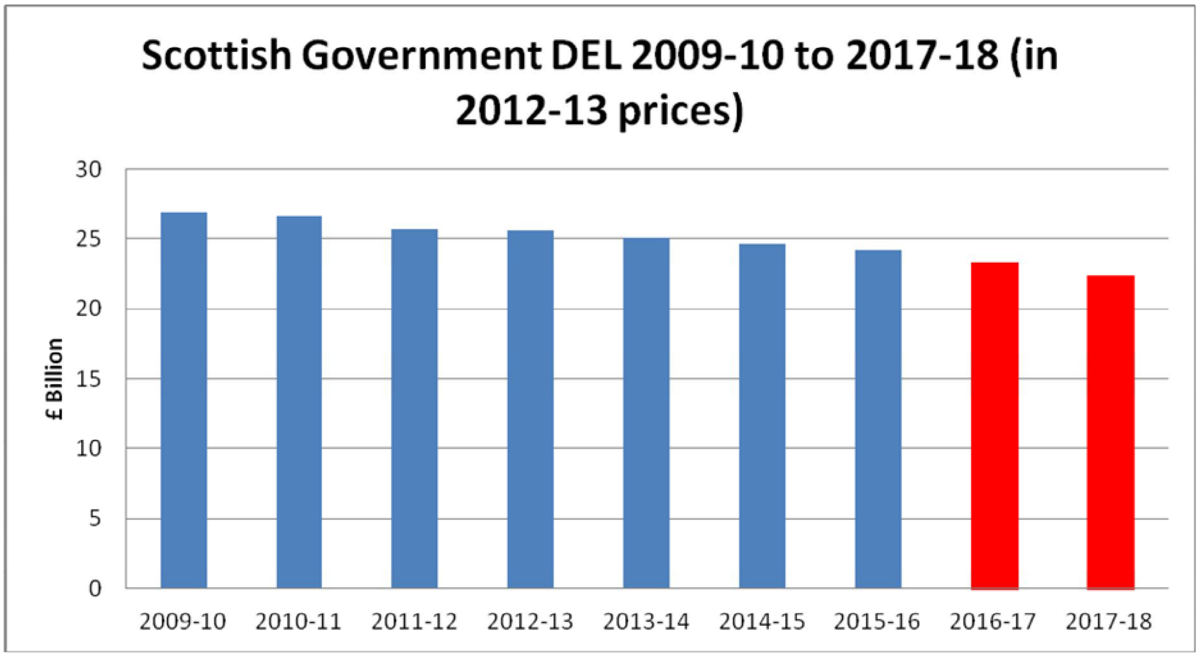
Scottish Government General Revenue Grant

3.5 The General Fund is the biggest part of the Council's activity. It represents all the revenue expenditure incurred across the Council's five directorates: Children's Services, Community Care Services, Corporate Services, Development Services and Infrastructure Services and the Chief Executive's office. General Fund net expenditure is funded from the Scottish Government General Revenue Grant, National Non-Domestic Rates Income and Council Tax. In addition, Shetland Islands Council draws on reserves to fund its General Fund Expenditure. From 2015-16, the reserves will be enhanced by income received from the TOTAL Gas Plant.

3.6 It is important to recognise that the Scottish Government is responsible for determining the overall level of funding available to the Council from General Revenue Grant and National Non-Domestic Rates (NNDR). Therefore, if there were to be an increase in the level of Non-domestic Rates coming into the Council, there would be a corresponding reduction in the level of General Revenue Grant to ensure the overall funding level didn't change. With the introduction of BRIS targets this may in the short term enhance the amount of NNDR income that the Council can retain. However, there is still insufficient clarity to determine what benefit BRIS might bring and the timing of it.

3.7 The table below highlights the reduction in expenditure that the Scottish Government has had available to spend on public services in the period from 2009/10 to 2017/18. The current year-on-year reduction in the amount of money that the Scottish Government has to spend has a knock on effect for Shetland Islands Council.

Real Change in Scottish Government Discretional Expenditure Limit (DEL) Expenditure



3.8 The figures in the table were obtained from the Centre for Public Policy for Regions (CPPR), and it can be seen that further reductions in Scottish Government expenditure are forecast for 2016-17 and 2017-18, and these reductions will be proportionately larger than those that have already been seen.

3.9 It is now likely to be into the 2020s before Shetland Islands Council starts to see any meaningful increase in its financial settlement resulting from more resources being available to the Scottish Government. However, any increases will be somewhat offset by the continuing reduction in Notional Loan Charge Support that the Council currently benefits from. This benefit, worth around £12.5m will reduce by approximately £0.5m per year until it eventually runs out.

Returns on the Council's Reserves

3.10 The Council generated reserves during the 1980s and 1990s as a result of the excess income that it generated from the oil industry over the annual level of expenditure that it incurred.

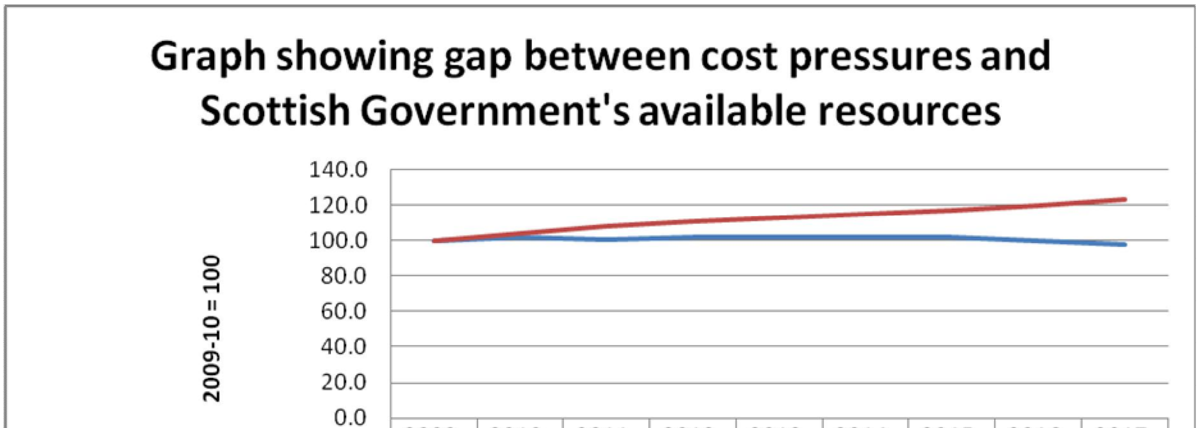
3.11 The long term average return made on these reserves (i.e. the amount earned in interest, dividend payments and increases in the value of stocks and shares held by the SIC) over a period of 20 years has been 7.3% per year. However, in order to protect against inflation, it is prudent to assume a real rate of return as being 7.3% less inflation. Therefore, in this plan the annual income available for spending on services from the reserves is estimated at between 4.8% and 5.3% depending on the forecast inflation rate. A real return of 5%

equates to £10m on £200m of reserves so is therefore a significant income stream to the Council.

Budget Gap

3.12 If this plan is adhered to and sets the parameters for an agreed 2015-16 Council budget, it will result in that budget being set at a sustainable level. However, in order to continue to set sustainable budgets and "live within our means" it will mean that future spending will need to be adjusted to reflect the resources available to the Council. in the medium term, this is likely to result in future reductions in spending.

3.13 The table below illustrates the growing gap between rising costs (the red line) and the cash value of Scottish Government spending (the blue line). The growing gap is called the "budget gap".



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
SG DEL in cash	100.0	102.0	100.4	101.6	102.0	102.0	102.0	100.0	97.6
Inflationary cost pressures	100.0	104.1	107.7	110.8	112.5	114.8	117.1	120.0	123.0

3.14 In order for the Council to avoid allowing the budget gap to grow to such an extent that it previously had up until 2012, thus creating a structural deficit, it will be necessary for the Council to bridge the funding gap by reducing expenditure, seeking new income sources or a combination of both.

