Shetland Islands Council

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Date: 15 August 2018

Dear Sir/Madam

You are invited to the following meeting:

Special Shetland Islands Council
Council Chamber, Town Hall, Lerwick
Wednesday 22 August 2018 at 10.00am

Apologies for absence should be notified to Lynne Geddes at the above number.

Yours faithfully

Executive Manager – Governance and Law

Convener: M Bell
Depute Convener: B Wishart

AGENDA

(a) Hold circular calling the meeting as read.

(b) Apologies for absence, if any.

(c) Declarations of Interest - Members are asked to consider whether they have an interest to declare in relation to any item on the agenda for this meeting. Any Member making a declaration of interest should indicate whether it is a financial or non-financial interest and include some information on the nature of the interest. Advice may be sought from Officers prior to the meeting taking place.

1. Shetland Islands Council Investment Strategy
F-061

2. Medium Term Financial Plan
F-071

3. Public and School Transport Network 2019/2024 – Strategic Outline Case
DV-31

Shetland Islands Council	Agenda Item 1

Meeting(s):	**Shetland Islands Council**	**22 August 2018**
Report Title:	**Shetland Islands Council Investment Strategy**	
Reference Number:	**F-061-F**	
Author / Job Title:	**Report Presented by Executive Manager - Finance**	

1.0 Decisions / Action required:

1.1 That the Council RESOLVES to adopt the Investment Strategy by:

a) Approving the proposed Investment Strategy at section 3.1 to 3.4 of Appendix 1

b) Approving the fund manager structure as set out in section 3.12 to 3.19 of Appendix 1; and

c) Delegating authority to the Executive Manager – Finance to implement the policy by making the necessary changes to fund manager arrangements.

2.0 High Level Summary:

2.1 The purpose of this report is to present a proposed Investment Strategy for the Council's investments that complements the Medium Term Financial Plan.

2.2 The Finance Service started a review of the Council Investment Strategy in 2017. Given the importance of the Council's investments to the Council's financial well-being, it was necessary to contract KPMG the Council's investment consultants to provide professional expert advice, and to perform financial modelling to test various proposals. KPMG's Investment Strategy and Structure Review document is attached as Appendix 2.

2.3 The Council aims to achieve gross investment returns of 7.3% per annum over the long terms.

2.4 The detailed Investment Strategy 2018 paper has been attached as Appendix 1 to this report.

2.5 Investment Consultants from KPMG will be in attendance at the Council meeting to answer any questions that Members might have on the proposed strategy.

2.6 If Members agree this overarching Investment Strategy, a number of changes to the current fund manager structure will be required to implement it.

3.0 Corporate Priorities and Joint Working:

3.1 The Investment Strategy complements the Medium Term Financial Plan which is important to the Council's long term financial resilience, and investment performance plays a key role in helping the Council deliver its corporate objectives, as described in the Community Plan, the Corporate Plan and other strategic documents.

4.0 Key Issues:

4.1 The proposed Council investment strategy seeks to introduce changes to the current investment strategy that aim to achieve the Medium Term Financial Plan's objectives as set out in section 1.5 and 1.6 of Appendix 1.

4.2 The new strategy proposes a mix of growth seeking assets such as equities and income returning assets such as direct lending investments. The strategy remains diversified by maintaining a diversified growth fund and adding a diversified alternatives fund.

4.3 In comparison to the current strategy it is estimated that the proposed investment strategy will improve the likelihood of investment returns (after fees) achieving the objectives compared to retaining the current investment strategy.

4.4 Financial markets continue to be volatile and the strategy introduces more protection against the negative impact of market change due to its diversity of investments and its steady income returning investments.

5.0 Exempt and/or confidential information:

5.1 *None*

6.0	**Implications :**
6.1 **Service Users, Patients and Communities:**	The performance of the Council investments has a direct impact on the level and volume of services that it can afford to provide to the people and communities of Shetland. Therefore reviewing and setting an investment strategy provides assurance that the additional funding that is created through the investments is maintained and sustainable.
6.2 **Human Resources and Organisational Development:**	*None*
6.3 **Equality, Diversity and Human Rights:**	*None*
6.4 **Legal:**	As required by the consent issued by the Scottish Ministers under the Local Government Investments (Scotland) Regulations 2010 the investment strategy should be approved by the local authority (i.e. full Council or Board).
6.5	Reviewing and setting an investment strategy is part of the

Finance:	governance and monitoring framework, which the Council undertakes to ensure that the investment strategy is working towards meeting the Council's long term objectives. It is not likely that the Council can expect a positive investment return from its investments every year but having robust governance and monitoring in place, alongside a diversified investment strategy, mitigates the financial risks and enables the Council to take action at appropriate times to address poor performance by the fund managers. On the basis of a robust investment strategy being implemented the Council will continue to rely on investment returns as a long term, inflation proofed, funding source that is incorporated into the annual revenue budget and Medium Term Financial Plan.
6.6 **Assets and Property:**	Long term investments are assets of the Council and represent money given to fund managers to manage on its behalf for sustainable long term benefit. The Council relies upon each fund manager's fiduciary duty and to buy and sell appropriate assets in accordance with the mandate awarded to them and to report regularly on the value and performance of the fund in which Council money is invested. The value of long term investments under these mandates can go down as well as up.
6.7 **ICT and new technologies:**	*None*
6.8 **Environmental:**	Whilst the fund managers have delegated powers for the acquisition and realisation of investments, fund managers will be expected as part of their investment process to consider all factors, including the social, environmental and ethical policies of companies in which they may invest, to the extent that these may materially affect the long term prospects of such companies. The fund managers will also be expected to enter into dialogue with companies in which they invest, in relation to the pursuance of socially responsible business practices, and report on these activities. Corporate Governance is a key responsibility for institutional shareholders and as a matter of principle the Council will seek to exercise all of its voting rights in respect of its shareholdings. It is recognised however that in practical terms this may not always be possible for overseas holdings. However for UK stocks all voting rights will be exercised in a positive fashion, i.e. no abstentions. The fund managers, who will act in accordance with this policy, will exercise voting. All of the Council Fund Managers have signed up to the United Nations Principles on Responsible Investment. The principles reflect the view that environmental, social and corporate

	governance (ESG) issues can affect the performance of investment portfolios, and therefore must be given appropriate consideration by investors, if they are to fulfil their fiduciary (or equivalent) duty. The Principles provide a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices, and so better align their objectives with those of society at large.	
6.9 **Risk Management:**	The investment strategy employed by the Council will impact on the long-term projected investment returns of the Council's investments, and have consequences for the daily operating cash capabilities of the Council. All investments carry risk. Risks, such as market risk are mitigated and actively managed through diversification of fund managers, asset classes, markets, size of holdings and through performance monitoring against benchmarks.	
6.10 **Policy and Delegated Authority:**	In accordance with Section 2.2.1(7) of the Council's Scheme of Administration and Delegations, the Policy and Resources Committee has delegated authority to secure the coordination, control and proper management of the financial affairs of the Council. The Investment Strategy is a specific plan contained within the Council's Policy Framework set out in the Council's constitution (Part A – 3(2)) to be prepared and performance managed by the Policy and Resources Committee. Approving, adapting or amending any plan within the policy framework is reserved to the Council (Part A – 3(1)).	
6.11 **Previously considered by:**	*None*	

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Appendices:
Appendix 1 – Shetland Islands Council Investment Strategy 2018
Appendix 2 – KPMG - Shetland Islands Council Investment Strategy and Structure Review

Background Documents:
None

Shetland Islands Council

Investment Strategy

2018

Securing the Best for Shetland

Contents

Introduction

1.1 The purpose of the Investment Strategy 2018 is to set out the overarching investment approach to complement the Medium Term Financial Plan.

1.2 It does not replace the requirement for the Council to produce an annual Investment Strategy document which is central to the consent issued by the Scottish Ministers under The Local Government Investments (Scotland) Regulations 2010. The consent states, "Local Authorities are required to prepare an Annual Investment Strategy before the start of the financial year and an Annual Investment Report after the financial year end. The requirement for local authorities to produce an annual strategy and annual report is also reflected in the CIPFA Treasury Code".

1.3 The Scottish Minister's consent also states that a local authority can produce a single strategy covering capital, treasury management, the setting of prudential indicators and the requirements of the regulations and consent. Therefore an Annual Investment Strategy will continue to be produced annually and will cover all aspects of Treasury's investment activities.

1.4 The strategy will also be updated on an annual basis to test whether the overarching objectives of the investment strategy complement the objectives of the Medium Term Financial Plan.

Medium Term Financial Plan's Policies on Investments

1.5 The Medium Term Financial Plan has the following investment return objectives –

- To achieve investment returns that are sufficient to enable an annual sum to be withdrawn to support the Revenue Budget;
- To achieve investment returns that protect the annual sum withdrawn from the impact of inflation; and
- Investment risk is mitigated by the diversification of asset classes, global coverage and a number of fund managers.

1.6 The current value withdrawn from investment returns is based on a targeted average return of 7.3% per annum.

1.7 It is a number of years since the investment strategy was reviewed and as a result, a review of the Council's investment strategy has been undertaken to ensure that the current mandates[1] and fund manager portfolios are structured to continue to deliver the

[1] Instruction to the fund manager from the Council about what they can and cannot invest in.

investment return objectives in the future. To carry this review out external support was obtained from the Treasury Services department of KPMG.

1.8 This strategy paper proposes some changes in the way the Council's investments are invested, in order to better reflect the Medium Term Financial Plan's objectives for the future.

Current Investment Strategy

2.1 The current investment strategy was put in place with the help and advice of the Council's investment consultants KPMG has been in place since 2013. The investment strategy has a strong focus on long term growth, while taking inflation and asset protection into consideration.

2.2 The fund managers who invest on behalf of the Council in the stated asset classes and per the benchmark percentages are as follows:

Manager	Fund	% of Investments
Bailie Gifford	Equities Diversified Growth	25% 17.5%
BlackRock	Equities	30%
Insight	Bonds Cash/Liquid Bonds	15% 12.5%

2.3 The percentages above are the initial benchmark percentages agreed after the reorganisation in 2013. Over the following years these percentages varied depending on withdrawals, market movements and investment returns. These fluctuations are expected over the short term.

2.4 There is no intention to rebase back to the initial percentages, as this would incur additional transaction costs. Large variations from the benchmark can be addressed when making withdrawals. The fund managers continue to invest during 2018/19 as per their investment percentage position, until the outcome of the current investment strategy review is known and approved.

2.5 The 12.5% allocation with Insight into a cash/liquid bonds investment was specifically included to be used for withdrawals when cash was required for Council expenditure to fund services over the medium term. This fund provided certainty that it would not lose any capital value, thus eradicating the risk of incurring losses when selling investments to meet current expenditure needs. The cash/liquid bond fund reduced over the medium term as it was used for withdrawals, and it came to an end during 2016/17.

Fund Manager Structure

2.6 The investment percentage position is constantly monitored by the Council's Treasury function. The current percentage of funds under management for each fund manager at the 31st May 2018 was:

Baillie Gifford	53%
BlackRock	36%
Insight	11%

2.7 Since 2013 equities have been in a bull market[2] which has seen equities rise in value over the period, therefore increasing Baillie Gifford and BlackRock's percentage allocations. Over this period Insight's cash/liquid bond fund ended and although their bond fund has increased in value it has not achieved the level of returns seen by the equity investments. This has resulted in the reduction of Insight's overall percentage allocation.

2.8 Baillie Gifford's mandate is invested 60% in equities which is further split equally between two unitised equity products, a UK Equity Fund and a Global ex UK Equity Fund. The remaining 40% of Baillie Gifford's mandate is invested in a diversified growth fund, which can invest in a mixture of about 15 asset classes and aims at achieving steadier long term equity like return.

2.9 BlackRock's mandate is invested into two passive unitised equity products, 75% in a Global Developed Passive Equity Fund and 25% in an Emerging Markets Passive Equity Fund.

2.10 Insight's Bond mandate is invested equally into three different unitised bond products. A UK Corporate Bond Fund, a UK Index Linked Bond Fund and a Bonds Plus Fund which is invested over a wider range of bonds.

2.11 Short–term investments are held in cash, either with the Council's bank or on short-term deposits. These are managed by the Council's Treasury function on a daily basis to ensure the efficient operation of cash flow requirements for Council activities.

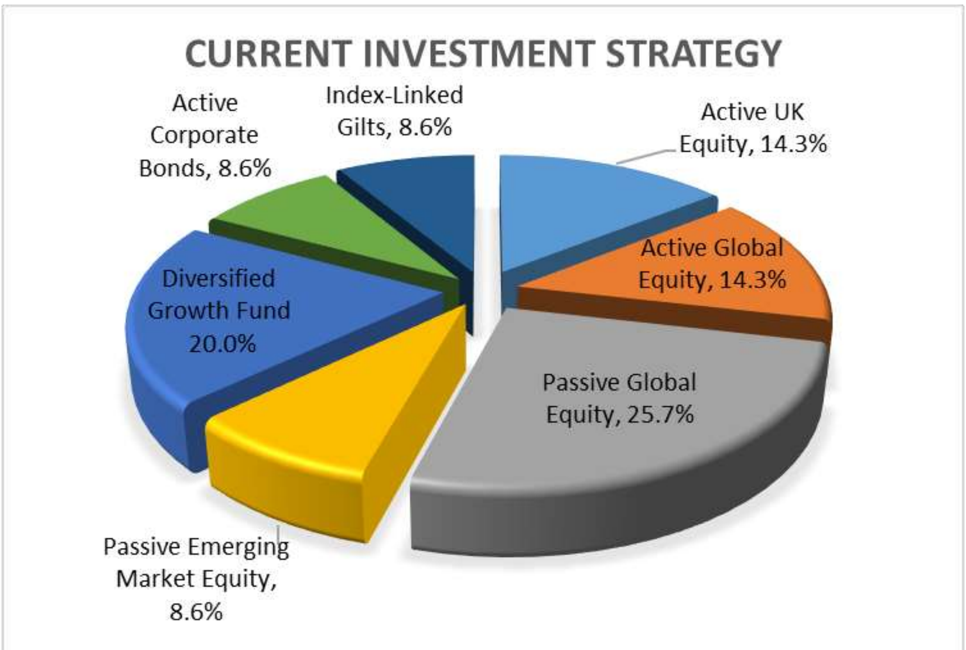
2.12 All long-term investments are held for the purpose of achieving an investment return. To this end all investments are managed in a way that manages the risk to the capital sum and optimises the return on the investment consistent with those risks. This involves setting benchmarks for each fund and for each unitised product within the funds. These benchmarks (market indexes, or where no index is suitable cash plus a certain % return is

[2] 'Bull market' is where shares and equities are performing strongly, forecasting growth and positive future performance.

agreed) are used to evaluate the performance of each investment, with large deviations both above and below these benchmarks resulting in particular scrutiny.

2.13 The long-term investments are a mix of active mandates where the fund manager has a target above the benchmark return; the fund manager makes investment decisions that move their investment profile away from a particular index and look to exceed the index by taking account of various investment decisions, whereas passive mandates are where the fund manager is trying to replicate the market return.

2.14 The pie chart below sets out the current strategy –



2.15 The current investment strategy is not only invested between three fund managers but is split up between seven distinct investment sectors with many different investments within each sector. This diversification not only spreads investment risk but also fund manager risk.

Proposed Investment Strategy

3.1 The Council's Treasury Service, Accountancy Team Leader and Executive Manager – Finance have worked with the Council's investment consultants KPMG to develop a proposed strategy that complements the Medium Term Financial Plan.

3.2 This resulted in KPMG preparing the report which is attached at Appendix 2. Leading up to the report, the Treasury Service, Accountancy Team Leader and Executive Manager – Finance discussed and reviewed various iterations of the proposed strategy which KPMG produced and advised on. The attached report from KPMG at Appendix 2 not only shows some of the other proposals but provides analysis of the proposed strategy and compares this to the current strategy.

3.3 The new investment strategy looked at the following issues and has the following proposals–

- **Growth** – The Council has set a target overall strategy investment return of 7.3%. To achieve this return the investment strategy requires a considerable allocation to growth assets. The strategy therefore retains a strong reliance on equities for the majority of the required return. To reduce the equity risk within the allocation the investment is spread between two fund managers that take very different investment approaches, i.e. one passive management and the other active management with investments also spread over different world markets. **Proposal –** ***to maintain an allocation to equities of 60% between two fund managers.***

- **Diversification** – To spread the Council's investments over different types of asset class in order to seek a smoother annual return, and have the flexibility to exploit short term opportunities in volatile markets. **Proposal –** ***to maintain a diversified growth manager and allocate 15% of the investments for this purpose (a reduction of 2.5% from the current strategy allocation)***.

- **Securing a steady income** – The Council will require to draw money from its investments over the next 5 years. It is therefore prudent financial management to gain some certainty over income from investments to help avoid the requirement to sell investments to generate cash. The addition of a long term lending fund to medium sized UK and European companies over a five to ten year period will produce a steady return that is completely independent from the other investments, while reducing overall risk as the loans hold senior debt positions. The steady return will provide some certainty of future income, with the option to have the income paid back to the Council if required. **Proposal –** ***to introduce a 12.5% allocation of direct lending into the asset portfolio to provide a steady consistent income that will be utilised to fund services.***

- **Protection against inflation** – It is important to ensure that the Council's investments are protected against inflation so that their future purchasing power for Council services is not eroded over time. A secure income fund will not only give inflation linked returns but will add diversification, through lending in Infrastructure, Real Estate and Private Credit projects over the long term. **Proposal – *to introduce a 12.5% allocation of a diversified alternatives fund into the asset portfolio to provide an element of inflation protection to the strategy*.**

- **Bonds –** The recent high cost of bonds and low yields is expected to continue for the medium term and therefore the benefits received in the past have been less effective in recent years. For the strategy to achieve the overall returns required it is advised that bonds could be replaced by alternative investments. **Proposal – to exit from bonds to enable funds to be available for alternative investments.**

3.4 Based on the rationale above, the pie chart shows the proposed investment strategy –

3.5 Further details about each asset class can be found in the KPMG report attached at Appendix 2 to this report.

Volatility and Investment Risk

3.6 As with all investment strategies volatility and risk are central to all investment decisions. When looking at any strategy there is a balance to be found between risk and return, and when a target return (7.3%) is set it should be met with the lowest acceptable level of risk possible. To this end the proposed strategy is increasing diversification of investments by maintaining a diversified growth mandate along with adding in a diversified alternatives mandate. Both of these will spread risk over various asset classes so increases the protection from the negative impact of any particular investment. The direct lending investment which has a steady income will also help dampen the volatility of returns while reducing the overall strategy risk due to the security of returns.

3.7 Equities are the major asset class (60% allocation) in the proposed strategy, so it has the biggest investment return potential and correspondingly the biggest investment risk position. Equity risk is mitigated by having more than one fund manager, with each fund manager investing differently (passive as against active management) and diversifying the equity investments into different global sectors. This all helps to reduce overall equity risk while generating the investment return the Council requires.

Annual Cash from the Investments

3.8 The proposed investment strategy is strategy 1 from the KPMG report at Appendix 2 page 16. The strategy is aiming at an expected return of 7.3% which was the target return KPMG were given at the start of their analysis and modelling exercise. This return less a future inflation proofing figure of 2.1% gives a sustainable annual withdrawal percentage from the investments of 5.2% which is in line with the medium term financial plan.

Fees

3.9 The proposed new structure will have an adverse effect on fund manager fees. The main driver for the cost of fees is whether investments are managed actively or passively. Passive management fees are significantly lower than active, but there is a risk that you lose the added value that active fund management can provide. At present, 34.3% of the Council's investments are passively managed compared to 20% in the proposed strategy.

3.10 The addition of the direct lending and the diversified alternatives mandates will also increase fund manager fees as the Council will be paying for a more active management arrangement.

3.11 The overall adverse effect on fund manager fees will be in the region of about £500,000 per annum. This is a big change but the proposed strategy is intended to not only cover the added costs but also produce a greater investment return that aims at achieving the long term objectives at 1.5 and 1.6 above.