3.15 This Medium Term Financial Plan sets out a level of expenditure that the Council can afford to spend to ensure that a budget gap does not open up, thus ensuring ongoing financial sustainability.

Council Priorities

4.1 The Council approved its Corporate Plan 2013-2017 on 26 March 2014. This sets out the Council's vision and priorities for the remainder of the current term.

4.2 The core priorities that have emerged are:

- ***Being a properly led and well managed council, dealing with the challenges of the present and the future, and doing that within our means;***
- ***Providing vital services for children and adults and the transport services we all need;***
- ***Mindful of how change could affect vulnerable and disadvantaged people;***
- ***Encourage strong communities;***
- ***Helping build a healthy economy;***
- ***Working with all our partners to achieve the best results possible.***

4.3 This Medium Term Financial Plan seeks to compliment each of the priorities above. It sets out a pathway to ensuring that the Council lives within its means, and targets available resources at priority areas.

4.4 It is proposed that the core Council services of Children's Services, Community Care and Transport should be relatively prioritised as far as that is possible. This is a reflection on the Council's statutory obligations in these areas, the fundamental scale and cost of these services and the Council's political commitment to sustain key front-line services as a priority.

4.5 The proportions of the available budget allocated to Development, Corporate and Executive Services are proposed to decrease to allow as much spend as possible to be directed to the areas above.

4.6 These "Directorate Target Budgets" are set out in Section 12. The approved figures will be the ceilings that directorates will be required to plan against to show how services can be reconfigured to sustainably deliver the most effective and efficient outcomes possible in the medium term i.e. covering the next five years.

4.7 Service plans will be developed through the planning and budgeting cycle that will start between August and October 2014, and formally reported to Council in December 2014.

4.8 These service plans will describe the proposals and options for service delivery within the "Directorate Target Budgets" and will also provide sufficient information for the Council to make any further adjustments between Directorates or Service areas.

4.9 Any such adjustment cannot however change the overall financial envelope; it could only be a movement of budget from one Directorate/Service to another. Any future movement between priorities would have to be done on the same basis.

4.10 These service plans will need to set out how the Council (and each Directorate / Service):

- Continue to meet any legal obligations (do what we must do)
- Seek to sustain, and if possible improve, key outcomes (key services)
- Identify and effectively manage risks (be safe and secure)

4.11 All service plans will be required to cover each of these areas; this work will need to be delivered on the timetable set out below:

- Medium Term Financial Strategy Agreed – 2 July 2014
- Directorates' Target Budgets for 2014- 2019 set – 2 July 2014
- Directorate / Service Priority Planning, Detailed Budget Planning and Strategic Risk Analysis – between August and November 2014
- Resourced and Risk Assessed Directorate / Service Plans for 2014 – 2018 communicated to Members – November 2014
- Resourced Directorate / Service Plans reported to Committees – December 2014
- Resourced Directorate / Service Plans and detailed 2015-16 Council budget reported to Council – December 2014

Reserves Policy – Financial Sustainability

“The Destination”

5.1 Shetland Islands Council has been operating on a financially unsustainable basis since the turn of the Millennium, during which time the Council’s reserves have been depleted by 60%. A key objective of the current Council since it started in 2012 has been to address the structural deficit that the organisation has been operating in order to put the Council on a financially sustainable footing and arrest the decline in the Council’s reserves.

5.2 By financially sustainable we mean that the annual Council expenditure can be met from the annual resources available to it, without eroding the capital value of the reserves. This means that the value of reserves no longer declines, so that they can be a benefit into the future for the community by providing an continuing income stream to fund services.

5.3 The levels of annual expenditure and amount of incoming resources does not remain constant from year to year, so in order to remain financially sustainable, the Council must respond to these external, and largely uncontrollable, factors. Therefore, financial sustainability is a continuous “journey”.

5.4 Until now, the focus of the Reserves Strategy has been on setting a “Tolerable Reserves Floor” which is a figure that the Council does not want to see its reserves fall below. However, as the Council moves towards being in a financially sustainable position in 2015-16, the focus for the Reserves Strategy should shift towards a broader concept of maintaining the reserves at current levels (i.e. financial sustainability), seeking to increase the value of the reserves or seeking to reduce the value of the reserves. Therefore there are 3 broad choices available to the Council with regard to its Reserves Strategy.

5.5 The 20 year rolling average return on investments has been updated and now stands at 7.3%. Once this is protected against inflation of 2.5%, it means that a sustainable draw on reserves is currently 4.8% per year. This means that to maintain the reserves at their current level, the Council can only budget to spend 4.8% of the value of reserves each year.

The Choices

5.6 By reaching the “destination” in 2015-16, the Council must make a choice regarding the future direction of travel. There 3 options available to the Council are:

1. **Deplete the Reserves** – Stop making savings after 2015-16 when the Council has reached its “destination”. This will result in a budget gap developing as core grant income reduces and cost pressures build up, with the gap being funded from reserves. However, by depleting the reserves, it will mean that the annual amount that could be sustainably drawn from reserves decreases each year.

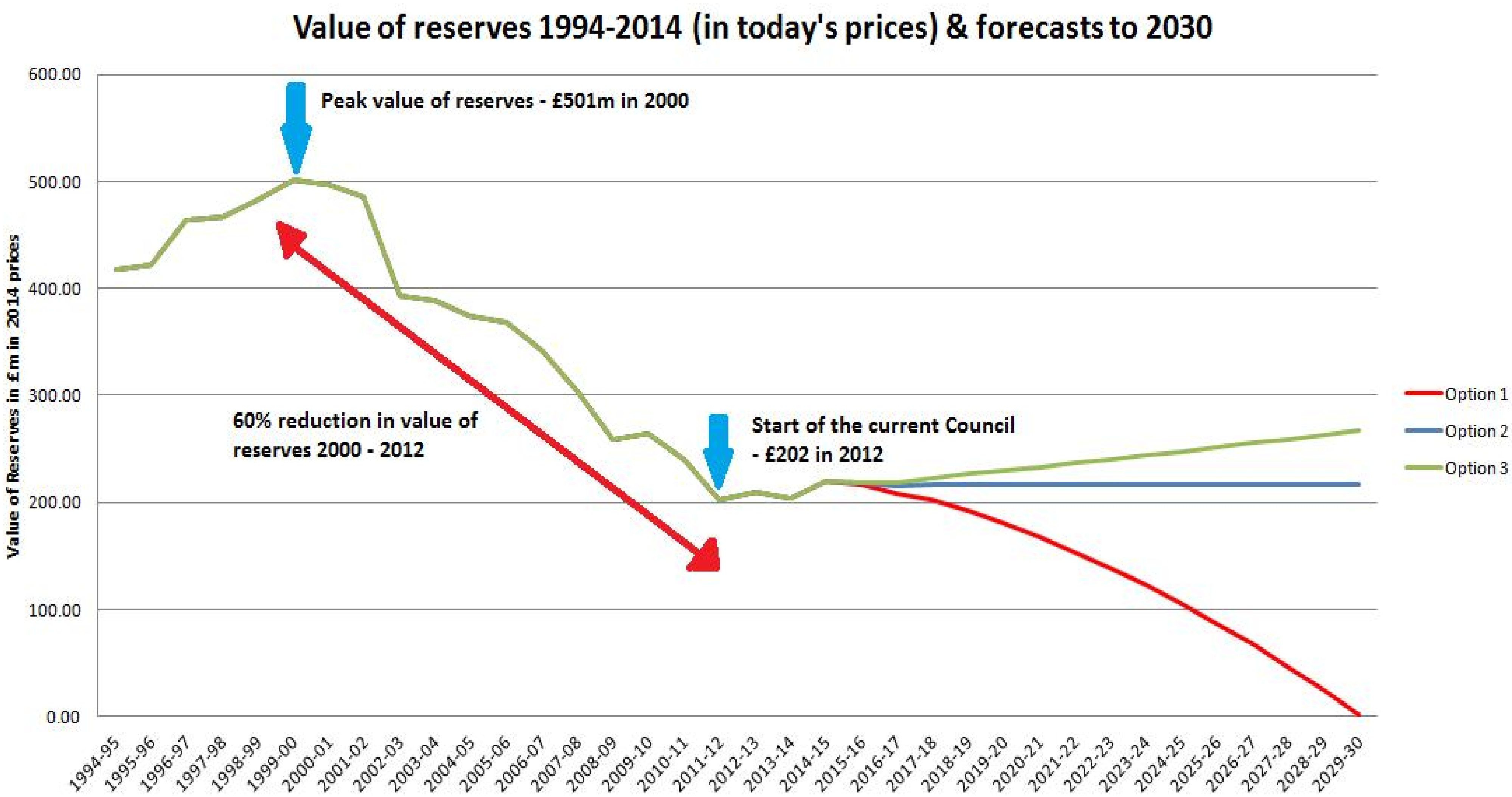
2. **Maintain the Reserves** – Continue on the "journey" by ensuring expenditure remains at a level that can be met from all available resources so as not to erode the capital value of the reserves. This means that a draw on reserves of around £10m each year will continue to be sustainable into the future.

3. **Grow the Reserves** – Seek to ensure that expenditure is at a level whereby it can be met from existing available resources, so that the new income stream from TOTAL can be set aside and used to grow the capital value of the reserves. Over a period of time the capital value of the reserves would grow so that a higher annual sustainable draw on reserves could be achieved.

5.7 The table on the next page shows the value of the reserves over the past 20 years (in today's prices) and also the projected value of the reserves to 2030, based on the 3 options set out above.

5.8 The key learning point from the graph is that if the Council had operated sustainably since the turn of the Millennium it would have reserves with a value of £500m in today's prices. That would have meant the Council could have sustainably supplemented its revenue budget with a £25m draw on reserves each year. However, because the Council spent £300m of the capital of the reserves as well as all the investment returns, it means a sustainable draw on reserves is now £10m per year, so the Council is £15m a year worse off than it would have been if the reserves' capital value had been maintained.

5.9 If the Council did decide to continue to spend the capital value of the reserves (option 1), the red line on the graph shows that the reserves would be fully depleted by 2030. If this were to happen, it would mean that the £10m annual draw on reserves that is currently sustainable would disappear, meaning that expenditure on services would be £10m lower than is currently affordable.



Value of reserves 1994-2014 (in today's prices) & forecasts to 2030
Value of Reserves in £m in 2014 prices
600.00
500.00
400.00
300.00
200.00
100.00
0.00
Peak value of reserves - £501m in 2000
60% reduction in value of reserves 2000 - 2012
Start of the current Council - £202 in 2012
Option 1
Option 2
Option 3
1994-95
1995-96
1996-97
1997-98
1998-99
1999-00
2000-01
2001-02
2002-03
2003-04
2004-05
2005-06
2006-07
2007-08
2008-09
2009-10
2010-11
2011-12
2012-13
2013-14
2014-15
2015-16
2016-17
2017-18
2018-19
2019-20
2020-21
2021-22
2022-23
2023-24
2024-25
2025-26
2026-27
2027-28
2028-29
2029-30

Proposed Reserves Strategy

5.10 Given that the Council is going through a period of Public Finance austerity, it is not a good time to be looking to grow the capital value of the reserves despite this being the best long term financial option for the Council.

5.11 Paragraphs 5.08 and 5.09 demonstrate the value of having reserves to sustain a higher level of annual expenditure, so whilst depleting the reserves has a short term gain, as it did for Councils between 2000 and 2012, the longer term results will be larger cuts in services.

5.12 **As a result it is proposed that the Council adopt Option 2, which is to continue on the journey of financial sustainability and stabilise the reserves at current levels**. This will ensure that the Council will be able to supplement core income with a £10m sustainable draw on reserves each year.

5.13 **In order to ensure that the policy of maintaining the reserves is managed effectively, this will also require Members to agree that the draw on reserves should match the estimated return on investments each year, but never exceed the estimated return on investment plus 2% of the capital value of the reserves.**

5.14 Once the Public Finances improve, and this is filtering through to the Council in the form of an increase in core grant funding, the issue of utilising TOTAL income for current expenditure should be reviewed.

Equalisation Fund

5.15 The returns generated on the Council's invested reserves during 2012-13 were exceptionally high at 14.6%, against a long term average of 5.75% (at the time). There have been large returns on this scale in the past, but also large negative returns, which has balanced out to 5.75% over the past 20 years (1992-2012).

5.16 As a result of this volatility a Reserves Equalisation Fund was established in 2013-14 which accumulates the returns in excess of the 20 year rolling average return in order that these can be released in the years when the returns fall below the average. The purpose of this is to artificially smooth the investment returns, to provide a higher level of confidence when undertaking financial planning into the future.

5.17 A sum of £15m was generated on the reserves in 2012-13, which was in excess of the long term average return. This sum was *therefore* transferred into a separate Equalisation Fund so that it can be released in future years when the returns on investment fall below average.

5.18 **The 2013-14 reserves generated a return close to the historic average. Therefore it is not proposed to either make a transfer to or from the Equalisation Fund in 2013-14.**

Capital Expenditure & Capital Funding

6.1 The Asset Investment Plan sets out the capital expenditure that the Council plans to incur over a five year period. Capital expenditure relates to spending on significant repairs and maintenance work where the result is to extend the life of a Council asset, or spending on the creation or purchase of a new asset.

6.2 Shetland Islands Council receives a capital grant from the Scottish Government each year to spend exclusively on capital, and also receives money from the sale of Council assets known as capital receipts. Any additional spending on capital items above these funding sources effectively has a cost of capital.

6.3 In the past the Council has used reserves to fund capital expenditure, which itself had a cost of capital in that by using reserves to fund capital expenditure, those reserves spent were no longer available to generate an investment income. However, this was not recognised as a cost. The Medium Term Financial Plan has essentially ruled out using reserves to fund capital expenditure.

6.4 It is important that the Council recognises the cost of capital expenditure so that it is not treated as a "free good" as was previously the case. This is because there is going to be a high demand for capital investment in future years as the Council seeks to maintain its existing asset base which is starting to age. More details on this issue will be presented in the Long Term Financial Plan (LTFP) which should be completed by Autumn 2014.

6.5 The LTFP is likely to demonstrate that if the Council wishes to maintain the asset base that it currently has, it will require a significant transfer away from spending money on ongoing service delivery and will instead have to make savings in order to find the money to pay to maintain assets. Therefore in anticipation of that report, the following policy in this Plan is proposed:

Capital Expenditure Policy

- No growth in the asset base.
- All capital expenditure to be focussed on the maintenance of existing assets (with the exception of the previously approved new Anderson High School and high-speed broadband).
- A full business case, including projected future demand, and investment appraisal process should be completed before a project can be considered for inclusion on the Asset Investment Plan.
- No project will be considered for inclusion on the Asset Investment Plan, and existing projects will be removed, unless they have a robust financial estimate of cost. The Executive Manager – Finance will determine whether the financial estimate of cost is robust.

- Focus on selling existing assets that are surplus to requirements to reduce the asset base.
- All capital projects clearly demonstrate the revenue consequences arising from a capital spending decision to assist Members in understanding the full financial impact.