Fund Manager Structure

3.12 In order to implement the proposed strategy, a number of changes will be required to the existing fund manager structure.

3.13 Included within the KPMG report at Appendix 2 is a table comparing the current structure against various the proposed structures (Page 16). Structure 1 is the preferred option.

3.14 The proposed new strategy will retain two fund managers, Baillie Gifford and BlackRock, who already have investment management agreements with the Council. This will not only help save costs but also reduce the time taken in the reorganisation of the investments from the current arrangements to the proposed arrangements.

3.15 From the suggestions in the KPMG report at Appendix 2 the proposed fund management structure to implement the new strategy is as follows:

Current Fund Managers

Baillie Gifford	-	Active Equities	40%
		Diversified Growth Fund	15%
BlackRock	-	Passive Equities	20%

New Mandates

	-	Direct Lending	12.5%
	-	Diversified Alternatives	12.5%

3.16 In line with the new investment strategy and fund management structure one fund manager Insight will have their active bond mandate terminated. Insight's performance since 2001 when they were appointed has been very good and the termination of their mandate is not a reflection of the fund manager but rather an investment allocation view by KPMG, as they do not believe that bonds will produce the Council's required investment return in the future.

3.17 Insight can tender for the two new mandates which are required as per the new investment structure.

3.18 The new investment strategy and fund management structure will require 2 new mandates to be awarded. Before a mandate can be awarded to a fund manager a tender exercise must be conducted in line with EU legislation. Each tender exercise is intended to find the best fund manager for each mandate. The final decision on which fund manager will be awarded each mandate is taken by the full Council, after hearing presentations by the fund managers who are invited to the final selection.

3.19 If the new strategy is approved, the selection process followed by the implementation of the new strategy could be completed during 2018/19.

Comparison between current and proposed strategy

4.1 The table below sets out the financial modelling that was performed by KPMG in relation to the expected future results of both the existing investment strategy at Section 2 and the proposed strategy as set out in Section 3 –

	Current Strategy	Proposed Strategy
Expected Return (p.a.)	6.5%	7.3%
Expected volatility (p.a.)	15.2%	14.7%
Investments in 5 years (1 in 20 bad outcome)	£190.6m	£205.0m
Investments in 5 years (Expected) excluding fund manager fees	£355.9m	£368.5m
Estimated annual fund manager fees per annum	0.40%	0.55%
Estimated cumulative fees over 5 years	£6.6m	£9.4m
Investments in 5 years (expected) including fund manager fees	£349.2m	£359.1m

4.2 The information was taken from Page 16 of the KPMG report attached as Appendix 3 to the Investment Strategy report. The proposed strategy is Option 1 from the table in the KPMG report. Option 3 increased fees and volatility with an even higher target and option 4 required further alterations to achieve the desired target. Option 1 and 2 were both seriously considered but option 1 was chosen as Direct Lending was preferred to Semi-Liquid Credit as its returns are more certain and completely unconnected to equity returns.

4.3 The table above shows that the proposed strategy is expected to earn 0.8% more per year than the current strategy, which over a period of 5 years would result in the investments having a value of £368.5m, as opposed to £355.9m under the current strategy.

4.4 Fund manager fees in the proposed strategy is estimated to be £9.4m over 5 years, which is expected to be £2.8m higher than the fees anticipated under the current strategy, but the new strategy will cover the additional fees and increase returns. The expected investment value in 5 years of the new strategy including fees is £359.1m as against the expected investment value including fees of £349.2m with the current strategy.

4.5 The proposed strategy is also less volatile than the existing strategy and as a result, in the 1 in 20 bad case scenario, the investments would be estimated at having a £205m value, compared to £190.6m under the existing value. Therefore, the proposed strategy carries less risk than the existing strategy.

4.6 The new strategy therefore aims at a higher return with lower volatility, and although fees will increase the expected investment value after fees will be higher than the current strategy.

Responsible Investment

5.1 The issue of responsible and ethical investment is challenging for all local authorities. This is because of the competing objectives of complying with legislation to ensure that Members satisfy their fiduciary duties, while often seeking to take a responsible and ethical approach to investments for social and moral reasons.

5.2 The Council does not make investment decisions itself, choosing to employ specialists (fund managers) to make those decisions and to determine the timing of transactions for it.

5.3 To achieve the investment returns required to support Council services the investment decisions made by fund managers may not always be in line with the views and beliefs of Councillors or the wider Shetland population. In order to manage this and define what is acceptable the fund managers need to understand the position of the Council to enable them to carry out their work effectively.

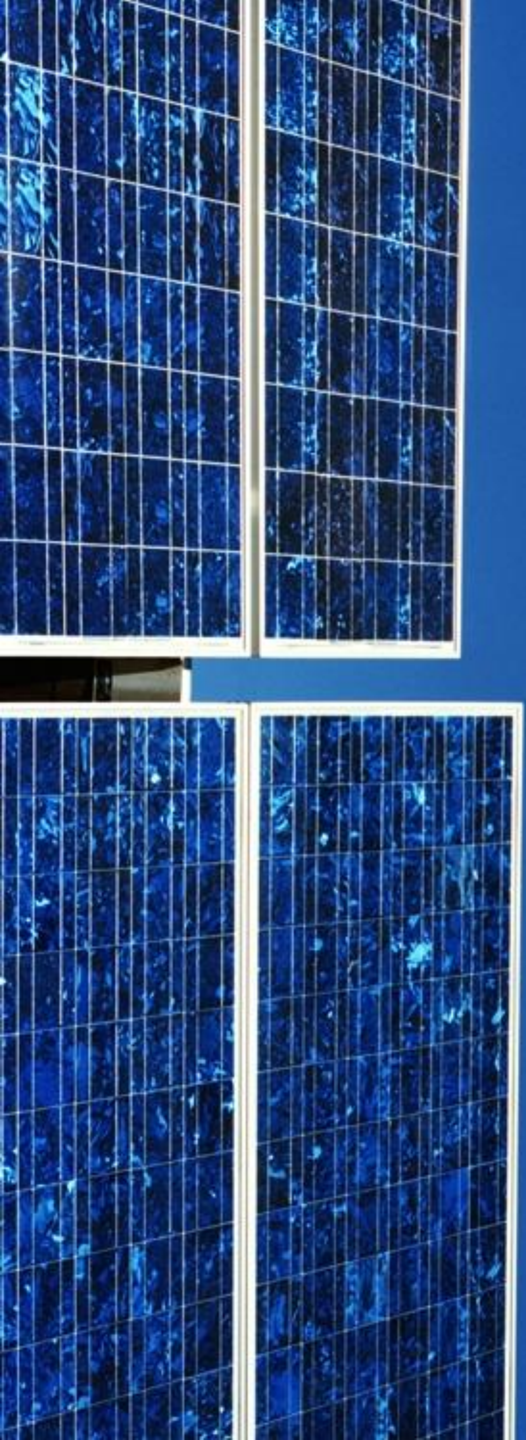
5.4 The approach that the Council has taken in the past is to have a clear policy statement on responsible investments, it is proposed that this continues. The following policy statement seeks to promote a responsible approach, whilst still ensuring that the fiduciary duty of the Council is recognised:

"Whilst the Council's fund managers have delegated powers for the acquisition and realisation of investments, fund managers will be expected as part of their investment process to consider all factors, including the social, environmental and ethical policies of companies in which they may invest, to the extent that these may materially affect the long term prospects of such companies. The fund managers will also be expected to enter into dialogue with companies in which they invest, in relation to the pursuance of socially responsible business practices, and report on these activities.

Corporate Governance is a key responsibility for institutional shareholders and as a matter of principle the Council will seek to exercise all of its voting rights in respect of its shareholdings. It is recognised however that in practical terms this may not always be possible for overseas holdings. However for UK stocks all voting rights will be exercised in a positive fashion, i.e. no abstentions.

The Council's fund managers must have signed up to the United Nations Principles on Responsible Investment. The principles reflect the view that environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios, and therefore must be given appropriate consideration by investors, if they are to fulfill their fiduciary (or equivalent) duty. The Principles provide a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices, and so better align their objectives with those of society at large.

Any fund manager employed by Shetland Islands Council must act in accordance with this policy."



Shetland Islands Council

Investment Strategy and Structure Review

Updated to August 2018

Contents

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Executive Summary

This report reviews the existing strategy and considers changes that could be made to align the investment strategy to the objectives set out in the Medium Term Financial Plan.

The Council should confirm its views on the various aspects of the investment strategy for the Reserves.

Once these have been confirmed, KPMG can propose a manager structure to achieve the desired risk/ return balance in the most efficient manner

Background

- The Council currently has Reserves of c. £334m invested with three fund managers (Baillie Gifford, BlackRock and Insight).
- The Council wishes to review the current investment strategy to ensure that this is aligned with the Council's objectives as outlined in the Medium Term Financial Plan ("MTFP") and in order to fully understand the inherent risks.
- This report provides our views on the existing investment arrangements and considers the suitability of the current investment strategy and of different investment structures and how the strategy could evolve to ensure it remains aligned to the Council's objectives.
- This report has been reviewed to reflect our initial discussions with the Officers to incorporate their initial comments and views on the preferred strategy options.

Your Objectives

- The Council expects to draw down around c.£13m per annum from the Reserves to support revenue and wishes to retain the capital value of the Reserves in real terms based on a CPI measure of inflation.
- The MTFP, outlined by the Council, currently requires the Reserves to target an overall return of 7.3% per annum. This is based on an assumption of future CPI of 2.1% with an additional return of 5.2% then required to meet the c. £13m target level of distribution.
- We believe that the real growth objective outlined by the Council may be challenging to achieve in the current market environment where many return seeking asset classes have relatively full valuations and forecast returns going forward are reduced. But it is achievable in the long term (i.e. over 20 years based on current implied market expectations). Careful consideration should be given to the cyclical nature of market returns.
- We believe that it is possible for the Council to employ an investment strategy that is more aligned with its objectives and which is expected to be more robust in a wider range of economic scenarios.

Recommended Approach

- The Reserves are currently targeting an absolute return of 6.5% p.a. This is below the target return required to deliver on the Council's objectives. The evolution of the existing strategy should reflect this. Given the strength of asset returns over the past 10 years, careful consideration should be given to pursuing a higher target return.
- We also believe that the Council could evolve the existing strategy to better align this to the objectives by: 1) increasing diversification and exposure to assets with a more certain return; 2) increasing the contractual income generated by the assets; and 3) increasing explicit inflation protection within the asset portfolio.
- To achieve the required return and increased alignment with the Council's objectives, we recommend the investment strategy evolves as follows:
  - Exploit credit opportunities;
  - Earn an illiquidity premium; and
  - Increase inflation exposure.
- We have developed several strategies for the Council to consider which introduce a number of new asset classes to incorporate the changes above. The new asset classes considered are:
  - Diversified Credit;
  - Direct Lending;
  - Semi-Liquid Credit;
  - Long Lease Property;
  - Commercial Real Estate Debt; and
  - Diversified Alternatives.
- We believe that an evolution of the existing strategy in a gradual manner rather than a revolution would be preferable.

Next steps

- The Council should confirm:
  - It is comfortable with the objectives set out in this report
  - Its view on the proposed investment strategy and whether there is an appetite to adopt any of the alternatives proposed
  - The timing of any change
- Whilst secondary to the decision on strategic asset allocation, the Council will also need to consider the investment manager line-up.

KPMG

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Introduction

The Council last reviewed the investment strategy employed for the Reserves back in 2012.

The Council wishes to review the strategy to ensure this remains appropriate going forward.

This report reviews the existing strategy and considers changes that could be made to align the investment strategy to the objectives set out in the Medium Term Financial Plan.

Addressee

- This report is addressed to the Shetland Islands Council (the "Council") and considers the investment strategy for the Council's Reserve funds (the "Reserves").

Background

- The Council currently has Reserves of c. £334m invested with three fund managers (Baillie Gifford, BlackRock and Insight). We understand that £31m of this was borrowed from PWLB for capital projects. The first capital repayment is due to PWLB in 10 years (2027).
- The Council wishes to review the current investment strategy to ensure that this is aligned with the Council's objectives as outlined in the Medium Term Financial Plan ("MTFP"). The Council wishes to retain a policy that is sustainable for the long term, which maintains the real value of the Reserves.
- The Council expects to draw down around c. £13m per annum from the Reserves to support revenue and wishes to retain the capital value of the Reserves in real terms based on a CPI measure of inflation.
- The MTFP currently requires the Reserves to target an overall return of 7.3% per annum. This is based on an assumption of future CPI of 2.1% with an additional return of 5.2% then required to meet the c. £13m target level of distribution.
- The return target of CPI plus 5.2% p.a. is challenging but can be achieved over the long term. To put this into context, long dated government bonds currently offer a yield of around CPI minus 1% over the next 5 years. The Council's target equates to the "risk-free" rate plus around 6% per annum over the short-term. Over the longer term, the market expects the gilt yield to increase to c. 2%, implying that the Council's target equates to the risk-free rate plus 5% over the long-term – we note this is still a challenging target, but this longer term lens is appropriate given the Council's objectives for the Reserves.
- We note that achieving the Council's return target requires an aggressive investment strategy, which carries significant investment risk.
- We understand that the Council wishes to review the existing strategy in order to fully understand the inherent risks, and to explore any alternative investment strategies that are better aligned to their objectives.

Scope

- This report provides our views on the existing investment arrangements and considers the following specific areas:
  - The suitability of the current investment strategy;
  - The suitability of different investment structures and our views on how the strategy could evolve to ensure it remains aligned to the Council's objectives;
  - Updated analysis based on our initial discussions with the Council Officers to take into account their views and preferences.
- We have undertaken analysis in order to illustrate the projected development of the Reserves and the risks inherent within a range of potential investment strategies.
- Our analysis is based on the reserve value as at 31 March 2017 and incorporates future anticipated draw downs, over the next 10 years based on the MTFP.

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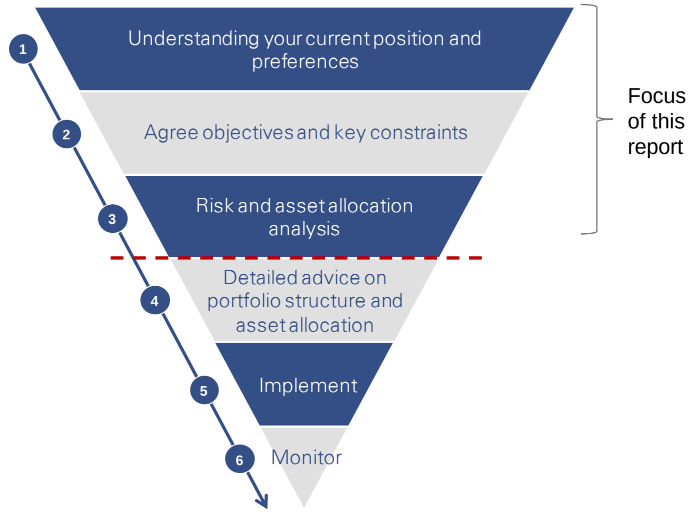
Our Approach to Investment Strategy

The initial stage of any investment strategy setting process is to understand the objectives and prioritise key requirements.

Investment strategy review

- The chart below highlights the key stages in our approach.



Set overall objectives

- When seeking to develop an investment strategy that strikes an appropriate balance between risk and return, it is important to explore the objectives and likelihood of achieving these with an acceptable level of risk.
- We often find this is an iterative process where objects are refined based on the potential risks.
- The Council should review the level of risk required to achieve the target return in order to ensure that this is appropriate.

Balancing risk and return

- We have undertaken analysis of a range of different asset classes and combinations of those asset classes to illustrate the risks and potential returns in order to help the Council evaluate various asset allocations and refine the objectives if required.
- The current level of distributions (c. £13m p.a.) is significant. Reducing volatility in the asset base is an important consideration to ensure the strategy and distribution policy remains robust. Generating income to meet cashflows will be efficient (in avoiding transaction costs). As a long term investor, the Council also has an opportunity to earn an illiquidity premium which we believe it should exploit.
- The alternative strategies we illustrate seek to deliver greater certainty over the growth in assets and in some cases, increased inflation protection to seek to deliver a more robust strategy.

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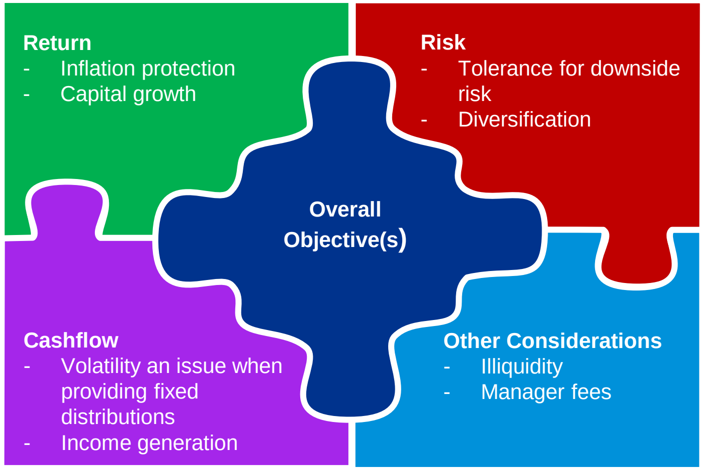
Setting objectives

The initial stage of any investment strategy setting process is to understand the objectives and prioritise key requirements.

Objectives

- The Council has £334m of assets today. Of this, £31m has been borrowed from the PWLB with the first capital repayment due in around 10 years (2027). The Council's current objectives are set out in the MTFP.
  - Maintain the value of the Reserves in real terms (e.g. protect the assets against inflation erosion). The Council expects CPI to average around 2% p.a. over the medium term.
  - Generate investment returns to support distribution of £13m p.a. to support revenue. The Council required a return of around 5.2% p.a. to support this when the MTFP was agreed.
  - Provide sufficient liquidity and stability to meet the reserve's funding objectives.
- The combined objectives of distributing £13m p.a. and returning the real value of Reserves translates to a required return of c. 7.3% p.a. based on the Council's agreed MTFP. This is an explicit return objective set by the Council.
- In additional to the requirement to generate return, the Council has a number of other potentially conflicting objectives that include:
  - **Risk management**: Pursuit of a high return comes with high risk and increased volatility. Volatility of returns is an important consideration when significant distributions are being made each year.
  - **Governance simplicity**: The Council does not have an unlimited governance budget. Consideration of the number and complexity of asset classes, investment strategies and investment managers is an important factor.
  - **Liquidity**: The Council needs to retain sufficient liquidity to meet distributions and to effect any future change in policy.
  - **Income**: Generating income to meet distribution is efficient in avoiding trading costs.
- We believe that the real growth objective outlined above is challenging in the current market environment but achievable over the longer term. Currently, many return seeking asset classes have relatively full valuations and forecast returns going forward expected to be lower.



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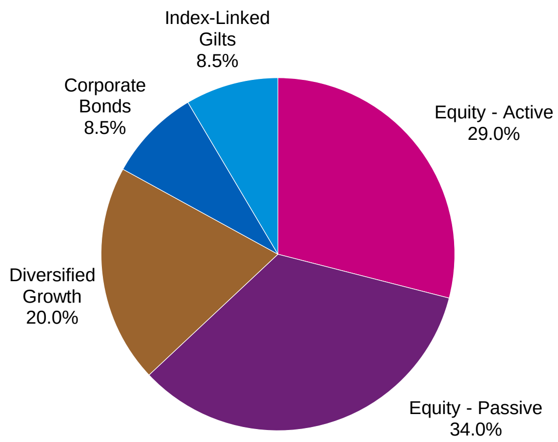
Current strategy - Return

The projected return from the existing portfolio is below the target return of 7.3% p.a. set out in the MTFP.

The current strategy has significant uncertainty over the future return and the potential volatility is a significant issue given the requirement to distribute cash.

There is a significant reliance on equity markets to generate return. This has paid off handsomely in recent years. The US market has returned 165% over the past 8 years (13% p.a.).