Capital Funding Policy

- Scottish Government Capital Grant will be applied to short life assets (e.g. vehicles, ICT, certain maintenance) as determined by Executive Manager – Finance.
- Capital Receipts will be targeted at core capital maintenance costs.
- Capital Funded from Current Revenue will be used were appropriate to fund low value, shorter life capital expenditure.
- All other capital expenditure will be financed by borrowing. If interest rates are lower than the 20 year average return on investments, external borrowing will be undertaken. If interest rates are higher than investment returns, internal borrowing will be undertaken.
- The service that benefits from the capital asset will be required to make sufficient revenue savings to free up budget to pay debt charges (interest charges and principal repayment of debt) for the borrowing. The only exception to this will be in relation to the New Anderson High School project as the Schools Service who will receive additional funding for debt charges on the basis that it was agreed to borrow for the school prior to the introduction of this policy.
- The level of borrowing required to finance the Asset Investment Plan is called the Capital Financing Requirement (CFR). The Council will be able to manage limits for borrowing based on what it thinks is prudent, affordable and sustainable through annually agreeing Prudential Indicators as part of the Annual Borrowing & Investment Strategy.

6.6 The Capital Expenditure and Capital Funding Policies are applicable to the General Fund, Harbour Account and Housing Revenue Account.

Housing Revenue Account

7.1 The 22 elected Members of Shetland Islands Council are collectively the largest landlord in Shetland, responsible for the letting and management of 1,762 properties as at 31 March 2014.

Accounting treatment

7.2 The Housing Revenue Account (HRA) is a statutory account that is completely separate from the General Fund. As such, it has to be financially self-sustaining as it is not possible for the General Fund to cross subsidise council house rents. All expenditure is funded by housing rents.

7.3 In addition, the HRA can only access its own ring-fenced reserve for repairs and maintenance expenditure, which had a balance of £10.864m at 31 March 2014.

Financial Sustainability

7.4 The HRA is now on a financially sustainable footing following the tripartite agreement between the Council, the UK Government and the Scottish Government to address the historic housing debt issue.

7.5 As the HRA will only be able to fund capital expenditure in line with the Capital Funding Policy (as set out in Section 6.5) it means that the Prudential Framework will be followed. This will ensure prudence, sustainability and affordability in all future capital investment decisions which should avoid the HRA becoming financially unsustainable in future.

HRA Financial Policy

7.6 The HRA must produce a 25 year business plan that is fully costed and demonstrates affordability. The overarching financial aims of the plan must be to –

1. Ensure annual HRA budgets are financially sustainable;
2. Focus on keeping housing rents at affordable levels;
3. Focus capital expenditure on maintaining the existing housing stock, ensuring housing quality standards are met in 2015 and beyond;
4. All capital expenditure funded through borrowing must comply with the Prudential Code and its key principles of prudence, affordability and sustainability; and
5. Ensure only a sustainable draw is made on the Housing Repairs & Renewals Account each year.

Harbour Account

8.1 The Harbour Account primarily represents the activity that takes place at Sella Ness, with the levels of activity dependent on the oil terminal at Sullom Voe. All surpluses generated on the Harbour Account are transferred to the Council's Reserve Fund.

8.2 The first priority of the accumulated surpluses in the Reserve Fund is to sustain the Harbour Account. The Zetland County Council Act 1974 states the purpose of the Fund as –

1. To cover any losses on the Harbour Account
2. To meet any claim or demand against the Council arising from the Harbour Account
3. To meet any capital expenditure required to maintain the Harbour Account
4. To meet any repairs and maintenance costs on the Harbour

8.3 The final provision in the Act is for the Reserve Fund to be used "for any other purpose which in the opinion of the Council is solely in the interests of the county or its inhabitants".

Harbour Account Surpluses

8.4 It is anticipated that the Harbour Account will begin to make surpluses again from 2015-16 and these could be in the region of £3m - £4m per year. This will used immediately to support annual general fund expenditure.

8.5 The oil industry has recently announced its intention to remain at the Sullom Voe Terminal (SVT) until around 2050, which means the Port will be required to allow for tankers to load at the jetties.

8.6 As a result of this announcement, the finance service has undertaken a financial modelling exercise to estimate future revenue streams, costs and the capital investment required to operate the Port until the extended date of 2050. This piece of work has still to be concluded, but some principles being adopted are:

- An Equalisation Fund should be created in the early surplus making years so that some of these surpluses can be set aside and released in the later loss making years;
- The cost of capital and full lifecycle costs of utilised port assets should be priced into harbour dues to ensure the port achieves full cost recovery plus a surplus in line with the Council's internal rate of return;
- An assumption has been made that the Port will continue to operate a 24/7 model;
- The oil industry should never be subsidised by Shetland taxpayers, and the measure of this is that over the whole remaining lifetime of the Port, the total value of the surpluses generated on the capital invested to 2050, should be at least equal to the average rate

of return that would be generated if the capital had been invested with the Council's fund managers.

Reserve Fund Commitments

8.7 The Reserve Fund balance was £66.436m at 31 March 2014 and as stated above, its first use is to sustain the Harbour Account.

8.8 Following the approval of the 2012-2017 Medium Term Financial Plan a figure of £39m has been set aside from the Reserve Fund for future Harbour Account commitments, specifically in relation to port reinstatement costs. This means that the available balance on the Reserve Fund for general use was £27.436m at 31 March 2014.

TOTAL Income

8.9 The finance service commissioned a piece of work from leading Oil & Gas analysts to estimate future throughput levels at the Shetland Gas Plant and also future gas prices in order to facilitate the production of an updated financial model for TOTAL income.

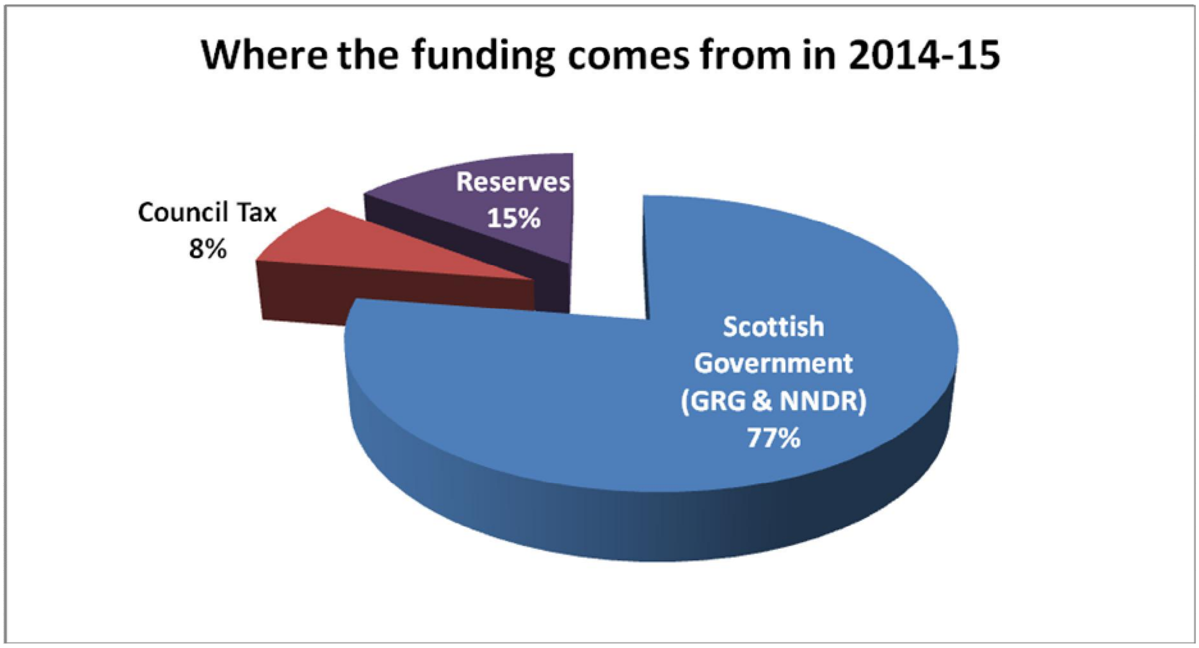
8.10 It is anticipated that the Council will start to receive an income stream from the TOTAL Gas Plant in 2015-16, and this will pick up in 2016-17 to around £2.5m to £3m per annum thereafter. However, as the actual income stream is linked to throughput and price, it is volatile and therefore will fluctuate from the forecast. These forecasts will be reviewed each year to ensure that they are as accurate as possible with the information available. The income that is received will be processed through the Harbour Account.

8.11 As proposed in Section 5, the additional income stream from TOTAL will be fully utilised immediately to support expenditure on general fund services. Once the core Scottish Government revenue grant starts to increase, consideration should be given to setting aside an element of the TOTAL income in order to build the value of the reserves.

Resources

9.1 In 2014-15 Shetland Islands Council's general fund will receive approximately 77% of its funding from the Scottish Government. This is made up of the core General Revenue Grant and the element of National Non-Domestic Rates that the Scottish Government grants to the Council.

9.2 The pie chart below shows where the funding comes from for the general fund budgeted expenditure in 2014-15:



9.3 The chart highlights the extent to which the General Fund requires reserves to make up the funding package. In order to achieve a fully sustainable financial position, reserves should only make up a maximum of 10% of the funding package. It is anticipated that this will be achieved during 2015-16 by reducing expenditure and benefiting from a recovery in the surpluses that can be generated from the Harbour Account, as well as a new funding stream from the TOTAL Gas Plant.

Estimated future resources available to the Council

9.4 The table below shows the estimated future resources available to the Council over the period of the Plan:

Source of Income	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	£000s	£000s	£000s	£000s	£000s	£000s
Scottish Government (GRG & NNDR)	-85,732	-85,328	-82,772	-80,270	-79,625	-79,112
Council Tax	-8,686	-8,773	-8,861	-8,949	-9,039	-9,129
Harbour Account Surplus	-2,432	-6,519	-5,417	-5,072	-4,856	-5,470
TOTAL Gas Plant contribution	0	-1,349	-2,864	-2,831	-2,911	-2,694
Total Funding	**-96,850**	**-101,969**	**-99,914**	**-97,122**	**-96,431**	**-96,405**

9.5 A number of assumptions have been made around the resources available to the Council. These are set out below –

- The Scottish Government has indicated the level of revenue support that it will be providing the Council with for 2015-16. The assumption made in the following years is a 2% cash reduction in both 2016-17 and 2017-18, reflecting the CPPR forecasts with regard to Scottish Government DEL. The assumption for 2018-19 and 2019-20 is a cash flat settlement. In addition, because of the diminishing level of notional loan charge support available to the Council, the overall result is that the core grant will reduce by approximately £0.5m year on year after 2014-15.

- The level of National Non-Domestic Rate income has been set by the Scottish Government up to 2014-15. The assumption in this model is that this income stream will remain at the same level in subsequent years on the basis that the economic outlook will remain challenging throughout this decade. However, depending on the timing of the next revaluation, the Council may receive a short-lived windfall from the new TOTAL Gas Plant as part of the BRIS scheme.

- It is expected that Council Tax income will rise by 1% per annum based on the assumption that the Council will continue with the national freeze, but due to natural increases in the property base of 1% per year income from this source will increase by that amount.

- Based on the latest understanding of when the Total plant will open, it is anticipated that this will provide an income stream to the Council from 2015-16. The level of income budgeted in the model reflects our best estimation of throughput and price of gas at that time. It should be noted that as a result of this, there is a certain level of volatility as to when this income will start to flow into the Council, and the exact amount that it might be.

- It is anticipated that the Harbour Account will see a recovery in 2015-16, which will result in a return to surplus, averaging £3m-4m per year. Again however, there is a certain amount of volatility when trying to estimate the income that might be generated from the Harbour Account several years into the future.

Business Rates Incentivisation Scheme

9.6 The Scottish Government has created a Business Rates Incentivisation Scheme (BRIS) which provides an opportunity for the Council to maximise its National Non-Domestic Rates income stream.

9.7 The way in which the scheme works is that the Scottish Government sets an annual target for the level of Business Rates (National Non-Domestic Rates) that Shetland Islands Council should collect during the year. If the Council collects more than its target, it is able to keep 50% of the additional income, with the other 50% going to the Scottish Government. Therefore, there is an incentive to the Council to generate economic development to increase the tax base. Opportunities should be sought to progress this scheme.

9.10 However, the rateable values of Non-Domestic Properties are revalued every five years, and new values are incorporated into the Council's target. Therefore, depending on the timing of the next revaluation, the Council may receive a limited windfall from the new TOTAL Gas Plant and the new hotel in Brae.

Cost Pressures & Financial Risks

10.1 Despite the drive to bring down the overall level of expenditure in order to work towards achieving a financially sustainable position, there will be cost pressures each year that put upward pressure on the levels of expenditure incurred by the Council.

10.2 It is anticipated that there will be significant cost pressures in 2015-16, with an allowance of £3.899m being budgeted to account for these.

10.3 The table below sets out the recurring cost pressures that have been considered for the 2015-16 budget, and the level of provision made for each:

Cost Pressure	Quant-ification	Description	Allowance for Cost Pressure in 2015-16 budget (£)
Pay Award	2%	It is anticipated that there will be a pay award of 2% in 2014-15	£1,751,000
Borrowing Costs – AHS	Interest rates	Cost of debt charges arising on the borrowing for the new AHS and roundabout.	£1,256,000
Bus & Air Contracts	Estimate	There is in-built annual inflation uplifts in both the bus and air services contracts.	£140,000
Demographic Pressures	2.6%	Based on the rate of Shetland's ageing population, it is anticipated that there will be extra demand on Community Care resources.	£302,000
Ferry Fuel	Estimate	Cost pressure arising from anticipated increases in the fuel used by Ferries. This could be an issue over 2 financial years.	£250,000
Utilities	Estimate	This is the anticipated cost increases for Water, Electricity, District Heating and Gas Oil during 2014-15. Where possible Procurement Scotland estimates have been applied.	£200,000
General Inflation	2%	It is anticipated that inflation will be around 2% in 2015-16. No allowance has been made, as corporate procurement efficiencies should off-set this pressure.	£0
Health & Social Care Integration	0%	If the Council and Health Board choose the Body Corporate Model, it is expected that any additional pressures can be met within existing resources, so no allowance has been proposed.	£0
TOTAL			**£3,899,000**

10.4 The budget pressures included in the table above will be reviewed, and adjusted as necessary as part of the 2015-16 budget setting process.

10.5 An allowance of 2.5% has been made for budget pressures in all future years covered by the Plan. This reflects the fact that the largest cost to the Council is salaries, and it is anticipated that there will be c.2% pay awards per annum in the medium term. In addition, general inflation (CPI) is forecast to settle at around 2.5% in the medium term.

10.6 However, it is likely that there will be specific budget pressures in future years, and as a result, these assumptions will be updated on an annual basis.

10.7 The known potential future budget pressures for specific items are as follows:

- **Abolition of Contracting Out National Insurance Contribution Rates** – The Government has decided to abolish National Insurance Rates for Contracting Out from April 2016. Currently the Council benefits from paying lower National Insurance Employer Contribution Rates (3.4% lower than the standard rate) because it operates a defined benefit pension scheme for staff. As a result, it is anticipated that the Council will be required to start paying an additional £2m each year in National Insurance contributions from 2016-17. This has been built into the Plan.

- **Borrowing to maintain the asset base** – The Long Term Financial Plan will inform Members of the likely cost associated with maintaining the current asset base. The Council has approximately £1.4bn of fixed assets and current annual capital expenditure of approximately £7-8m (Excluding the new AHS) over the next 5 years. At this rate of spending it would take 200 years to replace all existing assets, but given no asset has a 200 year economic life, this level of spending is insufficient to maintain the asset base. Any increases in spending over £7m per year will require to be financed by borrowing, which will subsequently result in a revenue cost pressure. The size of the revenue cost pressure will be determined by Members' decisions regarding the size of the asset base that it wishes to maintain into the future.