Strategic benchmark allocation



Observations

- Based on KPMG's model assumptions, the current investment strategy has an expected absolute return of 6.5% p.a. (i.e. CPI + 4.4% p.a.).
  - This is a best estimate of the future return. We note that there is very significant uncertainty around the forecasted outcome.
- This return is below the target return of 7.3% p.a. set out in the MTFP.

Our initial thoughts

- We believe that the Council could evolve the existing strategy to better align this to the objectives by:
  - Increasing the expected return generated by the investment strategy to achieve the required target rate of return;
  - Manage volatility by introducing assets which generate more contractual income; and
  - Introduce higher yielding assets with explicit inflation linkage to align with the target of maintaining the real value of the Reserves.
- The key changes required to achieve this would include.
  - ***Reduce reliance on equity markets***: The Council retains a heavy reliance on equities for returns (c. 63% of assets excluding the diversified growth fund exposure). We believe the Council could reduce the equity allocation in favour of assets with a more certain return profile and/or switch some passive equity exposure to an actively managed mandate to reduce broad market exposure.
  - ***Exploit credit opportunities***: A well-diversified portfolio of credit instruments exploiting current opportunities can be constructed to deliver an "average expected" return similar to that of equities. This portfolio provides seniority in capital structure together with a higher contractual income.
  - ***Earn an Illiquidity premium***: There is a premium available to investors with a long term horizon (like the Council) who are able to tie up capital in opportunities that are unattractive to banks due to liquidity stress test requirements. Local authorities are one of the few market participants able to exploit this. The Council should consider committing capital to long-term investments that provide relative secure future income flows.
  - ***Increase inflation exposure***: A higher allocation to directly inflation linked assets would provide directional protection against inflation (a key risk given your objectives). The Council could consider a range of long-term inflation-linked assets (e.g. long lease property, infrastructure equity, or increasing index-linked gilt exposure via a synthetic equity fund which has a dual objective of providing both inflation protection and equity exposure).
- We believe that an evolution of the existing strategy in a gradual manner rather than a revolution is preferable.

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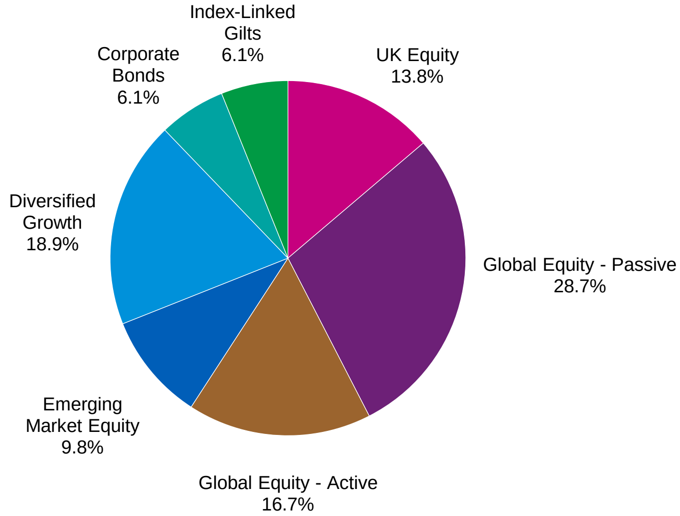
Current Strategy - Risk

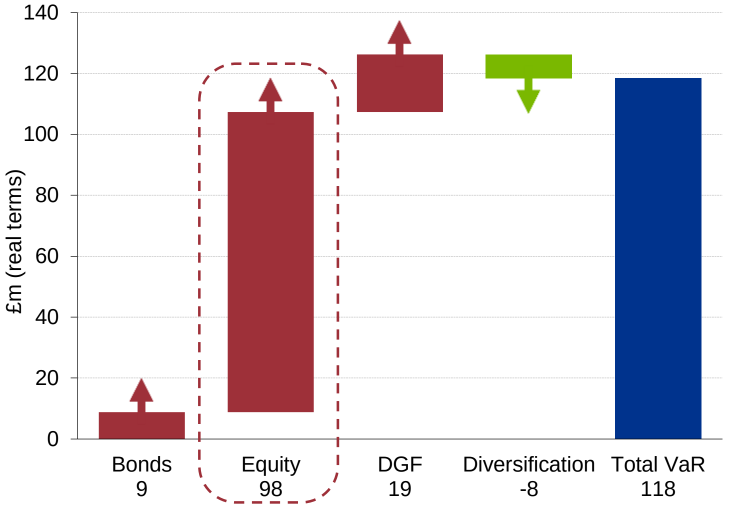
The analysis opposite considers the overall risk inherent in the current strategy. There is currently a significant concentration in equity risk.

We assume £334m of base assets for this analysis.

Actual asset allocation – as at 31 March 2017



Sources of absolute risk (3 year 95% VaR)



VaR: 3 year 95% Value at Risk represents the change in expected portfolio value in 3 years' time under the 1 in 20 worst investment outcome
Analysis date 31 March 2018.

Summary

- To quantify the risk position, and compare the indicative downside impacts, we consider the Value at Risk ("VaR") – a statistical measure of risk. This provides a measure of the difference between the expected fund value and the fund value that could be realised in a specific downside scenario over a given period (e.g. 5% worst investment outcome in 3 years' time).
  - Under the current allocation as shown above, there is a 5% (1 in 20) chance the Fund value could be at least c. £118m lower than expected in 3 years (i.e. c. £216m) in today's terms. We can observe that the majority of risk is concentrated in equity markets.
  - If this scenario was to unfold, the distribution of £13m would equate to c. 6% of the assets at that point. Achieving this and retaining the real value of Reserves the at the new lower level will require a return of above 8% p.a. at that point. This is unlikely to be sustainable.

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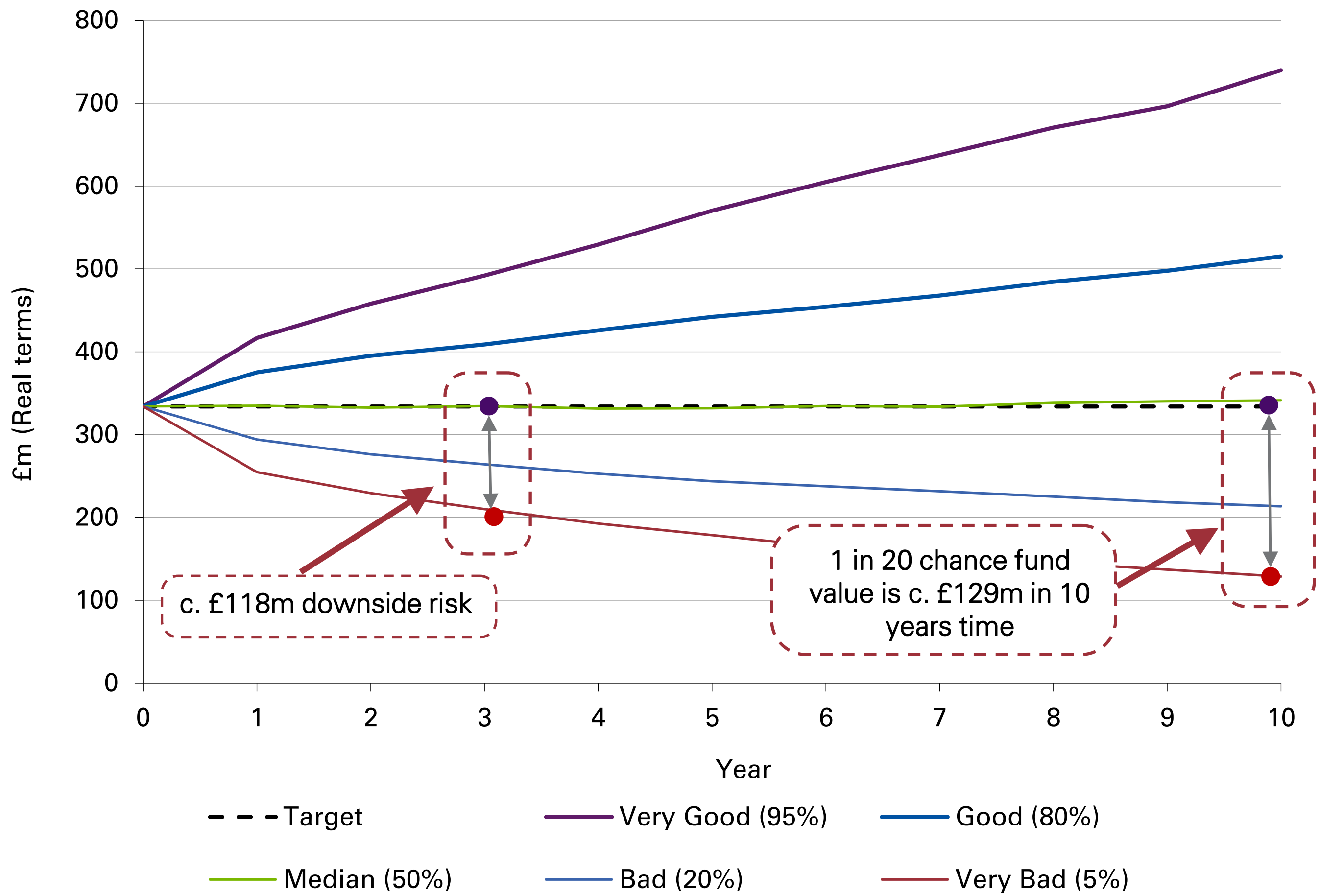
Current Strategy - Projected evolution in real terms

The chart on the right shows the projected fund value in real terms i.e. the value of the fund if valued today, allowing for the impact of future CPI inflation. This allows for an annual distribution of 5% p.a.

Achieving the objective requires the fund value in today's terms to remain constant at £334m in real terms, after making the distribution. There is a 50:50 chance (best estimate) that the fund will fall around £50m behind the objective over the next 10 years.

The arrows illustrate the risks. There is a 1 in 20 chance the fund falls to around £103m in today's terms over the next 10 years.

Projected fund value in real terms
(i.e. the projected value of the fund if valued today, allowing for the impact of future CPI inflation)



Source KPMG: 31 March 2018

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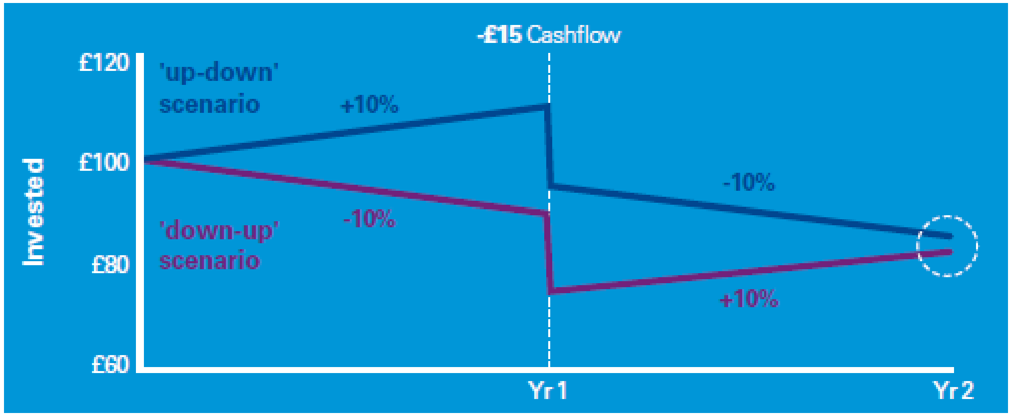
Cashflow and Risk

The distributions are significant and the requirement to meet these should influence the investment strategy.

Volatility is important when cashflow negative.

Cashflow Considerations

- The cashflow needs of the Reserves going forward are important and should be a key consideration when setting the investment strategy.
- For cashflow negative Funds, where outgoings are greater than income, “path dependency” is a key issue. Underperformance followed by outperformance will result in a significantly worse outcome than outperformance followed by underperformance.
- The chart below shows how a £100 portfolio will perform over a 2 year period. The portfolio experiences either 10% outperformance or -10% underperformance in the first year after which a £15 cashflow leaves the portfolio, followed by a rebound in markets. The outcomes are different.



- Reducing volatility in the portfolio is beneficial in managing this risk. The concentration of risk in equity markets means that performance in a single asset class could undermine the existing policy. We believe increasing diversification and reducing volatility will help make the existing strategy and policy more robust.

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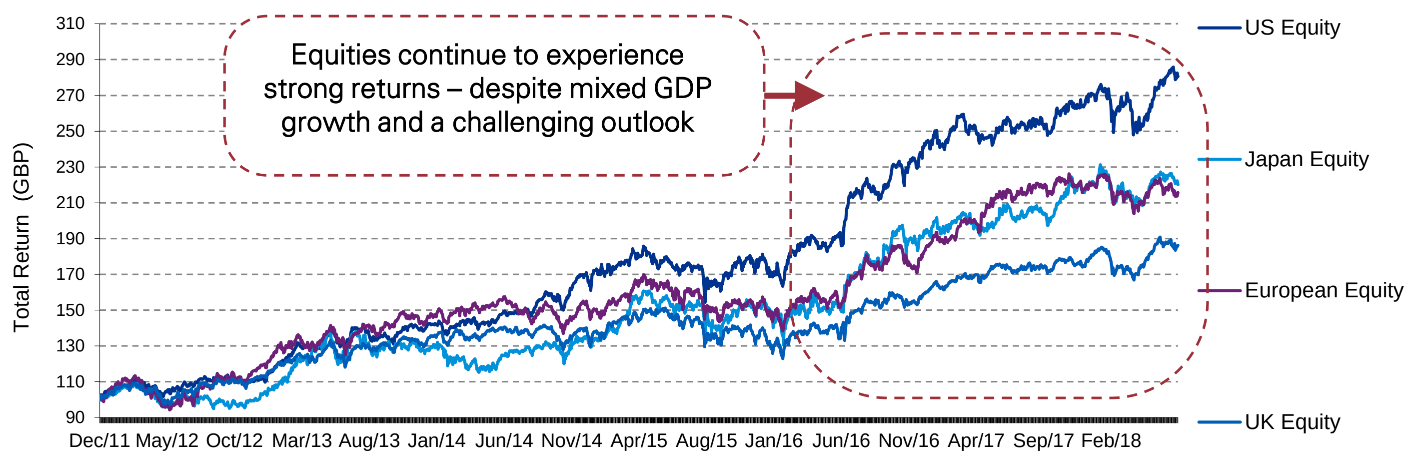
Key risk exposures - Equity risk

The Council retains a significant allocation to UK and global equities as a driver of long term returns.

In the current environment, we **believe** there is a reasonable rationale to reduce equity risk to exploit a wider range of high returning investment opportunities. This could be done by reducing or reshaping the equity allocation.

Equity risk

- The Council retains a significant allocation to UK and global equities as a driver of long term returns. Given the requirement to generate high returns, equities will remain at the heart of the long term growth focussed investment strategy for the Reserves given its long term investment horizon and its ability to tolerate some short term volatility.
- To date, this equity risk has paid off for the Reserves with equity markets marching higher supported by global quantitative easing and central government stimulus despite a challenging economic backdrop.
- It is inherently difficult to time entry and exit from equity markets and tactical calls on markets are extremely difficult for even the most well resourced and highly regarded asset managers.
  - Equity markets have performed extremely well since 2009 and many developed market indices have hit new or multi decade highs.
  - A number of market valuations now look relatively stretched (the US in particular) on a number of measures (i.e. cyclically-adjusted price earnings, price/ earnings, price to book).
  - In the current environment, we believe there is a reasonable rationale to reduce equity risk to exploit a wider range of high returning investment opportunities that should prove more robust if the economic environment deteriorates.
  - Given the strategic objectives, we believe the Council could continue to reduce equity market exposure in favour of other opportunities in order to broaden return drivers in the investment strategy and increase the certainty over the returns to support the MTFP.
- We would also be supportive of switching some of the passive equity exposure to an actively managed approach with a focus on providing increased downside protection should equity markets materially sell off. However, we note that, typically, active manager outperformance comes and goes and it is challenging to find an active manager who persistently outperformed. Active management also carries a significantly higher cost.



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Key risk exposures - Inflation protection

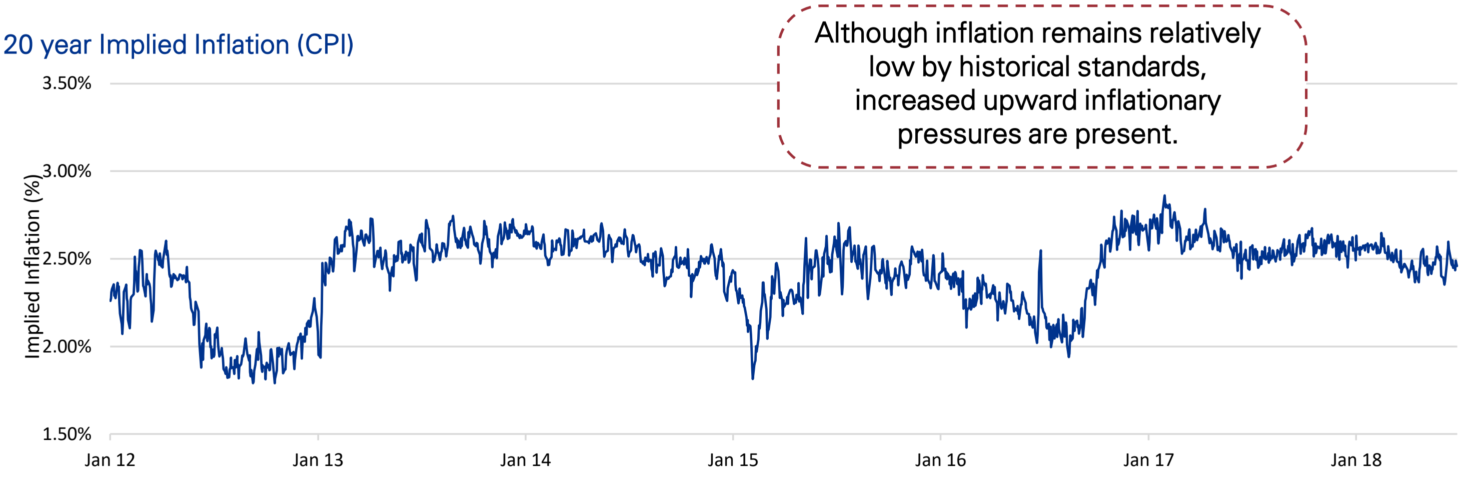
The Council has stated an objective to maintain the value of the Reserves in real terms.

Inflation is expected to increase over the next few years. As the assets do not currently have a significant link to inflation, any rapid increase in inflation would be detrimental.

Inflation risk

- The Council has stated an objective to maintain the value of the Reserves in real terms. The existing portfolio has little direct inflation protection, with only c. 6% of the assets (as at 31 March 2017) providing a direct inflation link via the Index-Linked Gilt allocation. Whilst equities tend to provide long term inflation-linked exposure, historical analysis shows they tend to underperform in short periods of sharp inflation increases.
- Despite a benign inflation environment over the past few years, recent market events and easing monetary policy have increased upward inflation pressures (both UK and global) and inflation is expected to increase over the next few years. As the assets do not currently have a significant link to inflation, any rapid increase in inflation would be detrimental, and erode the real value of the Reserves.
- The Fund could consider the following options to increase its inflation protection:
  - ***Directly***: The Fund could invest in assets directly linked to inflation, for example: Long Lease Property (inflation-linked capital values and rental repayments); Index-linked gilts (coupon and principal payments linked to inflation); Infrastructure assists with inflation-linked income;
  - ***Synthetically*** (included as part of initially proposed strategies): A key tool in increasing inflation protection without impacting expected returns is to replace physical equity exposure with "equity linked bond funds". This acts to retain the Fund's equity exposure, via derivatives, while also providing inflation exposure via index-linked gilt holdings. This is a relatively recent development and one that is becoming increasingly popular for institutional investors.
- We believe the Council should consider the above options to increase inflation protection, whilst seeking to preserve the expected return.