- **Pension Auto-Enrolment** – The Council opted to defer the implementation of Pension Auto-Enrolment in 2013 as it was a cost pressure that could be delayed to a future year. However, this cost pressure will now start in 2017, when all officers of the Council will be automatically admitted to the Pension Fund, and the onus will be on staff to opt out if they don't want to become a member of scheme, rather than the current situation whereby there is an onus on staff to complete a form to join the scheme. It is expected this change will result in more staff being in the pension scheme, and as a result the Council will need to make employer contributions on those peoples' behalf. This cost pressure could be in the region of £800,000.

- **Anderson High School** – the current level of maintenance expenditure on the Anderson High School is insufficient to keep the building in sufficient repair beyond the short-term. It is anticipated that a new school will require an increase in repairs and maintenance expenditure of approximately £0.415m from 2016-17 over existing levels to pay for Facilities Management and Life Cycle Costs, therefore this has been added as a specific cost pressure to the 2016-17 budget line over and above the 2.5% allowance. It should be noted that if there was no replacement school, repairs and maintenance expenditure would have to increase by approximately £1m per year to address the backlog maintenance issues at the current school.

- **Welfare Reform** – There are two potential pressures which could arise after the phased introduction of Universal Credit. The first is that there may be additional administrative burdens placed on the Council with regards to the implementation, and ongoing support of, the new arrangements. The second potential budget pressure is the risk of falling housing rents income to the HRA as a result of the housing element of benefits being paid directly to claimants instead of to the Council. The timing around the introduction of Universal Credit into Shetland still remains uncertain.

- **Demographic Change** – Shetland's population is aging at a faster rate than Scotland as a whole. It is projected that there will be a 130% increase in the number of people aged over 75 in Shetland within 25 years. It is clear that this will put increasing demand on care for the elderly services, which in turn will put pressure on budgets.

- **Reduction in Shetland Charitable Trust expenditure** –The Shetland Charitable Trust (SCT) is currently reviewing its expenditure choices as it comes to the end of a 3 year budget commitment cycle. At present SCT part funds certain services currently provided by the Council. As a result, any reductions in SCT expenditure on these services, will result in a Council cost pressure if Members wish to continue to provide them to the same level. It is not possible to quantify this at present as SCT has yet not announce the impact of its spending review.

10.8 These pressures will be given an accurate cost as more information becomes available.

10.9 In addition to the recurring cost pressures above, the Plan allows for one-off contingencies, which is equal to 2% of the budget. This figure is based on past experience of actual council expenditure patterns. This budget will manage unforeseen events, and one-off costs such as ER/VR costs.

Financial Risks

10.10 A number of financial risks, essentially uncertainties, have been indentified which could result in material changes to the Plan. These are as follows –

- **Public Finance Status Quo Assumption** – the Plan assumes the information available on future projections for core grant materialises. The Scottish Independence Referendum may result in a change to these projections, regardless of the outcome.

- **Health & Social Care Integration** – the Council will need robust arrangements in place to ensure that any increase in resources for services in the HSCI model can be demonstrated as necessary to meet Council statutory service demand and not NHS services.

- **Shetland Charitable Trust Spending Review** – the Plan assumes no changes in funding for 2015-16. However, if SCT informs the Council late on of changes, there will be no time to respond for the purposes of the 2015-16 budget.

- **Maintaining the Asset Base** – the scale of the revenue savings required to support the maintenance of the existing asset base will be so significant that there is a risk of reverting back to unsustainable budgets if Members fail to make the difficult decisions.

Budget Modelling

11.1 Based on the information gathered from the Medium Term Financial Planning process the following budget model has been produced:

		2014-15 £000s	2015-16 £000s	2016-17 £000s	2017-18 £000s	2018-19 £000s	2019-20 £000s
Expenditure	Prior year recurring general fund budget	112,317	107,205	107,703	109,773	110,288	109,792
	Structural deficit Correction - Savings requirement	-6,617	-2,145	-1720		-1,000	-3800
	Efficiency saving to manage inflationary pressures			-1,264	-1,999	-1,959	-1,920
	Non-recurring general fund budget	4,118	2,188	2,158	2,199	2,210	2,220
	Capital Charges	1,256	1,256	1,256	1,256	1,256	1,256
	Budget Pressures 2.5% plus specific issues	1,505	2,643	5,054	2,514	2,464	2,415
	Net-recharges out	-1,911	-2,000	-2,000	-2,000	-2,000	-2,000
	Total General Fund budgeted expenditure	110,668	109,147	111,186	111,742	111,258	107,963
Core Income	General Revenue Grant & NNDR income	-85,732	-85,328	-82,772	-80,270	-79,625	-79,112
	Council Tax	-8,686	-8,773	-8,861	-8,949	-9,039	-9,129
	Total Core Funding	-94,418	-94,101	-91,633	-89,219	-88,664	-88,241
	(SURPLUS)/DEFICIT ON GENERAL FUND	**16,250**	**15,046**	**19,553**	**22,523**	**22,594**	**19,722**
Deficit Funding	Harbour Account Surplus	-2,432	-6,519	-5,417	-5,072	-4,856	-5,470
	TOTAL Gas Plant contribution	0	-1,349	-2,864	-2,831	-2,911	-2,694
	Draw on Reserves	-13,818	-7,178	-11,272	-14,620	-14,827	-11,558
	TOTAL DEFICIT FUNDING	**-16,250**	**-15,046**	**-19,553**	**-22,523**	**-22,594**	**-19,722**
Council Reserves	Income earned from Reserves (including Harbour debt repayment)	12,346	13,942	12,760	12,533	12,446	12,346
	Less: General Fund Revenue Draw on Reserves	-13,818	-7,178	-11,272	-14,620	-14,827	-11,558
	Less: HRA, Capital and Spend to Save Draw on Reserves	-7,215	-1,450	-950	-450	-450	-450
	Estimated Increase/(Decrease) in Reserves for the year	**-8,687**	**5,314**	**538**	**-2,536**	**-2,831**	**337**
	As a % of the reserves estimated balance	**-3.98%**	**2.44%**	**0.25%**	**-1.21%**	**-1.37%**	**0.16%**

11.2 The purpose of the model is to set out the level of expenditure that is affordable each year, based on the total funding available and a desire to ensure that the Council's reserves can maintain their capital value and be protected against inflation to ensure their purchasing power doesn't erode.

Assumptions

11.3 The following assumptions have been made in the budget model:

Total General Fund expenditure

- The starting point for each year will be the prior year start point, less savings and then budget pressures added on. For example, the start point for 2015-16 is calculated as follows-

Description	Amount £m
2014-15 General Fund expenditure before savings	112.317
Less: 2014-15 savings	-6.617
Add: 2014-15 Budget pressures	1.505
2015-16 General Fund expenditure before savings	**107.205**

- The original structural savings requirements total the same as the 2012-2017 plan, the only difference is that they are profiled differently between 2014-15 and 2015-16 because the 2014-15 budget contained a higher level of savings than had been required in the plan. This has meant that the new savings requirement for 2015-16 has been reduced to account for the extra budgeted savings in 2014-15.

- In addition to the original structural savings requirement in the original plan, a further £4.8m of structural savings have been forecast as required over 2018-19 and 2019-20. This is in response to an anticipated reduction in the core capital grant of 2% in 2016-17 and again in 2017-18. These figures have yet to be confirmed by the Scottish Government, so these additional savings are indicative, and there has been no attempt to allocate them to services at this early stage. Once the core grant figures are confirmed and the savings requirement is known, the Council will need to determine how these savings should be made.

- As a result of continuing cost pressures and no corresponding increase in core revenue grant to match these, it is necessary to introduce the requirement for each directorate to make an annual 2% efficiency saving each year from 2016-17. The only exception to this is Children's Services, where the 2% efficiency saving requirement starts from 2017-18.