20 year Implied Inflation (CPI)



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Alternative Strategies - Initial strategic analysis

We have analysed a range of investment strategies for the Council to consider.

The initial proposed strategies looked to more closely align the investment strategy to the stated objectives.

Discussion points

?

Which asset classes should the Council consider and how do we combine these?

Key considerations

- The investment strategy (asset allocation) will determine the risk and return profile for the Reserves. The asset manager selection decision is very much second order relative to the strategic asset allocation.
- Various strategic asset allocations will give rise to different levels of expected investment growth (return); and expected levels of volatility or downside risk.

Initial strategic advice

- In July 2017, we provided the Council with four alternative strategies which looked to:
  - Broadly maintain, or marginally increase, the expected return
  - Reduce the Reserve's reliance on equities to drive growth
  - Increase the Reserves inflation exposure
  - Exploit attractive credit opportunities
  - Earn an illiquidity premium via long-dated assets.
- We initially proposed four alternative portfolios (see overleaf), which introduced a number of new asset classes:
  - ***Diversified credit*** offers exposure to a wide range of credit markets – diversified across geographies and across the full credit spectrum, via a single, actively managed, pooled fund.
  - ***Private credit/ direct lending*** opportunities offer an attractive yield by exploiting an illiquidity premium for long-term investors.
  - ***Long Lease Property*** provides an alternative source of long-dated, inflation-linked income.
  - ***Real Estate Debt*** offers an attractive income yield for investors with long-term investment horizons, an appetite for risk and a desire to reduce reliance on non-contractual asset classes.
  - ***Synthetic Equity*** is an efficient way to capture the equity risk premium whilst allowing underlying assets to be used for other purposes such as increasing inflation exposure through increased index-linked gilt holdings.

Initial strategies proposed

- In our initial discussions, we outlined three alternative high level investment strategies for the Council to consider.

  1. ***Diversified***: We introduce four new asset classes. Expanding the range of growth drivers, beyond equities, allows the reserves to target a higher return, which is has greater direct inflation linkage, whilst also reducing volatility.

  2. ***Return Focus***: This strategy seeks to maximise return whilst managing volatility.

  3a. ***Inflation Focus***: Given the expected focus of the Council on protecting the real value of the reserve assets against inflation erosion, we consider a strategy where the investments have a higher exposure to inflation (direct and indirect). This is more closely aligned with the Council's objectives, delivering a similar expected return as the diversified strategy.

  3b. ***Inflation Focus (strategic risk management)***: We introduce a strategy with very significant direct protection against inflation. The strategy makes use of a synthetic equity mandate, which allows increased holdings in index-linked gilts whilst maintaining equity exposure.

- The initially proposed strategies formed part of the initial discussions with the Officers to reflect the Officers views.
- We have included the summary above and analysis overleaf of the initial portfolios for reference.
- Following discussions with the Officers we analysed four further strategies with a primary focus on moving the expected return of the portfolio in line with the specified target return.

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Alternative Strategies - Initial strategic analysis

Asset Classes	0. Current Strategic Benchmark	1. Diversified Strategy	2. Return Focus Strategy	3a. Inflation Focus Strategy	3b. Inflation Focus Strategy (strategic risk mgmt.)
Equity – Active	28.0%	20.0%	28.0%	20.0%	25.0%
Equity – Passive [1]	35.0%	30.0%	35.0%	35.0%	-
Synthetic Equity	-	-	-	-	35.0%
Diversified Growth	20.0%	15.0%	17.0%	10.0%	10.0%
Corporate Bonds	8.5%	-	-	-	-
Index-Linked Gilts	8.5%	-	-	10.0%	-
Diversified Credit	-	10.0%	-	-	-
Direct Lending	-	5.0%	10.0%	5.0%	7.5%
Long-Lease Property	-	15.0%	-	15.0%	15.0%
Junior Real Estate Debt	-	5.0%	10.0%	5.0%	7.5%
Target return p.a.	**7.3%**				
Exp. Return (absolute) p.a. [2]	6.5%	6.7%	7.3%	6.6%	6.8%
1 year VaR [3]	£80m	£67m	£79m	£69m	£73m
Target fund size (real terms)	**£334m**				
Expected fund size in 10 years (real terms)	£341m	£370m	£368m	£378m	£367m
5% worst case scenario in 10 years (real terms)	£129m	£147m	£149m	£150m	£148m
Inflation exposure	**8.5%**	**15.0%**	**0.0%**	**25.0%**	**50.0%**

Notes: Analysis carried out as at 31 March 2018. All fund values quotes in real terms based on CPI. We have assumed CPI = RPI - 1% p.a. [1] Passive equity exposure includes existing Passive Emerging Market Equity exposure [3] Expected return uses 20 year gilt yield for reference. [3] Value at Risk ("VaR") measure represents the change in expected value of the portfolio in 1 year under the 1 in 20 (5%) worst investment outcome.

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Alternative Strategies - Revised strategic analysis

Following discussions with the Officers, we considered a further range of alternative strategies. These incorporate the views of the Officers, and look to focus on achieving the required return target and minimising any additional governance burden on Council.

We have included an allocation to a Diversified Alternatives mandates to simplify governance. This provides an efficient way to access an illiquidity premium within a diversified fund.

Key considerations

- Following the initial discussions between the Officers and KPMG on the initial strategy analysis, the Officers confirmed that:
  - The Council requires the Reserves to target an overall return of 7.3% p.a. (this is based on an assumption of future CPI of 2.1% with an additional return of 5.2% then required to meet the c. £13m p.a. target distribution).
  - They are comfortable retaining a significant equity exposure.
  - They wanted to minimise the extent of any additional governance that would arise from each alternative strategy in terms of the number of additional managers involved.
- As a result of the discussions and proposed direction of travel, we revised the alternative strategies initially proposed, to reflect the Officers' views.

Revised strategies

- To achieve the Council's target of achieving an overall expected return of at least 7.3% p.a. the resulting alternative investment strategies retain higher equity risk and do not deliver any explicit inflation-linkage.
- The revised strategies introduce two new asset classes to those added as part of the initial proposals:
  - ***Semi-Liquid Credit*** *which represents a portfolio of traditional (liquid) and alternative (illiquid) credit, targeting returns at the higher end of the spectrum in exchange for modest levels of complexity or illiquidity.*
  - ***Diversified Alternatives*** *funds offer exposure to a broad range of private market opportunities such as private equity, private debt, private real estate and infrastructure within a single fund.*
- We recommend that the Council considers the risk/return characteristics of the alternative portfolios in order to determine which approach is best aligned to its key objectives. This requires the expected return to be balanced against the risks involved (equity risk, inflation risk etc.) and the governance burden of addressing these.

Final proposed strategies

- Overleaf we present four alternative investment strategies for the Council to consider, which incorporate the views expressed by the Officers as part of our earlier discussions:
  1. ***Introducing Direct Lending and Diversified Alternatives***: This strategy seeks to increase diversification and exploit an illiquidity premium through the introduction of Direct Lending and Diversified Alternatives.
  2. ***Introducing Semi-Liquid Credit and Diversified Alternatives***: This strategy seeks to increase diversification and manage volatility through the introduction of Semi-Liquid Credit and Diversified Alternatives.
  3. ***Introducing JCRED and Diversified Alternatives***: This strategy seeks to increase diversification and increase expected return by introducing Commercial Real Estate Debt and Diversified Alternatives.
  4. ***Introducing Diversified Credit and Direct Lending***: This strategy seeks to increase diversification and manage volatility through the introduction of Diversified Credit and Direct Lending.

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Alternative Strategies – Revised strategic analysis

Asset Classes	0. Current Strategic Benchmark	1. Introducing Direct Lending and Diversified Alternatives	2. Introducing Semi-Liquid Credit and Diversified Alternatives	3. Introducing JCRED and Diversified Alternatives	4. Introducing Diversified Credit and Direct Lending
Equity – Active	28.0%	40.0%	40.0%	40.0%	40.0%
Equity – Passive [1]	35.0%	20.0%	20.0%	20.0%	20.0%
Diversified Growth	20.0%	15.0%	15.0%	15.0%	15.0%
Corporate Bonds	8.5%	-	-	-	-
Index-Linked Gilts	8.5%	-	-	-	-
Diversified Credit	-	-	-	-	12.5%
Direct Lending	-	12.5%	-	-	12.5%
Semi-Liquid Credit	-	-	12.5%	-	-
Junior Real Estate Debt	-	-	-	12.5%	-
Diversified Alternatives [2]	-	12.5%	12.5%	12.5%	-
Target return p.a.			**7.3%**		
Exp. Return (absolute) p.a. [3]	6.5%	7.3%	7.3%	7.5%	7.2%
1 year VaR [4]	£80m	£75m	£75m	£74m	£73m
Target fund size (real terms)			**£334m**		
Expected fund size in 10 years (real terms)	£341m	£370m	£368m	£378m	£367m
5% worst case scenario in 10 years (real terms)	£129m	£147m	£149m	£150m	£148m
Inflation exposure [5]	**8.5%**	**c. 6.0%**	**c. 6.0%**	**c.6.0%**	**-**

Notes: Analysis carried out as at 31 March 2018. All fund values quotes in real terms based on CPI. We have assumed CPI = RPI - 1% p.a.. [1] Passive equity exposure includes existing Passive Emerging Market Equity exposure [2] Modelling of Diversified Alternatives Fund based on an example manager's long-term target allocation. [3] Expected return uses 20 year gilt yield for reference. [4] Value at Risk ("VaR") measure represents the change in expected value of the portfolio in 1 year under the 1 in 20 (5%) worst investment outcome [5] Assumes c. 50% of diversified alternatives exposure is linked to inflation.

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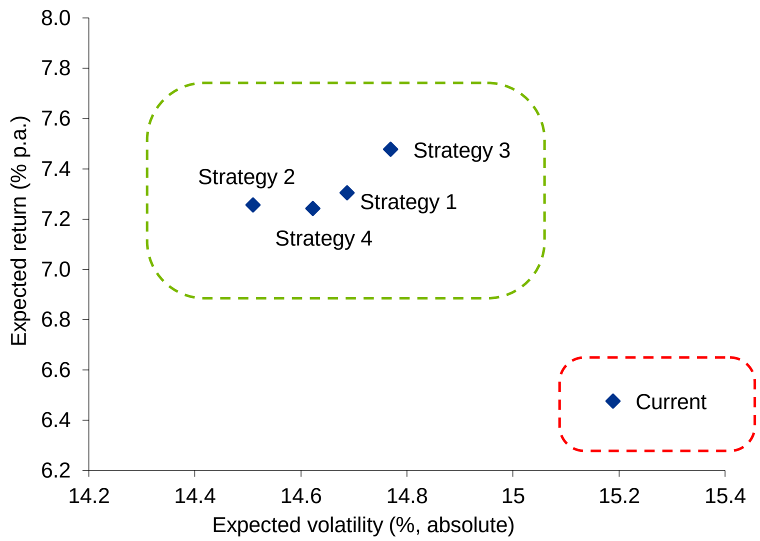
Alternative strategies - Focus on return requirement

The alternative strategies offer a range of expected returns, with varying degrees of risk.

Summary of the alternative strategies being considered

- Each of the alternative strategies targets a higher expected return than the current asset allocation, but with a different strategic focus.
  - The ***Introducing Direct Lending and Diversified Alternatives*** strategy targets a higher expected return than the current strategy (increase in expected return of 0.8% p.a.) by switching the bond mandates, and a portion of the Fund's equity and DGF exposure into a Direct Lending mandate, which provides longer-dated and more contractual returns at a broadly similar level to equities, and a Diversified Alternatives mandate, which provides exposure to the wider alternatives universe.
  - The ***Introducing Semi-Liquid Credit and Diversified Alternatives*** strategy is similar to the previous strategy and also targets a higher return (again, increasing expected returns by 0.8% p.a.) using a similar method but invests in a Semi-liquid credit mandate instead of a Direct Lending mandate. This strategy offers more liquidity than the previous strategy, albeit with a marginally lower expected return but increased diversification.
  - The ***Introducing JCRED and Diversified Alternatives*** strategy introduces a Junior Commercial Real Estate Debt mandate alongside a Diversified Alternatives mandate. This strategy targets the highest expected return out of the alternative strategies, but is the most illiquid, given the nature of JCRED.
  - The ***Introducing Diversified Credit and Direct Lending*** strategy targets the lowest expected return of the alternative strategies, and offers the most liquidity among the alternative strategies.

Risk versus Expected Return



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Summary and next steps

The Council should confirm their views on the various aspects of the investment strategy for the Reserves.

Once these have been confirmed, KPMG can propose a manager structure to achieve the desired risk: return balance in the most efficient manner.

Summary

- The Council has explicit objectives of delivering distributions of £13m per annum and maintaining the value of the Reserves in real terms.
  - The current investment strategy is targeting an absolute return of 6.5% p.a. which is below the target required to achieve the Council's objective
- We believe that the real growth objective outlined by the Council may be challenging to achieve in the current market environment where many return seeking asset classes have relatively full valuations and forecast returns going forward are reduced, but is achievable over the long term.
- We believe that it is possible for the Council to employ an investment strategy that is more aligned with its objectives and which is expected to be more robust in a wider range of economic scenarios.
- The Council should consider the alternative strategies outlined in this report and determine whether any change is desired. The Council need to balance the risks against the target return objective and also consider the governance of any new strategy.

Next steps

- The Council should confirm:
  - If they are comfortable with the objectives set out in this report;
  - Their view on the proposed investment strategies and whether there is an appetite to adopt any of the alternatives proposed;
- Whilst secondary to the decision on the strategic asset allocation, the Council will also have to consider the Reserves investment manager line-up:
  - Depending on the Council's views and decisions on the investment strategy, there may be a requirement to select new investment managers for new asset classes/strategies, if adopted.
- We look forward to discussing this report with the Council.

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Appendices

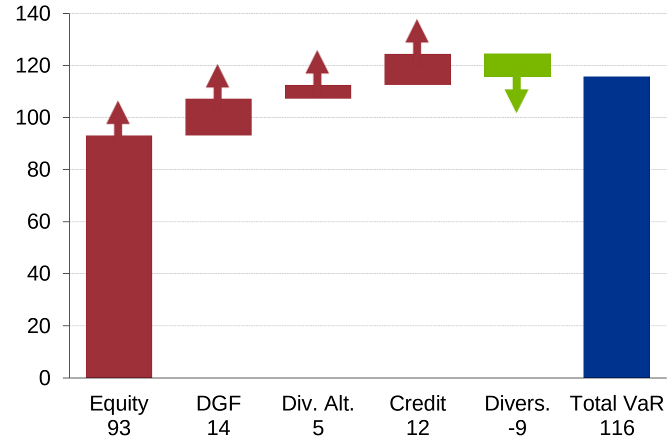
Alternative Strategies – Risk breakdown

Analysis date 31 March 2018.

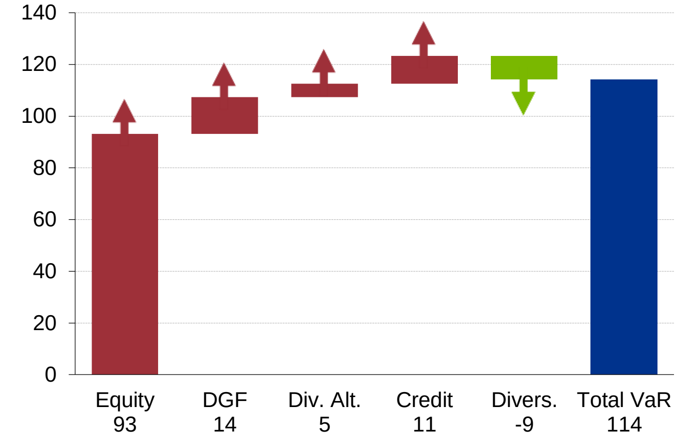
VaR: 3 year 95% Value at Risk represents the change in expected portfolio value in 3 years' time under the 1 in 20 worst investment outcome.

Sources of absolute risk (3 year 95% VaR) - £m (real terms)

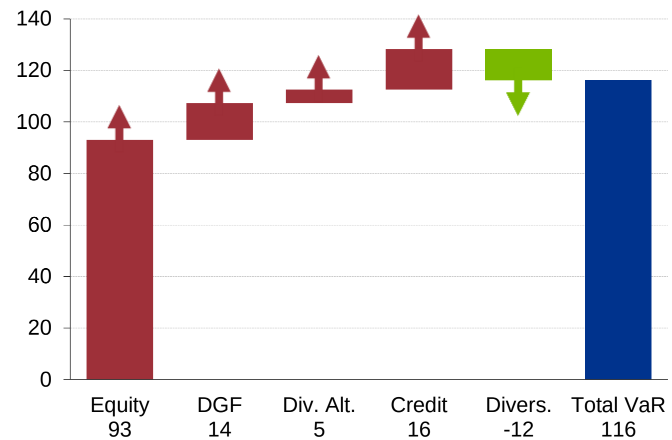
1. Introducing Direct Lending and Diversified Alternatives



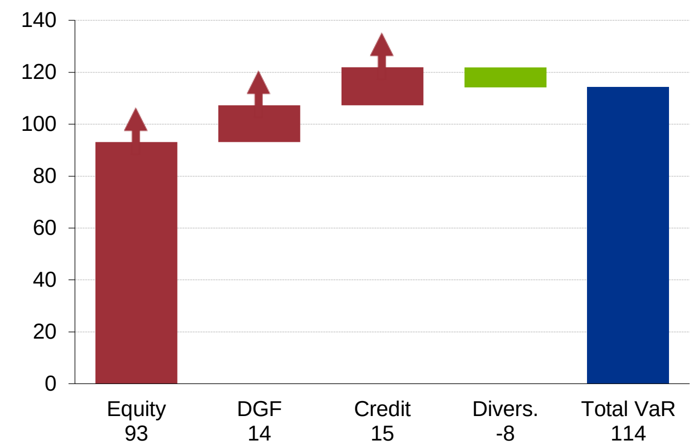
2. Introducing Semi-Liquid Credit and Diversified Alternatives



3. Introducing JCRED and Diversified Alternatives



4. Introducing Diversified Credit and Direct Lending



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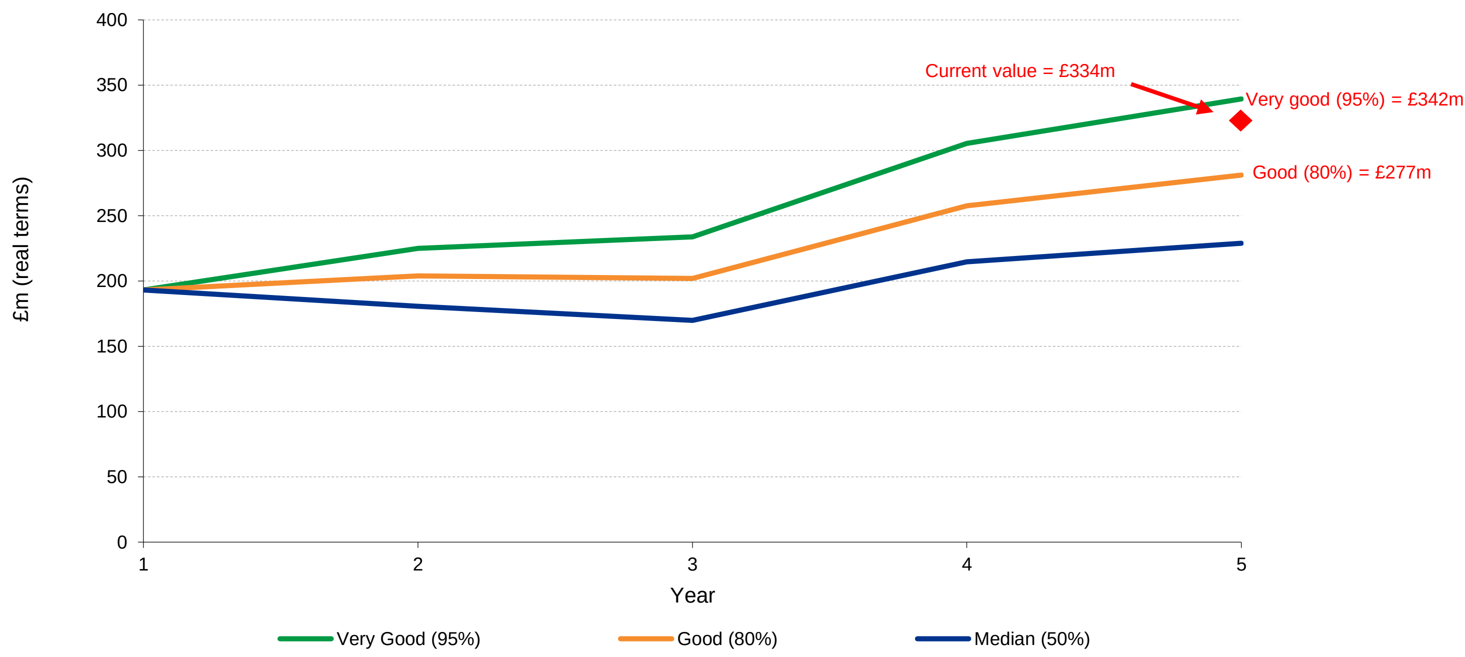
Current Strategy - historic 5 year projected evolution

The chart opposite illustrates the projection of the Reserve Fund's assets over a 5 year period from March 2012.

This is based on the Fund's asset valuation of £193m, as at 31 March 2012, and is based on our latest quarterly market assumptions as at 31 March 2018.

The analysis also includes known net cashflows which either paid out of or into the Reserve Fund over this time period. These are shown in the table.

Year	Net cashflows
2012/13	(£16m)
2013/14	(£16m)
2014/15	£46m
2015/16	£9.8m
2016/17	(£20m)



- The current asset value of £334m lies between the "good" and "very good" outcomes, this has been driven by the high allocation to equities and the exceptionally strong equity market performance during this period.

Source KPMG: 31 March 2018

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Diversified Credit

Diversified Credit Funds ("DCF") provide investors with an efficient vehicle by which to access a global pool of credit opportunities. A DCF can provide investors with a more contractual payoff profile and can improve the risk/return profile of an exiting investment strategy.

Diversified Credit portfolios consist of primarily Investment Grade, High Yield and Emerging Market Debt, but managers have discretion to access other areas within credit markets such as Bank Loans and Asset / Mortgage backed securities.

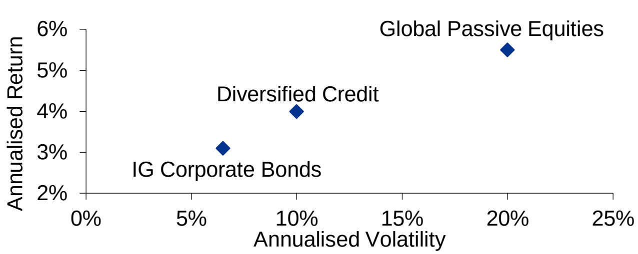
Diversified Credit Fund is a cost and risk–return efficient way to access a broader opportunity set within the credit spectrum.

- The different dynamics within each market means that there is a potential benefit from having exposure to a number of different fixed income markets, and tactically adjusting these allocations over time.
- Investing in a combined fund reduces the governance burden of appointing numerous mandates in each underlying credit sub-asset class and eliminates the need to time an allocation to each of these fixed income segments

Diversified Credit Funds seek to generate majority of the returns from credit risk, and to a lesser extent from other risks like duration, political and currency risks.

Similar to other credit funds, outperformance relative to benchmark is usually from asset allocation and stock selection, both of which are dependent on manager skill.

Historic Risk/Return profile



Expected Return	Low	High	Gilts + 2.5% p.a.
Expected Volatility	Low	High	8% - 10% p.a.
Shape of Outcomes	0% Contractual	100% Contractual	Mostly contractual
Liquidity	Immediate	Long	Immediate
Diversification	Concentrated	Highly Diversified	Diversified
Management Fee	Low	High	0.5% - 0.7% p.a.
Performance Fee	No	Yes	No

Implementation Considerations

Availability	Segregated and Pooled options available
Governance	Low, standard quarterly monitoring
Trading Costs	0.00% - 0.50%
Turnover	Medium to high turnover of underlying investment
Lock-Ins	None
Active / Passive	Active
Geography	Global

Past Performance

Year	2017	2016	2015	2014	2013
Example Fund	4.5%	6.7%	1.2%	1.4%	7.2%

Note: Performance is based on M&G Alpha Opportunities Fund GBP A Share class

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Direct Lending

Direct Lending offers institutional investors with long-term investment horizons an opportunity to replace banks in lending to middle market companies in exchange for attractive risk adjusted return.

Traditionally, European middle market companies (e.g. EBITDA of around £10m-£250m) relied on banks to raise capital for refinancing, acquisitions and restructuring. As banks have reduced lending activities in the aftermath of the financial crisis, institutional investors that can afford to lock up their capital for up to 10 years have the opportunity to step into the role traditionally played by banks and capture attractive risk-adjusted returns.

Direct lending refers to loan investments originated by a dedicated asset manager to a range of borrowers, typically medium sized businesses.

Returns of the asset class are derived primarily through coupon payments and origination fees, making them contractual in nature, although higher return strategies can also include Payment in Kind ("PIK"), which is a form of equity participation.

Key features of direct lending include:

- Senior position in capital structure leads to relative security in event of default;
- Access to illiquidity premium rewarding the investor for investing in an asset that cannot readily be sold;
- Customisation and regular monitoring (quarterly) of covenants (terms & conditions) means greater control to prevent defaults;
- Limitations on issuer activities which are not beneficial to the senior lenders (e.g. restriction on payment to junior debt holders prior to senior lenders being paid);

Key risks include:

- Default risk, although direct lending benefits from much better recovery rates than bond investors.
- Prepayment risk (capital being returned to investor sooner than expected), however this is partially mitigated by penalties.

The financing gap for Small and Medium Enterprises offers pension schemes an attractive opportunity to provide financing via pooled funds. Direct lending across the capital structure provides more attractive risk adjusted returns compared to the bank loan markets.

Expected Return	Low	High	Libor + 4-10% p.a.
Expected Volatility	Low	High	8-10% p.a.
Shape of Outcomes	0% Contractual	100% Contractual	Contractual
Liquidity	Immediate	Long	Long
Diversification	Concentrated	Highly Diversified	Diversified
Management Fee	Low	High	0.8-1.25% p.a.
Performance Fee	No	Yes	8-15% p.a. subject to return hurdle

Implementation Considerations

Exp Holding Period	5-10 years
Availability	Segregated and pooled options available
Governance	Medium, standard quarterly monitoring
Trading Costs	None
Turnover	Low
Lock-Ins	Withdrawals are not permitted. Capital will be distributed towards the end of the Fund's life.
Active/ Passive	Active
Geography	Mixture of regional and global

Past Performance

Vintage Year	2016	2015	2014	2013	2012
Example Fund	4.9%	6.3%	4.2%	4.4%	6.0%

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Semi-Liquid Credit

Semi-Liquid Credit ("SLC") is an active strategy comprised of a diversified portfolio of traditional (liquid) and alternative (illiquid) credit. SLC targets returns at the higher end of the spectrum in exchange for modest levels of complexity or illiquidity.

SLC managers combine traditional high return liquid credit (e.g. High Yield) with allocations to alternative credit opportunities that benefit from illiquidity (e.g. Real Estate Debt) and/or complexity (e.g. Structured Credit) premiums.

SLC managers have a high degree of flexibility to shift allocations across individual sub-asset classes as their views of market conditions change, which has the potential to further benefit investors through either higher return or lower risk.

The strategy fills the gap (in terms of risk, return and liquidity) between the liquid and illiquid credit asset classes that pension schemes typically invest in. This makes it particularly suitable for clients that are looking to replace their equity (or other non-contractual high return allocations) without incurring a material reduction in expected return or the illiquidity from investing in closed-ended Funds.

Characteristics that we look for in a Semi-Liquid Credit strategy include:

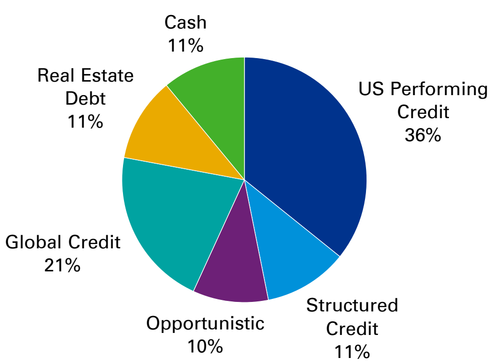
Core holdings of Investment Grade, High Yield and Loans, combined with opportunistic allocations to alternative credit

— Minimal leverage at the Fund level

— Lower credit risk than funds limited to High Yield and Loans

— Low correlation with other major asset classes.

Allocation of a sample Semi-Liquid fund



Expected Return	Low	High	Gilts +3.5% p.a.
Expected Volatility	Low	High	6% to 10% p.a.
Shape of Outcomes	0% Contractual	100% Contractual	>50% contractual
Liquidity	Immediate	Long	Medium
Diversification	Concentrated	Highly Diversified	Diversified
Management Fee	Low	High	0.6% to 0.9% p.a.
Performance Fee	No	Yes	No performance fee

Implementation Considerations

Availability	Limited number of pooled funds currently available
Governance	Moderate, standard quarterly monitoring
Trading Costs	Fund specific
Turnover	High turnover of underlying investments
Lock-Ins	Quarterly liquidity, some initial annual lock ups
Active/ Passive	Active
Geography	Global

Past Performance

Year	2017	2016*	2015*
Example Fund	5.0%	6.3%	2.6%

Note: Performance is the performance of the example manager's pooled fund. *Performance shown for the pooled fund is for the USD share class.

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Junior Commercial Real Estate Debt

Investors with long-term investment horizons, an appetite for risk and a desire to reduce reliance on non-contractual asset classes may wish to consider an allocation to Junior Commercial Real Estate ("CRE") Debt.

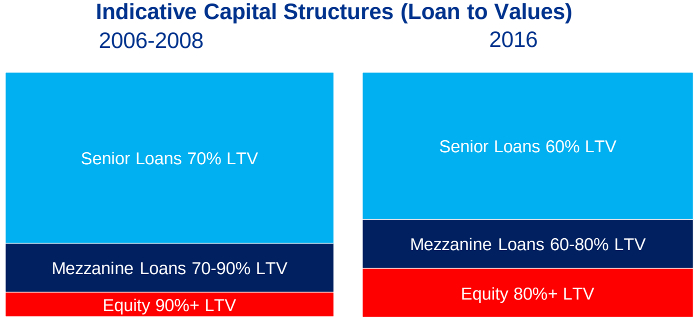
Until recently, financing of European CRE purchases was done almost entirely via commercial banks; however, they have increasingly withdrawn from this space since the financial crisis. As a result, institutional investors that can afford to lock-up their capital for 8-10 years (e.g. Pension Schemes) have the opportunity to fill in this gap and reduce their reliance on non-contractual asset classes (e.g. equity) as primary return drivers.

Prior to the financial crisis, junior loans were typically supported by an equity cushion of 5-15%, this ratio has now increased to 10-20%. This has been in favour of CRE debt holders as a larger proportion of equity in the capital structure increases the 'cushion' to protect debtholders from falls in property values.

Unlike traditional property investments, which rely heavily on capital appreciation for returns, the returns on CRE loans come primarily in the form of coupon payments and origination and prepayment fees. This increases the certainty of returns and reduces reliance on property values to drive returns.

Key investment risks for CRE loans include falls in rental income, falls in property values, increases in vacancy rates and a lack of investors to refinance loans upon maturity. These risks are partly mitigated by hard asset collateral, strong covenant clauses, return generated through current income and increasing equity cushions.

Indicative Capital Structures (Loan to Values)



Expected Return	Low	High	Gilts + 5.0%
Expected Volatility	Low	High	15 - 20% p.a.
Shape of Outcomes	0% Contractual	100% Contractual	>50% Contractual
Liquidity	Immediate	Long	Long
Diversification	Concentrated	Highly Diversified	Concentrated
Management Fee	Low	High	1.0-1.5% p.a.
Performance Fee	No	Yes	15% over 8% with catch-up

Implementation Considerations

Exp Holding Period	8-10 years
Availability	Relatively small range of Funds
Governance	Medium ongoing governance (drawdowns)
Trading Costs	None
Turnover	Low turnover of underlying investments
Lock-Ins	Possible but not expected
Active / Passive	Active

Past Performance

Vintage Year	2009-11 Vintage	2012-14 Vintage	2016-17 Vintage
Example Fund	13.5%	13.0%	13.0%

Note: Performance is the performance of the example manager's pooled fund. *Performance shown for the pooled fund is for the USD share class.

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Diversified Alternatives

Diversified Alternatives funds offer pension schemes a simple way to diversify away from public markets via traditional Equity and/or Diversified Growth Funds, and provides a convenient way to access an illiquidity premium.

Diversified Alternatives funds offer exposure to a broad range of private market opportunities such as private equity, private debt, private real estate and infrastructure within a single fund.

These funds provide a simple solution for accessing different segments of private markets with a low administrative burden. The investment manager can tactically allocate to the best private market opportunities and manages the drawdowns and distributions within the fund.

Hence, Diversified Alternatives funds offer clients of all sizes the opportunity to increase diversification and benefit from the illiquidity premium of private market assets.

Diversified Alternatives funds offer several appealing characteristics:

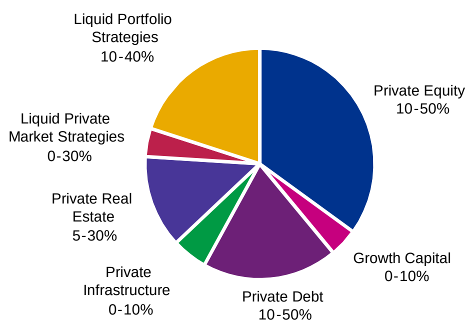
— Attractive risk adjusted returns with low historic volatility compared to other asset classes;

— Simple, cost effective access to a range of private market opportunities with low governance requirements;

— Low historic correlation with public markets such as equities; and

— Higher liquidity than a direct investment in the underlying assets.

Allocation of a sample Diversified Alternatives Fund



Expected Return	Low	High	Gilts + 6.0%
Expected Volatility	Low	High	7% - 10% p.a.
Shape of Outcomes	0% Contractual	100% Contractual	>25% Contractual
Liquidity	Immediate	Long	Medium
Diversification	Concentrated	Highly Diversified	Diversified
Management Fee	Low	High	1.0% to 1.5% p.a.
Performance Fee	No	Yes	12.5% with high watermark

Implementation Considerations

Availability	Segregated and Pooled options available
Governance	Low governance
Trading Costs	No explicit costs (single swinging price)
Turnover	Low turnover of underlying investments
Lock-Ins	Monthly liquidity with gating for large withdrawals
Active / Passive	Active
Geography	Predominantly US and Western Europe

Past Performance

Year	2015	2014	2013	2012	2011
Example Fund	8.5%	12.0%	13.5%	6.5%	10.2%

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Return and Volatility Assumptions - 31 March 2018

This page shows our current asset class return and volatility assumptions.

Where these assumptions are used within asset-liability modelling, please note that the model's projections are sensitive to the starting position and the econometric assumptions. Changes to the assumptions can have a material impact upon the output.

Introduction to the assumptions

- These are our "best estimate" asset class return, volatility and correlation assumptions. We believe there is a 50:50 chance that the actual outcome will be above/below our assumptions.
- The assumptions are long-term estimates for a 20-year period. Our medium-term views are available separately.
- Return assumptions are:
  - Annualised (i.e. geometric averages), net of fees;
  - Expressed relative to the expected return on long-dated fixed-interest gilts (Over 15 Year index).
- Volatility assumptions are based on the standard deviation of absolute annual returns over a 10-year period.
- Please note that the assumptions have a subjective element, particularly regarding alternative asset classes (e.g. fund of hedge funds) due to the limited data history and rapidly evolving markets.
- SOFIA (our asset and liability model) does not simply assume the normal distribution for equities and fund of hedge funds — i.e. it allows for the expected non-normal return distributions of these asset classes. It also allows for the instability of correlations between asset classes in times of high volatility.
  - This means that we assume extremely poor outcomes occur more frequently than the normal distribution predicts; and
  - Correlations between asset classes change in extremely poor conditions — e.g. the correlation between equities and bonds reduces and the correlation between equities and fund of hedge funds increases.

Asset Class	Sector [1]	Return [2]	Volatility [3]
Global Equity	Developed (passive)	4.0%	20.0%
	Developed (core active)	4.5%	20.5%
	Developed (unconstrained)	5.0%	21.0%
	Emerging (passive)	5.0%	30.0%
Alternatives	Hedge Funds: Multi-Strat FoF	2.5%	10.0%
	Private Equity	7.0%	30.0%
	Diversified Alternatives	6.0%	22.0%
Property	UK Balanced	1.5%	13.0%
	Long Lease	1.0%	8.0%
DGF	Diversified Growth Funds	3.5%	12.0%
Gilts	Fixed Interest Gilts (passive) [4]	0.0%	6.5%
	Index-Linked Gilts (passive) [4]	0.0%	11.0%
Credit	Investment Grade (passive) [4,5]	1.3%	6.5%
	Diversified Credit [5]	2.1%	10.0%
	Distressed Debt	6.0%	26.0%

Notes: [1] Includes active management specific to the scheme except where specified as passive
[2] Expected return per annum, net of fees, on an absolute basis
[3] Expected standard deviation of absolute annual returns
[4] Includes an allowance for downgrades/defaults (0.3% for passive Investment Grade)
5 Includes an allowance for downgrades and defaults (0.2% for Investment Grade)

Source: KPMG

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Model Limitations

This page highlights the limitations of our investment strategy modelling.

Limitations of modeling

- When considering the modeling output for each structure, and in particular the risk measures, the following limitations of modeling should be noted
- This report has been prepared for the sole benefit of the Shetland Islands Council and is based on their specific facts and circumstances and pursuant to the terms of KPMG LLP's Services Contract. It should not be relied upon by any other person. Any person who chooses to rely on this report does so at their own risk. To the fullest extent permitted by law, KPMG LLP accepts no responsibility or liability to that party in connection with the Services.
- The outcomes illustrated in this report are not intended to be the best possible, or worst possible outcomes. The actual outcome could be better than the 5th percentile, or worse than the 95th percentile.
- The output from our modelling is based on a large number of underlying assumptions. Changes to these assumptions can have a material impact on the results of the modelling.
- The modelling analysis is based on portfolios containing a wide range of asset classes and different approaches to fund management. Clients should not make decisions to invest in these asset classes or approaches to fund management based solely on the modelling analysis.
- The only risk factors we have considered in our modelling are those that affect the value of assets and the financial assumptions used to value any liabilities. Some of the risks we have not considered include demographic risks such as the life expectancy of pension schemes' members and future changes to members' benefits where applicable.
- The work carried out for this exercise is compliant with the applicable Technical Actuarial Standards in force published by the Financial Reporting Council. In particular the standards for Reporting Actuarial Information, Data, Modelling, and Pensions have been followed so far as their requirements are material for this work.
- Past performance cannot be relied upon as a guide to the future.

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Disclaimers

- The information contained herein is provided for the Shetland Islands Council. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.
- The output from our modelling is based on a large number of underlying assumptions. Changes to these assumptions can have a material impact on the results of the modelling.
- The outcomes shown are not intended to be the best possible, or worst possible outcomes. The actual outcome could be better than the 5th percentile, or worse than the 95th percentile.
- The modelling analysis is based on portfolios containing a wide range of asset classes and different approaches to fund management. Clients should not make decisions to invest in these asset classes or approaches to fund management based solely on the modelling analysis.
- The only risk factors we have considered in our modelling are those that affect the values of Reserves assets and the financial assumptions.
- Past performance cannot be relied upon as a guide to the future.