- An in-year non-recurring contingency budget of 2% has been allowed for in the Plan. This centrally held budget is to meet one off costs resulting from the restructure of services as well as manage any unexpected items of expenditure that occur.
- An allowance for budget pressures has been built into the model. In 2014-15 this figure has been calculated as £2.761m (including capital charges). In subsequent years, this has been calculated at 2.5% of the in-year General Fund expenditure before the savings figure. Further details of these calculations have been discussed in section 10 of the Plan.
- Any additional budget pressures, such as general inflation will be required to be met from service budgets.
- Net recharges out are estimated to remain constant based on an expectation that there will still be the same level of service delivered to the HRA and Harbour Account and Capital from the General Fund.
- If the plan is followed, it will mean that the 2015-16 Council budget will be sustainable, and the final budget set by this Council in February 2017 will only include a requirement for a 2% efficiency saving, with all the required structural savings having been delivered by that point.

Total funding

- The Scottish Government has indicated the level of revenue support that it will be providing the Council with for 2015-16. The assumption made in the following years is a 2% cash reduction in both 2016-17 and 2017-18, reflecting the CPPR forecasts with regard to Scottish Government DEL. The assumption for 2018-19 and 2019-20 is a cash flat settlement. In addition, because of the diminishing level of notional loan charge support available to the Council, the overall result is that the core grant will reduce by approximately £0.5m year on year after 2014-15.
- The level of national non-domestic rate income has been set by the Scottish Government up to and including 2014-15. The assumption in this model is that this income stream will remain at the same level in subsequent years on the basis that the economic outlook will remain challenging throughout this decade.
- It is expected that Council Tax income will rise by 1% per annum based on the assumption that the Council will continue with the national freeze, but due to natural increases in the property base of 1% per year income from this source will increase by that amount.

- Based on the latest understanding of when the Total plant will open, it is anticipated that this will provide an income stream to the Council from 2015-16. The level of income budgeted in the model reflects our best estimation of throughput and price of gas at that time. It should be noted that as a result of this, there is a certain level of volatility as to when this income will start to flow into the Council, and the exact amount that it might be.

- It is anticipated that the Harbour Account will see a recovery in 2015-16, which will result in a return to surplus, averaging £3-4m per year. Again however, there is a certain amount of volatility when trying to estimate the income that might be generated from the Harbour Account several years into the future.

Reserves

- The budget model builds in a return on investments of 4.8% to 5.3% for each financial year covered in the Plan. The long term average return over the past 20 years has been 7.3% so once inflation is removed from this total, a figure of 4.8% to 5.3% appears prudent.

- The model excludes the £15m that was set aside from the reserves in 2013 to set up a separate Equalisation Fund which will be used to smooth out the impact volatile investment returns in future years. There has been no requirement to draw from, or add to the Fund in 2014.

- The annual set aside for the principal repayment of debt has been excluded from the available reserves, as this money will be required to repay loans upon their maturity date.

- An amount of £0.5m is anticipated to be drawn from the Housing Repairs and Renewals Reserve each year after 2013-14.

- A figure of £3m will be available to fund spend to save projects between 2014-15 and the end of the current savings programme in 2016-17.

Summary

11.4 When all these factors are taken into account with forecasted future draws on reserves, it is expected that the value of the reserves in 2019-20 should be within 0.25% of the value of the reserves at the end of 2014-15 (protected against inflation). This demonstrates that their real terms value will be maintained over the period, and the Council is operating a financially sustainable model.

Addressing the Budget Gap

12.1 Based on the modelling performed in Section 11, the budget gap for the next 5 years is as follows:

Description	2015-16 £000s	2016-17 £000s	2017-18 £000s	2018-19 £000s	2019-20 £000s
Original MTFP Structural Savings	2,145	1,720	0	0	0
New 2% Annual Efficiency Saving		1,264	1,999	1,959	1,920
Additional Structural Savings				1,000	3,800
Gap to be met by directorates	**2,145**	**2,964**	**1,999**	**2,959**	**5,720**

12.2 The budget gap can only be made up through a combination of increasing fees and charges and reducing costs across the Council.

Priorities

12.3 It is important that the budget gap is addressed based on Members' priorities. In effect, this means that the priority directorates receive the greatest level of protection against the cuts.

12.4 The base year for the Medium Term Financial Plan was 2012-13 and the allocation of savings between directorates has remained unchanged since then. This means that on an underlying basis, the effect of the Medium Term Financial Plan will be to have made the following resource allocation adjustments across directorates as follows:

Directorate	2012-13 % of General Fund (exc Police and Fire)	2017-18 % of General Fund	Movement in % share of funding between 2012-13 and 2017-18
Corporate & Chief Executive	10.98%	10.87%	-0.11%
Children's Services	37.18%	38.46%	1.29%
Community Care	18.79%	19.95%	1.16%
Development	14.41%	11.84%	-2.57%
Infrastructure	18.64%	18.87%	0.23%
TOTAL	100%	100%	0%

12.5 Section 4 of this report describes the themes around Members' priorities, as agreed in the Corporate Plan, and this has been used as the basis for determining the resource allocation as shown in the table above. This means that Children's Services, Community Care and Infrastructure Services will have a proportionately larger share of the budget at the end of the life of the current Council than they did at the start of it, with corresponding reductions in Corporate & Executive Services and Development Services.

Target Operating Budgets

12.6 Based on the priorities set out above, and the reallocation of resources between directorates as set out above, each Directorate has been provided with a Target Operating Budget for each of the next 5 years. These remain based on the original levels of structural savings that were agreed in the first two iterations of the Plan.

12.7 In this third version of the Plan, in addition to the original savings, the Target Operating Budgets incorporate a 2% efficiency saving for each directorate from 2016-17 (2017-18 for Children's Services) and every year thereafter.

12.8 Whilst the Plan has identified that a further £4.8m of structural savings may be required across 2018-19 and 2019-20, these will depend on the financial settlement from the Scottish Government in 2016-17 and 2017-18. Therefore, at present, no attempt has been made to incorporate those indicative savings into the Target Operating Budgets.

12.9 It is important to understand the Target Operating Budgets provide directorates with a financial envelope for developing a budget, but an iterative process will take place throughout the Autumn, whereby Members will have the chance to adjust directorate budgets based on the proposed budgets developed by directorates.

12.10 However, it is important to note that in order to operate within the overall financial envelope that is affordable to the Council, if Members agree to award more funding to one directorate or service, it will have to be at the cost of reducing a budget elsewhere.

12.11 The following Target Operating Budgets and associated budget gaps are proposed for each directorate:

2014-15 £000s	Directorate		2015-16 £000s	2016-17 £000s	2017-18 £000s	2018-19 £000s	2019-20 £000s
10,996	**Corporate & Chief Executive**	**Target Operating Budget**	**10,629**	**10,416**	**10,208**	**10,004**	**9,804**
		Budget gap	(367)	(213)	(208)	(204)	(200)
40,484	**Children's Services**	**Target Operating Budget**	**39,769**	**38,049**	**37,288**	**36,542**	**35,811**
		Budget gap	(715)	(1,720)	(761)	(746)	(731)
19,953	**Community Care Services**	**Target Operating Budget**	**19,551**	**19,160**	**18,777**	**18,401**	**18,033**
		Budget gap	(402)	(391)	(383)	(376)	(368)
13,066	**Development Services**	**Target Operating Budget**	**12,725**	**12,471**	**12,221**	**11,977**	**11,737**
		Budget gap	(341)	(255)	(249)	(244)	(240)
20,601	**Infrastructure Services**	**Target Operating Budget**	**20,281**	**19,875**	**19,478**	**19,088**	**18,707**
		Budget gap	(320)	(406)	(398)	(390)	(382)