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Agenda Item

2

Shetland Islands Council

Meeting(s):	Shetland Islands Council	22 August 2018
Report Title:	Shetland Islands Council Medium Term Financial Plan 2018/19-2023/24	
Reference Number:	F-071-18 -F	
Author / Job Title:	Jonathan Belford Executive Manager - Finance	

1.0 Decisions / Action required:

1.1 That the Council RESOLVES to adopt the Medium Term Financial Plan 2018/19-2023/24 and:

1.1.1 approve the principles of the Plan set out in section 2.2 of the Medium Term Financial Plan;

1.1.2 approve the assumptions on income and expenditure that underpin the Plan set out in Appendix G and Appendix H of the Plan;

1.1.3 approve the Financial Strategy set out in Section 1 of the Plan; and

1.1.4 agree the financial objective to be tackled by the Council over the life of the Medium Term Financial Plan as detailed in Appendix A and Appendix B.

2.0 High Level Summary:

2.1 The purpose of the Medium Term Financial Plan (MTFP) is to set out the financial framework within which Shetland Islands Council is expected to operate over the next 5 years and to present a financial strategy that will help the Council to deliver its services within the financial constraints that have been forecast.

2.2 An unmistakable finding of the MTFP is that it is more likely that the net cost of services will rise over time faster than the income that the Council can expect to receive. The creates a gap that the Council must address in order to set a balanced budget and an appropriate level of Council Tax annually.

2.3 Identifying what to change, to make decisions and to initiate alterations to the way current service operate is undoubtedly difficult as taking these types of decisions has an impact on at least some citizens, customers, staff, partners and stakeholders. However to fail to address funding shortfalls in an affordable and ultimately sustainable way is not acceptable, potentially exposing the Council to national scrutiny and criticism and would be a failure to comply with fiduciary and best value duties.

2.4 Set this in the context of the duty to continuously improve and there are clear obligations on the Council to review what it does, how it does it and to make changes. The fact is that the evidence in the MTFP shows that this needs to be done with an objective of reducing cost or increasing income to balance the books.

2.5 It is recommended that the work is put into defining the allocation of resources to support the strategic objectives and to develop a set of options that deliver £15.6m of cost reduction over the next five years. This should be done within the context of the priority outcomes and presenting business cases that describe the changes that need to be delivered to achieve these outcomes and manage the finances of the Council.

2.6 Furthermore the Plan recognises the Council's clear commitment to its medium term objectives and outcomes. The Plan makes a clear case for the need to bring about change, to transform the approach the Council takes to the ways in which it delivers services and to focus on Service redesign and for urgent action to be taken on this by all Council Services.

2.7 In the absence of that strategic work being completed then the MTFP recommends an alternative 'salami slicing' approach. A Service focused financial target that essentially looks for each Directorate to deliver their budget proposals with no growth and set an efficiency target that requires to be delivered beyond that. The figures are indicated in Appendix C.

2.8 This alternative approach is not likely to actually deliver the outcomes for the citizens of Shetland that the Council wants and will potentially target activities/Services that are needed in the medium to long term for the ultimate achievement of what is important. It does however ensure there is clarity in what is expected in event of a void of information.

2.9 The Plan allows the Council to continue the progress already made towards reducing the underlying cost base of Council services and identifying and maximising income opportunities. By agreeing the recommendations and financial strategy contained within the MTFP it will allow the Council to ensure it makes best use of all of its resources and reserves.

3.0 Corporate Priorities and Joint Working:

3.1 There is a specific objective in the Corporate Plan that the Council will have excellent financial management arrangements to ensure that it continues to keep a balanced and sustainable budget, and is living within its means; and that the Council continues to pursue a range of measures which will enable effective and successful management of its finances over the medium to long term. This involves correct alignment of the Council's resources with its priorities and expected outcomes, and maintaining a strong and resilient balance sheet.

3.2 Despite the work done so far, sustainability in particular is extremely challenging at this time with reducing Scottish Government funding being the trend since 2011/12. It is expected that this will continue while the UK and Scottish Governments seek to balance their budgets and prioritise their spending. In order to take action on improving the Council's approach to identifying and implementing sustainable solutions for the future; Directorate plans identify core priority areas for action between now and 2020 as set out in Appendix E.

4.0 Key Issues:

4.1 The Medium Term Financial Plan sets out the challenges that the Council faces in the coming five years and describes the need and evidence that supports a message that the Council acts now to address the expected gap between income and expenditure. By taking action to address the forecast gap it will provide the Council with the best possible opportunity to prepare and approve a balanced budget in future.

4.2 The Council will have to change and adapt to the financial climate it faces. It will have to identify and deliver on a number of transformational changes and consider savings that are that not only deliver savings but focus attention on the Council's objectives and outcomes.

4.3 The medium term of UK Public Finance remains bleak with no foreseeable upturn in cash available to the UK public sector. The analysis of the recently published Scottish Government Medium Term Financial Strategy provides no alternative view on the finances of Local Authorities – failing to be in their six top priorities.

4.4 The forecasts and projections incorporated into the Plan have been based on recent data that is available and from examination of expert and independent opinion to ensure that a reasonable and prudent approach has been taken.

4.5 It is clear, as with all Plans that the MTFP will require to be reviewed on a regular basis in order to maintain its relevance and integrity in relation to the information available and internal and external factors that impact upon it.

4.6 The financial constraints that are presented by the Plan remain very challenging but are achievable as the Council is well placed to move forward with a recent history of delivering on its budget, being able to implement change, to take appropriate decisions and act responsibly.

4.7 The Council's own resources have again been looked at, with a new investment strategy recommended in another report on this agenda. Relying on the funding for the long-term is fundamental to the level of services that the Council can deliver in the future and it is for this reason that there has to be a balance struck between risk and reward.

4.8 The Plan maximises the sustainable draw from investments, recognising that the Council has committed to using some of its funds to carry out specific work in the future and therefore must always have access to that money. By having a difference between the absolute value of investments and the value of investments from which returns can be drawn means that there is an added level of risk management. The likelihood of actual investment returns meeting the target returns every year is slightly increase, which means that for every year that the Council fails to actually receive 7.3% return from investments there is a small degree of variance that can be tolerated so that it doesn't jeopardise the sustainable draw from investments.

4.9 As evidence of maximising the use of the investments I've compared the value of the sustainable draw calculated for year 1 of the Plan with the value in 2015/16, only four years ago. This demonstrates a huge increase in the investment that the Council is making in the General Fund budget annuall, going from £7.2m in 2015/6 to £13.7m in 2019/20, a 90% increase.

4.10 The Council has also benefited from successfully securing £5m of new funding to support ferry operations in the current year. Political engagement alongside officers working with Transport Scotland is aiming to ensure that reaching a 'mutually acceptable solution' has continued to be progressed throughout 2018/19 in order to prepare for the 2019/20 Scottish Budget later in the year.

4.11 The 2018/19 General Fund budget has incorporated the first of the Service Redesign savings to be worked on and the MTFP emphasises the importance of taking this approach forward, to identify the options available, build appropriate cases for change in relation to outcomes and the money and to expand this to address the shortfall in funding that is forecast by 2023/24 of £15.6m.

4.12 In summary, the Plan is based on the following building blocks:

- Risk aware projections in relation to income;
- Continuing a long-term approach to drawing sustained financial benefit from investments;
- A commitment to reduced costs through various means;
- Allocation of resources, cost reduction and income generation will be strategically focused and prioritised in the line with the Corporate Plan;
- The need to bring about change, to transform the approach the Council takes to the ways in which it delivers services and to focus on Service redesign and for urgent action to be taken on this by all Council Services; and
- Recognising the potential benefits that will arise from pro-actively engaging with the Scottish Government to ensure a fair share of financial resources is received by Shetland for the Services delivered.

5.0 Exempt and/or confidential information:

5.1 None

6.0 Implications :

6.1 Service Users, Patients and Communities:	Section 3 of the Medium Term Financial Plan covers engagement and how this should be developed to meet the national target of 1% community participation in the allocation of resources by 2020.
6.2 Human Resources and Organisational Development:	There are no direct implications arising from the Plan. In developing the actions and implementation of those in order to address the financial strategy human resource implications may arise, which will be detailed at such times.
6.3 Equality, Diversity and Human Rights:	There are no direct implications arising from the Plan. In developing the actions and implementation of those in order to address the financial strategy equality, diversity and human rights issues that may arise, which will be detailed at such times.
6.4 Legal:	Under Section 95 of the Local Government (Scotland) Act 1973, there is a requirement for each local authority to make arrangements for the proper administration of their financial affairs and that the chief financial officer/Section 95 officer has responsibility for the administration of those affairs. The Plan recommends a financial strategy that may lead to implications for the Legal Service, an example being that the

	Council should capture savings from improved and robust procurement and commissioning processes, including the re-negotiation of contracts.
6.5 Finance:	The Plan sets out the resources available to the Council over the next five financial years. The Plan also proposes how these resources should be allocated between revenue and capital, with the overall aim of ensuring the Council continues to be financially sustainable. The Plan recommends maintaining the discretionary usable reserves around current levels in order to underpin the year on year return of income from investments to support the revenue costs of Council Services.
6.6 Assets and Property:	The Plan recommends that the Council services operates as efficiently and effectively as is possible which will include reviewing the use of assets and property.
6.7 ICT and new technologies:	The Plan recommends that the Council focus on developing an effective use of ICT and new technologies as part of business transformation.
6.8 Environmental:	The Plan recommends that the Council services operates as efficiently and effectively as is possible which will include continuing work on reducing carbon emissions to support the Council's duty under the Climate Change (Scotland) Act 2009.
6.9 Risk Management:	There are a number of assumptions within the budget model that are based on the best information available to date. These assumptions are largely around returns on investments (section 7), anticipated income levels (Appendix G) and cost pressures and demands (Appendix H). In practice the actual figures will vary from the forecast figures and therefore on a regular basis the Medium Term Financial Plan will be reviewed so that assumptions can be updated. A financial risk still exists in relation to the income projections from the Harbour Account and from the Shetland Gas Plant as a result of the volatility around levels of throughput and the price of oil and gas. The Plan has been prepared on the basis of an optimistic approach to income during the life of the Plan but cautions that there are undoubtedly challenges beyond 2023/24 that will need to be addressed. The Council should be proactive in tackling the challenges to mitigate the impact of this risk. The Plan estimates a net 5.2% return on reserves annually which results in an estimated return of approximately £13.7m. Taking a long term view of investment returns is vital to providing assurance that this level of return can be achieved as markets and the value of investments will go down as well as up. A net 5.2% return has been based upon a gross return of 7.3% per annum, and is at the upper end of the range over the last 20

	years that has seen longer term rates of between 3.56% and 8.49% per annum. Managing the Council's investments through a diversified investment strategy and monitoring performance ensures the Council remain in a position to achieve this level of investment return over the longer term. The outcome of the most recent review of the Council strategy is presented to the Council on today's agenda.	
6.10 Policy and Delegated Authority:	The determination of new strategies requires a decision of Council, in terms of Section 2.1.3 of the Council's Scheme of Administration and Delegations.	
6.11 Previously considered by:	n/a	n/a

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17 August 2018

Appendices:
Appendix 1 – Medium Term Financial Plan 2018/19-2023/24

Shetland Islands Council

MEDIUM TERM FINANCIAL PLAN

2018/19 – 2023/24

Corporate Plan Vision:

By the end of this plan (2020), we want to be known as an excellent organisation that works well with our partners to deliver sustainable services for the people of Shetland.

Contents Page

Foreword by the Executive Manager - Finance

The Medium Term Financial Plan (the MTFP) is a crucial strategic document that provides the financial framework for the delivery of Council services to the citizens of Shetland. The MTFP captures data from across the various Council accounts and presents an overall projected funding position and financial strategy for the next five years that is based on:

- Risk aware projections in relation to income;
- Continuing a long-term approach to drawing sustained financial benefit from investments;
- A commitment to reduced costs through various means;
- Allocation of resources, cost reduction and income generation will be strategically focused and prioritised in the line with the Corporate Plan;
- The recognised need for the Council to transform the approach the Council takes to the ways in which it delivers services and to focus on Service redesign and for urgent action to be taken on this by all Council Services; and
- Recognising the potential benefits that will arise from pro-actively engaging with the Scottish Government to ensure a fair share of financial resources is received by Shetland for the Services delivered.

The data upon which income projections have been modelled takes into account the views, observations and conclusions of expert external parties. Finance and service staff have provided cost information to provide robust projections.

Councillor input has come from the seminars and work conducted in preparing the 2018/19 annual budget.

Public engagement is increasingly important to enable the Council to meet its community empowerment obligations and also to achieve the Scottish Government target of having 1% of the budget being decided by communities through participation. This has been agreed by the Convention of Scottish Local Authorities (COSLA) and based on that methodology the value for the Council is approximately £800k per annum.

Risk management has been an increasingly important aspect of Council governance and the MTFP sets out financial risks associated with delivering Council Services and the means through which these are managed.

The Council has a Corporate Plan and the emphasis on the achievement of the defined outcomes cannot be understated. The MTFP recognises that those outcomes are delivered through the range of Council Services and that all will play their part in adding to that achievement. Equally all must contribute to the effective and efficient delivery of Services.

Maintaining a balanced budget in times of continuing austerity, significant public sector change and volatile external market conditions is extremely challenging.

The Council does however find itself in a strong financial position and with a reliance being placed on continuing Council resources to support service delivery and a belief in securing permanent funding to support ferry operations the Council has time to plan and deploy resources effectively to deliver change over the life of this MTFP. The opportunity should be grasped with both hands.

Should nothing change then future Service demands and cost pressures will significantly outstrip the resources available. As well as the ongoing need to continue to improve its productivity and efficiency in order to maintain and improve the Services provided it must prioritise its spending. Decisions will have to be taken that will lead to funding reductions in lower priority areas to enable funding to be maintained elsewhere.

The MTFP emphasises that action needs to be taken now to achieve future savings and that changes that are proposed and implemented have to move the Council towards the achievement of the Corporate Plan and contribute to the Shetland Partnership Plan outcomes.

The conclusions and the financial strategy for the period of the MTFP are shown in the Executive Summary.

The MTFP develops over time but provides the framework for the Council to understand the financial position that it faces. It should continue to be reviewed and updated regularly to maintain its relevance and integrity in relation to the information available and the internal and external factors that impact upon it.

Jonathan Belford

Executive Manager – Finance

22 August 2018

1. Executive Summary and Financial Strategy

1.1 Introduction

1.1.1. Financial planning by the Council is good with improved financial management, improved financial and risk awareness and the adoption of medium and long term plans to lead and direct the actions and activities of the Council.

1.1.2. This has enabled the Council to deliver Services to the Shetland public within budget and in doing so has improved the financial sustainability and resilience of the Council. However it cannot remove the need for the Council to continue to look forward and to recognise the enormous challenges that lie ahead in relation to the availability of Scottish Government resources, the cost pressures arising from duties and obligations it has and the level of risk that Council is exposed to in relation to the Resources it can contribute on a sustainable basis.

1.1.3. To continue to strengthen the financial management arrangements in place for the Council this MTFP has outlined those challenges. It recommends that decisions are not only taken to address the forecast financial position but to carry out and implement a programme of change that moves Council resources to be focussed on delivery of the activities that are most important and achieve the outcomes that it strives for.

1.2 Financial Strategy

1.2.1. Looking forward and taking into account the principles (set out in section 2) the recommended Financial Strategy to enable the effective management of financial resources over the next five years is as follows:

Scenario Planning

- To take a prudent approach to core Scottish Government funding projections for the next five years; and to take a fairly optimistic approach to the benefits that may be generated from oil and gas related income (section 3);
- To recognise the significant risk posed to the General Fund budget from a reliance on external income, over which the Council has no control, the Council should consider the options it has for replacing that income in the event that it falls and / or stops faster and sooner than estimated (section 11.1.14);
- To take a measured approach to the long-term investment returns that will be generated (section 7), to ensure an inflation proofed sum of £13.7 million (for 2019/20) can be relied upon as an annual income stream for the General Fund revenue budget;

- To include a modest General Fund revenue budget contingency, taking a risk based approach, to protect it from unplanned expenditure in-year (section 12.1.6);
- To consider how longer-term financial planning can be effectively undertaken by the Council (section 4.2.9).

Policy

- To apply the Charging Framework in considering, setting and applying charges for services, recognising the important place income has in addressing rising costs (section 10.1.28);
- To treat all non-specific grants received as a corporate resource (section 10.1.6);
- To continue to adopt the Investment Returns Withdrawal Policy, which includes a long-term investment return rate of 7.3% and long-term inflation rate of 2.1%, resulting in an affordable draw from investment returns of 5.2% of the investment return base (section 7.3);
- To focus investment returns on supporting revenue expenditure (section 7.4);
- To adopt a robust pricing policy for the Port to ensure that an annual return on investment is achieved and that the surplus is used to deliver benefit to the Shetland public (section 5);
- To deliver the Housing Revenue Account business plan and to work with Partners to maximise the opportunities for the delivery of quality affordable housing in Shetland, one of the Council's top priorities (section 6);
- To maintain an uncommitted General Fund Reserve to mitigate the risk of significant unplanned one-off events (such as Major Incident, Major Disaster and the Financial Climate) that the Council may face (section 12.1.10);
- To adopt a medium term target of £15.6 million of recurring savings being achieved by 2023/24 (Appendices A and B);
- To agree that in the absence of a strategic, Council-wide approach being taken to addressing rising costs and plans being produced then Directorate savings are set as indicated in Appendix C will apply;
- To prioritise Service delivery that is identified as being most likely to successfully achieve the Corporate Plan objectives and outcomes in the long term or is required to fulfil the Council's statutory duties, and to agree to reduce and / or stop those Services that contribute less to outcomes or are a lower priority (section 3);

- To continue to build upon the financial management improvements that have already been made, and continue to base decision making on evidence based reporting, following the building better business cases methodology, demanding fully costed options and recognise that the use of Council resources all come with a cost (Appendix F);
- To continue to set aside an annual sum of Funding for Change and authorise the Director of Corporate Services, in conjunction with the Executive Manager – Finance, to approve the allocation of funding to projects meeting the criteria, subject to the availability of funding (Appendix F 9.1.1);
- To continue the scheme for the Spend to Save and Improvement Funding earmarked within the Council's Usable Reserves and authorise the Director of Corporate Services, in conjunction with the Executive Manager – Finance, to approve the allocation of funding to projects meeting the criteria, subject to the availability of funding (Appendix F 9.1.17);
- To continue to adopt the Capital Expenditure Policy and limit capital expenditure to a programme that is deliverable and affordable based on the estimated level of Scottish Government Capital Grant, supplemented by capital receipts (section 8.3);
- To continue to adopt the Capital Funding Policy and borrow in specific circumstances for capital investment, that cannot be funded from Capital Grant or capital receipts, the cost of which will be borne by the Service(s) that the investment benefits. Borrowing will be carried out under the Prudential Code framework of prudence, sustainability and affordability in line with the Borrowing Policy[1] (section 8.4)

Actions

- To take action on costs over the life of this MTFP on the basis that Scottish Government funding will not increase nor return to historic funding levels (in real terms) (section 3.4);
- Effectively manage annual budgets to maintain discretionary Usable Reserves[2] around current levels to protect the underlying financial resources of the Council that can be relied on to provide a stable investment return base (i.e. reserves that are not committed to specific projects) (section 7.3);
- To capture savings from improved and robust procurement and commissioning processes, including the re-negotiation of contracts;

[1] Shetland Islands Council, Borrowing Policy and Strategy 2013 - 2018

[2] Discretionary Usable Reserves are the Equalisation Fund, Repairs & Renewals Fund, Capital Fund and Harbour Reserve Fund

- To develop a strategic approach with the Corporate Management Team to resource allocation to determine the options that will best focus on delivery of priority outcomes and statutory obligations within the resource limits of the MTFP (section 2);
- To acknowledge rising costs and anticipated falling income from the Scottish Government, and agree to take action to build a plan during 2018/19 that identifies what the Council will do to eliminate the gap that exists between income and expenditure in the future. This should incorporate the Service redesign proposals and link to the business transformation programme (Appendix H);
- To structure Services in a way that maximises productivity and operates as efficiently and effectively as is possible (Appendix E);
- To agree Directorate Plan priorities can only be taken forward in the context of the challenging financial forecast in this MTFP, and as a result growth of Services is not permitted (Appendix E);

Engagement

- To continue to seek all opportunities for political engagement with the Scottish Ministers and Scottish Government in relation to Services for which the Council does not receive its fair share of funding, or where inconsistency exists between Shetland and other local authorities (section 3.5.20);
- To recognise the importance of oil and gas to the Council and to continue to work closely with the locally based companies and wider oil and gas sector to explore how community benefits achieved through the Harbour Account can be continued over the long-term (section 5.2);
- To work closely with partners to identify and deliver cost effective solutions to achieve shared objectives and outcome priorities;
- To increase community participation in the allocation of resources decisions and to ensure the target of 1% of the Council Budget being subject to community participation is achieved by 2020 (section 3.3.11)

2. Medium Term Financial Plan 2018/19 – 2023/24

2.1 Introduction

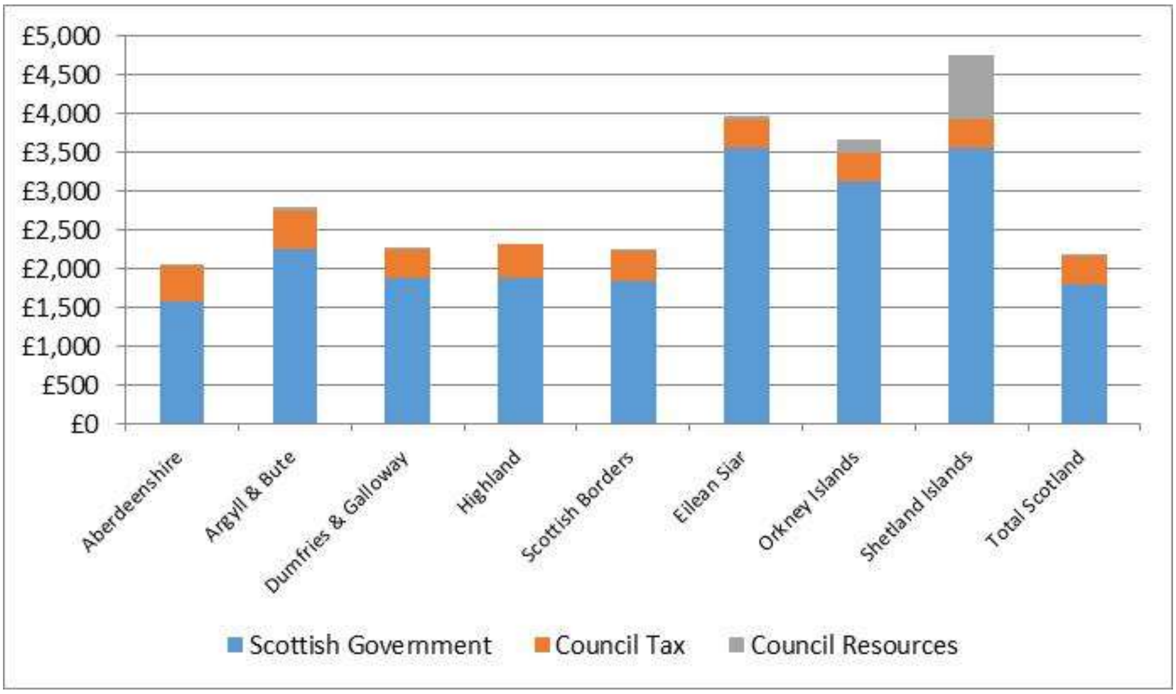
2.1.1 The MTFP provides the financial planning framework for the delivery of services to the citizens of Shetland. It sets the financial context in which the Council should plan to deliver its services, meets legal obligations and achieve its outcomes.

2.1.2 The MTFP integrates with other strategic documents, fundamentally referring to the Corporate Plan and the newly developed Shetland Partnership Plan, the achievements of which will be measured in the medium to long term.

2.1.3 Acting as a tool for financial planning the MTFP considers income and expenditure across the range of Council service areas including the Council housing stock (Housing Revenue Account) and the harbours (Harbour Account). It addresses both the need for revenue and capital expenditure and how these will be funded.

2.1.4 For Shetland Islands the long-term benefits of having retained a proportion of the money generated from oil and gas is a luxury that most local authorities would love to have available to them. With careful and balanced strategic investment this money enables the Council to top-up Scottish Government funding to enhance and extend its service delivery across the Islands see Chart 1 below for evidence of the impact it has compared to the funding of other Councils. These long-term investments are managed in accordance with the Annual Investment and Treasury Strategy. That strategy doesn't determine the application of investment returns, this is addressed within this Plan ensuring that the use of all Council resources are included within a single document.

Chart 1: Revenue funding per head of population, comparison with Councils with the most highly dispersed populations.

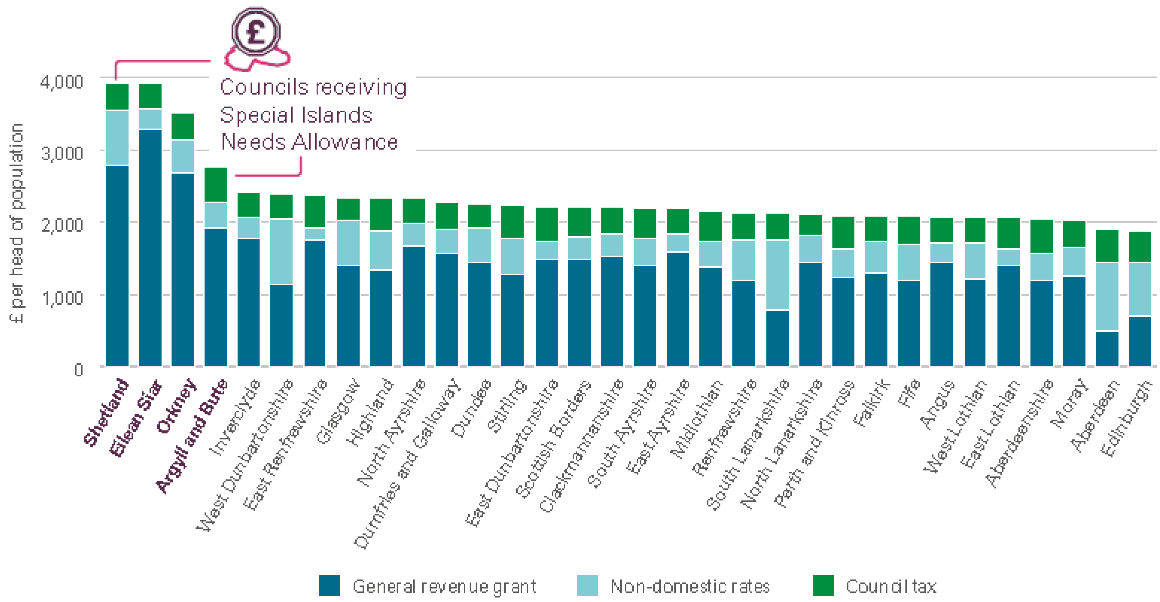


2.1.5 The Accounts Commission drew attention to the funding differences between island and mainland local authorities in the Financial Overview report[3] based on the 2016/17 annual accounts. Their Exhibit 3, shown as Chart 2 below, emphasises the additional funding that the islands already receive in the local government settlement.

Chart 2: Income from General Revenue Grant, Non-Domestic Rates and Council Tax per head of population 2016/17.

Income from General Revenue Grant, Non-Domestic Rates and council tax per head of population, 2016/17

Most councils received between £2,000 and £2,400 per head of population.



Source: Annual accounts 2016/17; and National Records of Scotland mid-year population estimate for 2015

2.1.6 The economic environment within which the Council operates remains extremely uncertain, not least because of the unknown impact of Brexit, a Scottish Government financial settlement that extents to a single year and a recently published Medium Term Financial Plan by the Scottish government that presents few positives for local authorities as other priorities are targeted.

2.1.7 The MTFP makes use of many assumptions based upon the information that was available at the time of writing this report. UK and Scottish government policy changes and funding decisions have a significant impact on the Council requiring the MTFP to be reviewed on a regular basis.

[3]Local Government in Scotland: Financial Overview 2016/17
http://www.audit-scotland.gov.uk/uploads/docs/report/2017/nr_171128_local_government_finance.pdf

2.2 Principles of the Medium Term Financial Plan

2.2.1 The MTFP is based on the following principles:

- The Council will live within its means, and in doing so approve an annual budget that is balanced and affordable.
- The Council has agreed to use its long-term investments as an investment fund and draw a sustainable amount of the long-term anticipated return from those investments each year to support Services.
- The cost of capital will be recognised by the Council, and the cost of any borrowing undertaken will be borne by the revenue budget and met by the relevant Service that will benefit from the capital investment.
- The Executive Manager – Finance will determine the costs associated with the management of significant corporate cost pressures, such as pay, pension and tax implications of national and local conditions of service. Where these cannot be applied to service budgets a central contingency will be retained and allocated to service budgets when required.
- A risk based approach will be taken to areas of the budget that Services identify are uncertain in any single year and a central contingency will be retained and allocated to service budgets if required.
- The Plan will identify the level of funding that can be made available for the delivery of services and estimate the gap between income and expenditure for which income generation, savings options and further efficiencies will have to be implemented

2.3 Benefits of the Medium Term Financial Plan

2.3.1 The Accounts Commission, in their Financial Overview 2015/16[4] report, identified the need for financial scenario planning:

> *"Long-term financial strategies must be in place to ensure council spending is aligned with priorities, and supported by medium-term financial plans and budget forecasts. Even where the Scottish Government only provides councils with one-year financial settlements, this does not diminish the importance of medium and longer-term financial planning. This is necessary to allow councillors and officers to assess and scrutinise the impact of approved spending on future budgets and the sustainability of their council's financial position."*

[4] Local Government in Scotland: Financial Overview 2015/16, published November 2016
http://www.audit-scotland.gov.uk/report/local-government-in-scotland-financial-overview-201516

2.3.2 Forecasting the future is crucial to understanding what the Council may have to address, particularly in an environment where the demands and expectations of the Shetland public are continually changing. Add to this the duties and responsibilities placed on the Council by UK and Scottish Government policies that continue to evolve and respond to the economic and social environment within which we live. Predicting the impact of macro-economic issues, such as Brexit, is naturally fraught with difficulty.

2.3.3 In such an environment, where our customer's desire to maintain service levels and quality exceeds the capacity of the resources the Council has , there is a need for a clear view on what the limitations are, and how service delivery can be maximised within those resource limitations.

2.3.4 The Accounts Commission emphasised in their Financial Overview 2016/17 report[5] that Councils that have been proactive in making difficult decisions will be better placed to deal with future financial pressures. They stated:

> *"Councils have had to make difficult decisions in recent years in the light of falling resources and increasing demand for services. Councils that have a track record of effective leadership, self-evaluation, robustly addressing the financial challenges, and are implementing effective medium to long-term strategies and plans, will be in a better place than those that have avoided difficult decisions or not applied sufficient pace to making changes. That is not to say that the challenges faced by councils have necessarily been uniform. Differences in the resources available to them, the demand for services and the costs councils face as a result of their size and remoteness can also impact on their financial position."*

2.3.5 The MTFP enables Councillors to understand the constraints that apply in Shetland, within which each annual budget setting process takes place and the overall principle of living within its means and maintaining service costs that are affordable.

2.3.6 Through adopting the MTFP the financial planning and financial management of the Council's revenue and capital resources are improved. This provides the targets that have to be achieved over a five year timeline, within which to implement and deliver the change and improvement needed.

2.3.7 The MTFP can enable the alignment of resources to the Council's spending priorities. The priorities of the Council relate to the outcomes that it aspires to achieve. The recommendation in the MTFP is that decisions are taken and actions are put in place to focus on the priorities and outcomes set out in the Corporate Plan and other strategic documents (refer to Appendix D for further detail).

[5] Local Government in Scotland: Financial Overview 2016/17
http://www.audit-scotland.gov.uk/uploads/docs/report/2017/nr_171128_local_government_finance.pdf

3. The Context

3.1 Introduction

3.1.1 The primary focus of the MTFP is to establish the financial environment within which the Council is expected to deliver Services to the citizens of Shetland over the coming years. It does not sit in isolation and has to be relevant to the context within which the Council is working. Neither is it exact, taking account of the best information available at the time - from corporate priorities and vision to the latest economic circumstances, from political / national policy to social data that is available, and from known cost pressures to anticipated demand.

3.2 The Strategic Plans

3.2.1 A number of strategic plans are outlined in Appendix E and D, to demonstrate the complex landscape that exists for the Council. At the heart of this is the Corporate Plan, which sets out the Council's priorities and identifies how these priorities will contribute to the achievement of the Council's medium term outcomes. The Council has also recently agreed, as a community planning partner, the Shetland Partnership Plan[6] that sets out the ambitions of the Shetland Partnership[7] and agrees to contribute to the delivery of the outcomes and targets described.

3.2.2 The Council, in defining its strategic plans should be clear about its ambitions and as such this should inform the allocation of resources to ensure those ambitions are achieved. There is a need for further work to be completed to recognise the limitations that the Council has in terms of resource availability and to develop the way it will ensure that those priorities are suitably funded by transferring funding away from other services.

3.2.3 This will lead to Services no longer existing and no longer being a priority. At the same time there is a continuing need to be as efficient and effective as possible, and as such using different ways of providing Services will also have to be feature. It is vital that the Council recognise that its outcomes have not been achieved by doing what its being doing or they have changed over time, therefore something different needs to be done that makes the difference.

3.2.4 The answer is not simply spending more on more of the same.

3.2.5 The MTFP considers the financial context for the Corporate Plan prioritisation and must inform the Council's decisions.

[6] The name given to the Local Outcomes Improvement Plan (LOIP) for Shetland.

[7] The name given to the Shetland Community Planning Partnership, made up of representatives of partners and community bodies. Those with a duty to facilitate community planning are the Council, NHS Shetland Board, Police Scotland, Scottish Fire & Rescue Services and Highlands & Islands Enterprise.

3.3 Engagement

3.3.1 By being clear in the priorities then the Council will need to avoid the pitfall of trying to continue to do all that it currently does in the same ways, just simply with less money. The fact is that while the Council enjoys the highest level of funding per head of population, and it can reasonably assume to sustain that position, the national context is that the core funder of Services is the Scottish Government and its funding is continuing to fall.

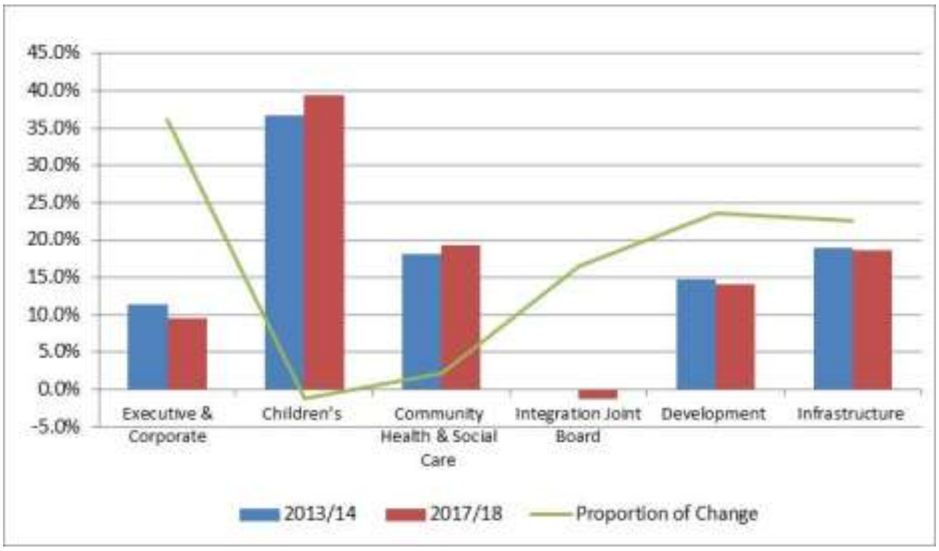
3.3.2 To have an effective MTFP is to be clear on what is going to be done and when and it is imperative that the detail of the actions to be taken, the commitment to the priorities and communication of those with the citizens of Shetland is a key next step during 2018/19 to ensure that in the years ahead there is not simply 'salami slicing' budgets in an attempt to keep everything as it currently is. There are undoubtedly activities and Services that are of greater value than others, these need to be defined, articulated and stuck to.

3.3.3 Through Council Budget Seminars officers have engaged with Councillors on how the change agenda can be taken forward, it is fair to say that Councillors expect officers to explore a wide range of service areas to then present business cases that once approved would then be incorporated into the Service redesign programme.

3.3.4 In relation to public engagement there is scope to develop the approach further. Going back to 2014 and 2015 'Building Budget' exercises were undertaken, where members of the public were presented information on the Council's current financial position. Systems were developed that allowed an individual or group to build their own budget, within the parameters set by the system.

3.3.5 The information gathered from these exercises informed budget setting and local priorities, with both Children's Services and Community Care Services being highlighted in Chart 3.

Chart 3: The proportion of the Council Budget spent by Directorate, 2013/14 compared to 2017/18.



3.3.6 As demonstrated in Chart 3 the Council is able to show that these two services have faced lower funding reductions than other Council services.

3.3.7 During 2016 the Council undertook a consultation on the "Shetland Place Standard" and this included feedback to community forums that were put in place to better understand the results of that consultation. The opportunity was taken to again share financial information about the Council in those forums. Gathering data from those events was difficult to evaluate given the limited information.

3.3.8 The Council also supported Community Councils in 2016 and 2017 to undertake participatory budgeting projects, providing match funding. These were hugely successful and engaged a large number of people in various local communities.

3.3.9 Additional funding was awarded by the Scottish Government to undertake the development of the community engagement and decision making; this is under the banner of "Community Choices". The Council delivered a larger scale event in which the public participated directly in the debate and decision making.

3.3.10 Another piece of work under this heading is exploring how these techniques are made part of the normal process of budget setting. This will definitely be an evolving aspect of financial planning but one that has many opportunities for getting a greater understanding of local priorities and decisions being made closer to where the impact is felt.

3.3.11 This sits in the context of the Scottish Local Government target for community participation in allocating resources being 1% of the Council's budget. Based on the Convention of Scottish Local Authorities (COSLA) methodology agreed with the Scottish Government then the Council should be allocating resources with the participation of the community to the value of approximately £0.8 million per annum. It is suggested that increased community involvement needs to become a more routine way of working.

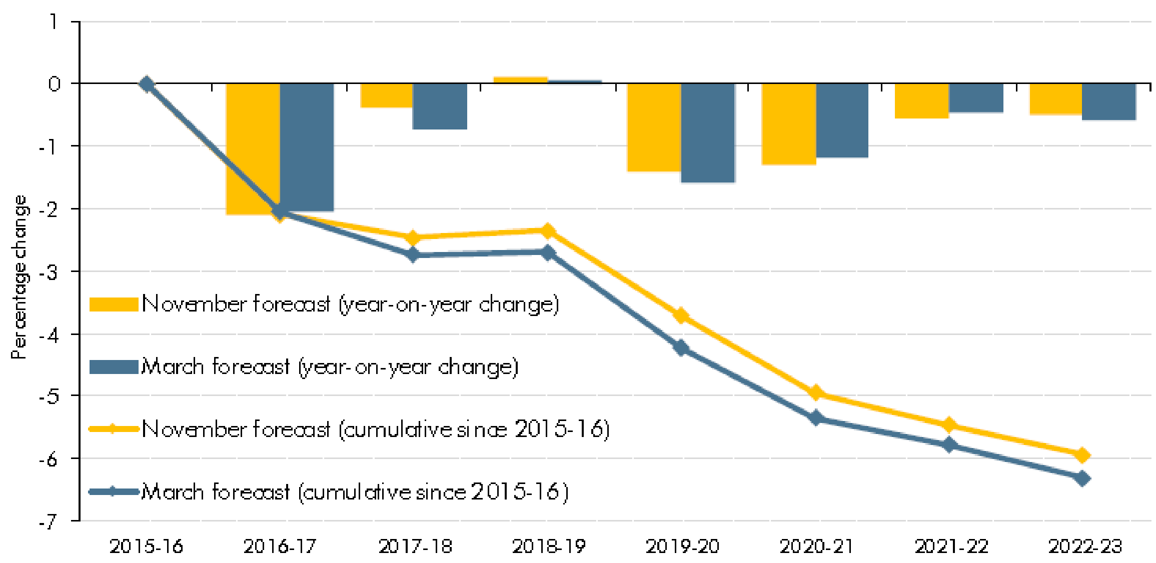
3.4 The UK Context

3.4.1 According to the Office for Budget Responsibility[8] (OBR) the national picture for public sector spending, compared to when the last MTFP was being prepared, remain similar.