12.12 The table below shows how the Target Operating Budgets per directorate reconcile back to the Total General Fund expenditure figure included in the budgeting model in Section 11:

	2014-15 £000s	2015-16 £000s	2016-17 £000s	2017-18 £000s	2018-19 £000s	2019-20 £000s
Corporate & Chief Executive	10,996	10,629	10,416	10,208	10,004	9,804
Children's Services	40,484	39,769	38,049	37,288	36,542	35,811
Community Care Services	19,953	19,551	19,160	18,777	18,401	18,033
Development Services	13,066	12,725	12,471	12,221	11,977	11,737
Infrastructure Services	20,601	20,281	19,875	19,478	19,088	18,707
Cumulative unallocated Savings	0	0	0	0	(1,000)	(4,800)
Total directorate budgets	**105,100**	**102,955**	**99,971**	**97,972**	**95,012**	**89,292**
Cumulative Cost Pressures	2,761	5,404	10,457	12,972	15,436	17,851
Fund Manager Fees	600	600	600	600	600	600
Carry-forwards & Contingency	4,118	£2,188	£2,158	£2,199	£2,210	£2,220
Total Spending	**112,579**	**111,147**	**113,186**	**113,742**	**113,258**	**109,963**
Less: Recharges Out	(1,911)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)
TOTAL GENERAL FUND EXPENDITURE	**110,668**	**109,147**	**111,186**	**111,742**	**111,258**	**107,963**

Addressing the budget gap

12.13 Directorates will be required to address the budget gap set out in 12.11 above, in order to deliver budget proposals that are within the Target Operating Budgets above.

12.14 There are 2 options available to directorates to fill budget gaps; identifying savings and introduce or increase existing fees and charges. In practice a combination of both options will be adopted by directorates where there is scope to do so.

Fees and Charges

12.15 Shetland Islands Council has budgeted to achieve income of £27.5m from fees and charges levied on customers in 2014-15. This represents a significant amount of income and increasing these charges and creating new charges could make a significant impact on bridging the budget gap within directorates. The table below shows the breakdown of the income:

Category	Amount (£)
Sales	4,103,619
Fees & Charges	9,072,570
Rental Income (excluding Housing)	1,321,500
Harbour Dues	13,018,596
TOTAL	**27,516,285**

12.16 This means that for every 1% increase in fees, charges and rents, based on the current charging bases, almost £275,000 would be raised.

12.17 In relation to fees and charges there is an expectation in the Plan that:

- Where these are already levied, consideration will be given to increasing them;
- Where there are concession fees and charges, consideration will be given to reducing these or scrapping them altogether;
- Where the Council provides a service that could be provided by the private sector, consideration is given to introducing charging in instances where this doesn't already exist.

12.18 Any decisions around fees and charges should be undertaken in compliance with the Council's charging policy. An updated Charging Policy will be presented to Council in Autumn 2014.

Council Tax

12.19 It is possible for the Council to increase Council Tax in order to contribute towards bridging the budget gap, but this would be in contravention to the concordat agreement between Scottish local authorities and the Scottish Government.

12.20 The Scottish Government provides an element of additional funding to Shetland Islands Council in its financial settlement as an incentive not to increase Council Tax. This funding would be lost if the Council were to increase Council Tax.

12.21 Council Tax provides limited scope for generating income for the Council. A 1% increase in Council Tax would generate approximately £86,000, so a significant increase would be required in order to make an impact on the budget gap.

12.22 As a result of these factors, the Plan assumes that Council Tax will remain frozen for the remainder of this Council term.

Contingency Measures

13.1 There is a risk to any organisation that its budget strategy may not be delivered. It is therefore important to ensure that there are appropriate contingency arrangements in place that can be used in order to help put the organisation back on track for delivering its budget.

13.2 This will be important to Shetland Islands Council, particularly over the next 18 months to ensure that by 31 March 2016, the organisation is clearly working on a financially sustainable basis. By that stage, the recurring draw on reserves for the year should be approximately £7m, and the 2015-16 budget should include savings that will ensure that general fund net spending is no higher than £109m.

13.3 Therefore this paper sets out a number of options available regarding contingency measures to ensure that the objectives of the Plan are delivered throughout the next five years.

Contingency Measures

13.4 The Plan proposes to grant delegated authority to the Chief Executive to invoke the following measures if they are required –

- Taking decisions to make minor alterations to the level of service provision in order to stop the need to recruit to a post;
- Closing the purchase ledger as required (except for essential payments e.g. utilities);
- Removing access to ordering systems;
- Centrally close down non-essential budgets;
- Cancel training (with the exception of instances where there was a legal requirement);
- Temporary recruitment freeze (except for essential posts);
- Ban non-contractual overtime;
- Stop third party grant payments;
- Delaying the commencement of contracts or cancelling them;
- Stopping all capital purchases (such as PCs etc).

Consultation

14.1 The Medium Term Financial Plan will drive the Council budget parameters. Followings its approval, the 2015-16 budget setting timetable will be developed, and this will incorporate a series of public meetings which will facilitate a participatory budgeting exercise.

Participatory Budgeting

14.2 It is proposed to hold public meetings across Shetland during August 2014 where members of the public will be presented information on the Council's current financial position, and a 5 year forecast. The information will largely come from the material included in the Plan. Members of the public will then have an opportunity to ask questions regarding the Council's finances.

14.3 Following that, the public will be asked to complete a "build your own council budget" exercise, using the information obtained from the Directorate Budget Activity Sheets, which has been populated into a ICT budgeting tool. This will allow members of the public to determine which activities should be reduced, and which should be stopped, in order to meet the savings requirement agreed in this Plan.

14.4 The information gathered from these public meetings will be collated and shared with Directors, so that it can feed into the budget proposals that are presented to Members are part of the draft 2015-16 budget.

14.5 Members will also be presented with the feedback from the public Participatory Budgeting exercise, so that they are informed of the collective views of those who took part. This will be done as part of the budget seminar meetings.

14.6 The draft 2015-16 budget report presented to Members in December 2014 will set out how the results of the Participatory Budgeting exercise have fed into the proposals presented in the budget.

Service Reviews

14.7 The subsequent budget proposals developed, following the participatory budgeting exercise will impact on services, communities and staff. To ensure there is a consistent and robust approach to service reviews, it is vital that consultation is part of the process. The Council has in place and is currently utilising the Community Consultation and Engagement Guide and Communications Plan. This can be found on the Council's website: http://www.shetland.gov.uk/communityplanning/documents/CommunityConsulationEngagementGuide.pdf.

14.8 Consultation and communication of the Plan and the resulting reviews will be essential if the Plan is to be implemented, and be successful in reducing expenditure but at the same time minimising the inevitable impact on services delivered to the Community.

14.9 Managers have also been provided with an in-depth review guide, which incorporates advice on the appropriate level of consultation. This guide ensures that issues such as risk assessment, equalities impact assessments, environmental and economic impacts etc are properly considered.

14.10 It should be recognised that the over-riding factor, in any consultation exercise is “the Council has to reduce expenditure” and expectations from any consultation exercise needs to bear this in mind.

Conclusion

15.1 Good progress has been made since the 2012-2017 Medium Term Financial Plan was adopted by Members in September 2012. The 2015-16 Council budget will be the first that is financially sustainable since the 1990s. Once this has been achieved, the Plan sets out what is required to ensure that the Council continues to "live within its means".

15.2 There are minimal changes in this plan overall, but the changes that have been introduced have been designed to further strengthen the financial management arrangements in place at the Council, particularly in the area of reserves management and the cost of capital.

15.3 The Council has now formally adopted its Corporate Plan and the proposals in the Medium Term Financial Plan compliment that plan and target resources to ensure that it can be delivered.

15.4 The medium term future of UK Public Finance remains bleak, but by following this plan the Council will be in a far stronger financial position than it has been for many years, and will be well placed to deal with the financial challenges of the future.