3.4.2 With the uncertainty of the impact of Brexit on UK finances the OBR stated in their report[9] "Given the uncertainty as to how the Government will respond to the choices and trade-offs facing it during the negotiations, we still have no meaningful basis for predicting a precise outcome upon which we could then condition our forecast. Moreover, even if the outcome of negotiations were predictable, its impact on the economy and the public finances would still be uncertain." Testament to the difficulties with predicting an uncertain future.

3.4.3 Chart 4 is produced by the OBR[10] and shows the latest forecasts for Resource Departmental Expenditure Limits (RDEL)[11]. The implication for public sector spending is continued austerity.

Chart 4: OBR Change in real RDEL per capita from 2015/16.



Note: 2017-18 and 2018-19 exclude the effects of business rates pilots. All other figures adjusted as far as possible for consistency with the latest forecast. See source table in OBR supplementary fiscal tables: expenditure.

[8] Office for Budget Responsibility Economic and Fiscal Outlook, March 2018

[9] Office for Budget Responsibility Economic and Fiscal Outlook, March 2018

[10] Office for Budget Responsibility Economic and Fiscal Outlook, March 2018

[11] RDEL – day to day central government spending on public services, grants and administration.

3.5 The Scottish Context

3.5.1 The primary source of funding for the delivery of Council Services is the Scottish Government through the allocation of general revenue and capital grants, and the distribution of national non-domestic rates. With approximately three quarters of the Council's revenue funding being received in this way it is simple to see why UK and Scottish Government policies and economic forecasts impact on the level of Council funding.

3.5.2 No funding announcements have been made by the Scottish Government beyond 2018/19.

3.5.3 In May the Scottish Government published its first Medium Term Financial Strategy[12] (MTFS) and doesn't make for positive reading for Local Authorities. It is probably the clearest statement of intent by the Scottish Government of its future funding plans made for many years.

3.5.4 With regards to the Resource Budget, the Scottish Government confirmed its spending priorities areas, to be:

- **Health:** with a budget of around £13 billion in 2018/19, but rising to over £14 billion by 2021/22 (and with scope for further increases, not included yet, in 2022/23);
- **Police:** with a budget of around £1 billion which is protected in real terms, i.e. growing at the rate of inflation;
- **Early Learning and Childcare (ELC):** with a budget rising to over £500 million by 2021 and with implications for Local Government resource funding;
- **Attainment:** (i.e. raising attainment levels and closing the attainment gap) via the £750 million. Attainment Scotland Fund covering the term of the Parliament;
- **Higher Education**: with a budget of over £1 billion; and
- **Social Security:** with a budget that grows to over £3 billion by 2021/22, largely due to the phased transfer of responsibilities from the UK Government.

3.5.5 The overall Resource Budget that is utilised by the six commitments highlighted above grows from 56% in 2019/20 to 64% in 2022/23. Of the remaining £12 billion of funding, the majority relates to Local Government. Due to the six commitments taking up a greater share of the overall Resource Budget over time, the 'central' scenario of the Scottish Government suggests that there will be no cash terms increase in resource funding over the period from 2018/19 to 2022/23, although this is equivalent to real terms cuts of around 2% a year. Furthermore, in the case

[12] Scottish Government: Medium Term Financial Strategy, May 2018
https://www.gov.scot/Publications/2018/05/1497/downloads

of the 'lower' scenario there will be cash terms reductions, estimated to be over 2% a year and equivalent to about a £1 billion cut overall.

3.5.6 The MTFS report also notes that "It is, however, clear that even under the most optimistic scenario, if no reprioritisation or reform were agreed and no additional revenues generated, then efficiency savings of 5 per cent per year could be required. While future efficiency targets (rightly) will be challenging, the decisions we take will ensure they are manageable." It is unclear whether this means that all spending areas will need to find such savings or whether they will be just be concentrated in a few.

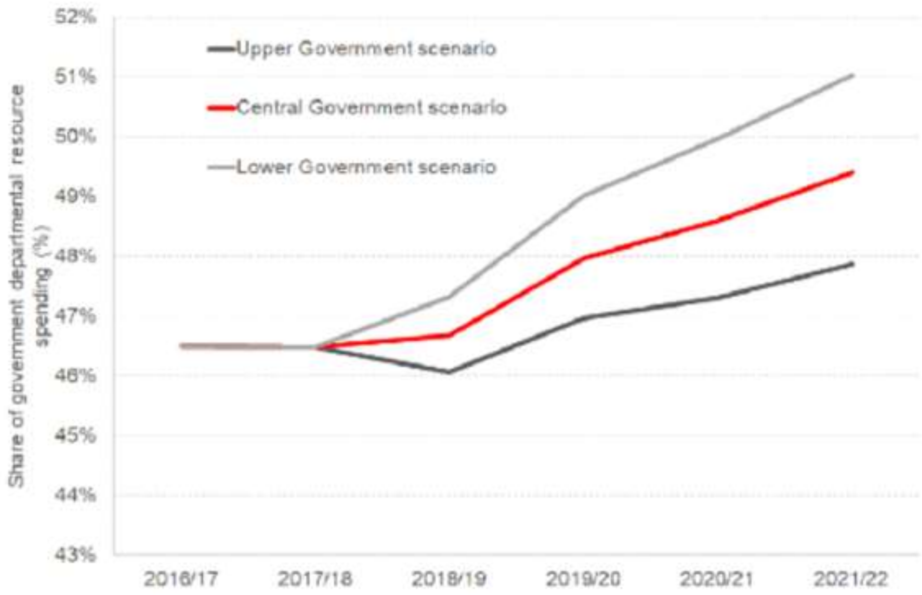
3.5.7 The Scottish Fiscal Commission (SFC), in May 2018, published their second set of economic and fiscal forecasts[13]. Key points to note are:

- **Economic growth:** Scottish GDP growth is now forecast to remain below 1% a year for the foreseeable future (up to at least 2023).
- **Wages:** Scottish wages growth is also well below what the Scottish Government had been expecting 18 months ago and in real terms average wages will not surpass their 2016 level until 2022.
- **Taxation:** Income Tax (IT) receipts are now forecast to be well below the level expected 18 months ago. These have been negatively affected by the downgrading of both GDP growth and of wages growth. For such a downgrade not to affect future Scottish budgets, the revenue loss would need to be replaced by higher taxes or more borrowing. Despite slower growth in GDP and wages, forecasts of Scottish IT revenues in coming years are still on a par with those seen for the UK (just over 20% in the period 2017/18 to 2022/23).

3.5.8 Analysis of the MTFS by both the Fraser of Allander Institute and the Scottish Parliament Information Centre (SPICe) reach similar conclusions, that the three different budget scenarios significantly affect the degree to which Health's share of the overall resource budget grows over time (see Chart 5).

[13] Scottish Fiscal Commission: Scotland's Economic and Fiscal Forecasts 2018, May 2018 http://www.fiscalcommission.scot/media/1314/scotlands-economic-and-fiscal-forecasts-may-2018-full-report.pdf

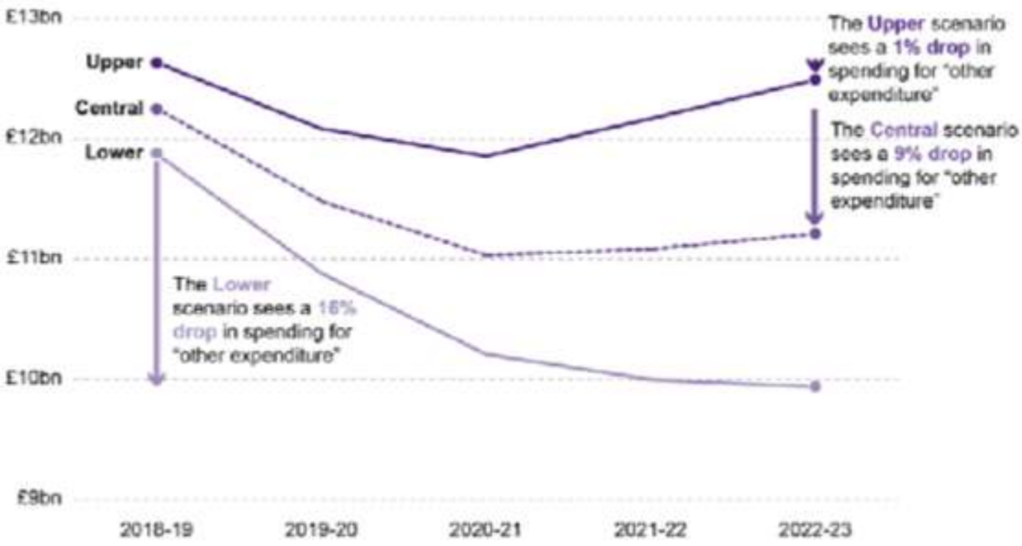
Chart 5: Resource spending on health as a % of departmental resource budget, 2016/17 to 2021/22



Source: FoA, 'Economic Commentary: The medium-term fiscal outlook for the Scottish Government'

3.5.9 This is important to Local Authorities because of the impact that protecting and allocating resources to Health (and other priority areas as referenced above) diminishes the value of resources that will be allocated to Local Government. This is illustrated in Chart 6 below and it should be noted that 'other' category includes local government, enterprise, the environment, tourism and culture and the cumulative effect includes commitments to the six spending priorities.

Chart 6: Cumulative 'real terms' change in spend on 'other' policy areas.



Source: SPICe, FoA, 'The Scottish Government's Five Year Financial Strategy'

3.5.10 SPICe estimate that the resources available for ‘other’ spending areas will fall by around 8% over the course of the parliament in real terms, under the central scenario. Although this excludes Non-Domestic Rate Income (NDRI), which is forecast by the Scottish Fiscal Commission (SFC) to rise rather than fall in both cash and real terms. This implies that the Local Government settlement may suffer less of a percentage terms cut overall. However, any NDRI boost may simply be offset by a deeper cut in the Scottish Government Grant element, resulting in a similar outcome to other unprotected spending areas.

3.5.11 In cash terms, by 2021-22, Chart 6, above, suggests that: the ‘High’ scenario results in a Resource budget increase of around 7%; the ‘Central’ scenario results in a budget of near flat cash (-1%); and the ‘Low’ scenario an 8% fall in budget.

3.5.12 The analysis provides independent opinion on the expectation that the Council should have about where its primary funding comes from. The assumptions made within this Plan reflect, over the next 4 years (to 2022/23) the ‘Central’ scenario, that there will be a near flat cash result for Local Government of -1%. This is then adjusted to take account of the impact of other factors within the Local Government distribution methodology, such as diminishing loan charges support to 2035.

3.5.13 Local Authorities receive a distribution based on the Grant Aided Expenditure (GAE) formula agreed by COSLA, this is a needs-based distribution methodology that takes into account nationally recognised indicators and weightings. The Council receives approximately 0.85% of the total distribution to local government, in 2018/19 a sum of £80.5 million, for 0.4% of the total estimated population of Scotland[14]. Specific ‘Special Islands Needs Allowance’ funding within the methodology is a major factor supporting additional funding for the island Local Authorities.

3.5.14 This may appear to be a positive proportion of Scotland’s funding however the scale and remoteness of the population that the Council is delivering services to results in expensive service models. Add to this the minimum levels expected of any Local Authority and additional costs of transport and goods and services being simply more expensive then it is clear that the Council has a need for funding at this level.

3.5.15 Shetland also has transport requirements that others (with the exception of Orkney) do not have, the provision of inter-island transport, which is delivered by sea and air and is funded by the Council after a proportion of the costs are covered in the grant funding received from the Scottish Government.

[14] National Records of Scotland, mid-year 2015 population estimates (23,200 people in Shetland out of 5,373,300 in Scotland)

3.5.16 The Scottish Government made a commitment to fair funding for inter-island transport and this resulted in a one-year allocation of £5 million for Shetland. The expectation of Scottish Ministers is that a mutually acceptable solution will be reached for the long-term. This is being taken forward by the Working Group of officers from Transport Scotland, Shetland and Orkney Islands Councils, Highlands and Islands Enterprise, HiTrans and ZetTrans. This has so far resulted in clarifying the financial requirements of the two Councils for 2019/20 within the parameters defined by Transport Scotland. This 'ask' will form part of the initial budget submission of Transport Scotland for next year, after which political decisions will be determine the final outcome in the Scottish Budget, due to be presented to the Scottish Parliament in December 2018.

3.5.17 Due to the evidence of funding having been made available to the Council in 2018/19 and the positive ongoing commitment to finding a mutually acceptable solution this Plan takes into account the receipt of all of the funding requested, almost £8 million and assumes that inflation protection for this recurring sum will continue into the future.

3.5.18 Other transport costs, the buses, are also funded to a different level in Shetland because of they are on a scale and with a volume of customers that makes many, if not all, routes uneconomical to operate and therefore only exist due to Council subsidy. Other Councils do not have to provide significant levels of funding for the Services because the private sector fills that gap.

3.5.19 Island proofing provisions within the recently introduced Islands Act is an opportunity that cannot be missed by Shetland. As well as creating the obligation on the Scottish Government to produce an Islands Plan, it introduces the concept of placing a duty on Scottish Ministers and other relevant public bodies to 'island proof' their functions and decisions, the financial implications of which for the Islands needs to be effectively communicated.

3.5.20 All of this demonstrates the unique qualities and challenges that Shetland has as an island community and the importance of effective and continued political engagement with, in particular, Scottish Ministers, local and list MSP's and Scottish Government officials to seek all opportunities to enter into dialogue about Services for which the Council does not receive its fair share of funding, or where inconsistency exists between Shetland and other Local Authorities.

3.6 The Shetland Context

3.6.1 Resources are used to fund revenue expenditure across the five Directorates: Children's Services, Community Health and Social Care, Development Services, Executive and Corporate Services, and Infrastructure Services.

3.6.2 Net Expenditure on Services delivered from the Council's General Fund is funded by Scottish Government General Revenue Grant (GRG), a distribution by the Scottish Government of the National Non-Domestic Rates (NNDR) pool, Council Tax and a draw from the returns achieved from the long-term investments (see section 7). The Council also operates a harbour account (see section 5), from which a surplus is generated and a proportion of this surplus is drawn annually from reserves to support Council Services.

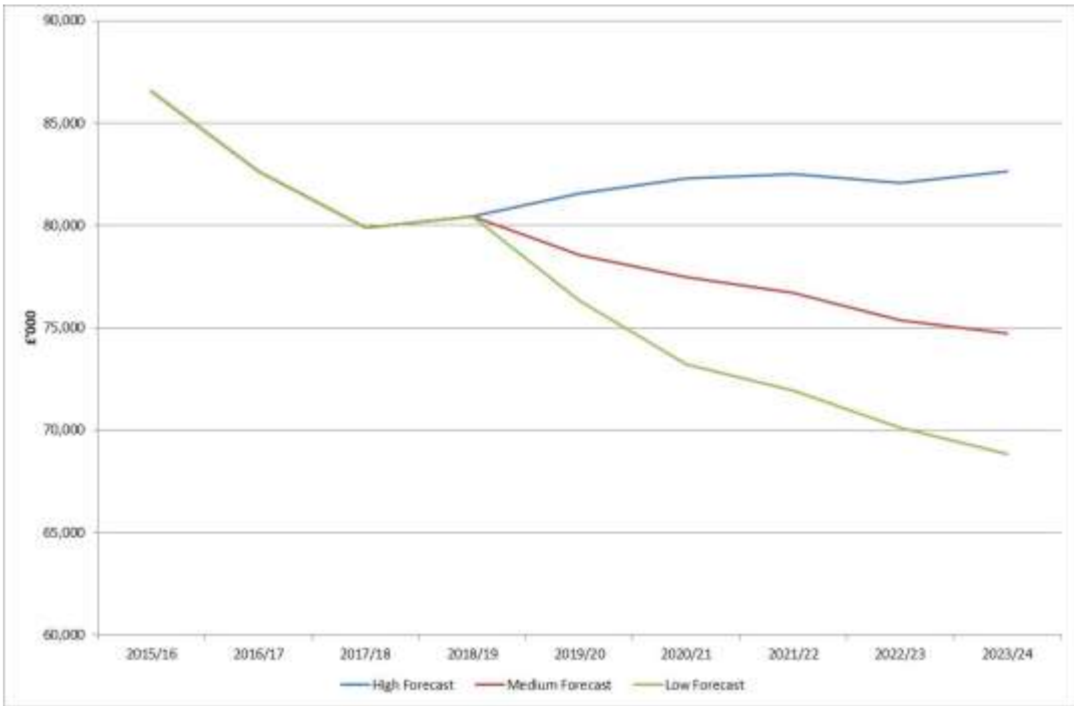
3.6.3 The Council's General Fund budget is however underpinned by the money it receives from the Scottish Government, in 2018/19 75% of the overall net expenditure. Changes therefore in the value of this funding have a significant impact on the resources available to deliver Services.

3.6.4 It is important to understand that the Scottish Government is responsible for determining the overall funding available to the Council in terms of both the GRG and NNDR pool. Therefore if there were to be an increase in the level of Non-Domestic Rates collected locally by the Council, there would be a corresponding reduction in the level of General Revenue Grant to ensure the overall funding level didn't change. This reflects the fact that the Scottish Government hold the risk in terms of a shortfall in relation to the national collection of Non-Domestic Rates during the year, i.e. if there were to be an overall shortfall the Council still receives the same level of grant funding it has been basing the delivery of services on.

3.6.5 In the absence of detailed information at a UK and Scottish Government level it is only possible to predict the future funding for the Council on the basis of publicly available information and by listening to relevant commentators. Using that approach a number of scenarios have been modelled and this has produced an array of possible funding levels for Shetland Islands Council.

3.6.6 In financial year 2018/19 the Council was allocated a sum of £80.5 million in GRG and NNDR distribution, and this is the starting point for the projections shown in Chart 7.

Chart 7: Shetland Islands Council, Scottish Government Funding Forecast to 2023/24.



3.6.7 The projections in Chart 7 take into account different levels of protection offered to other parts of the public sector in Scotland, as referred to in section 3.5, and also the impact that there may be from UK decisions on Scotland. The MTFP makes use of the 'Medium' forecast.

3.6.8 This option assumes a 7.29% reduction in grant by year five.

3.6.9 Based on the evidence it is unlikely that that there will be any increase in the Council's core financial settlement over the course of the MTFP. The continued reduction in funding that is built into the GRG for Notional Loan Charge Support will undoubtedly offset any future upturn in grant funding levels. This element of GRG (£8.8 million in 2018/19) is falling at approximately £0.6 million per annum, and will continue to do so until it runs out in 2034/35.

3.6.10 The Public Bodies (Joint Working) (Scotland) Act 2014 allows Local Authorities and Health Services to integrate health and social care services in a way that best fits local needs. The Shetland Community Health and Social Care Partnership Integration Joint Board (IJB) became operational in November 2015. Local Government settlements have become more complicated since 2016/17 due to funding for Social Care being directed by the Scottish Government through the NHS to the IJB. A sum of approximately £1.3 million is expected through this route in 2018/19 and the MTFP assumes that small increases in funding will be channelled through this route in future years.

3.6.11 Through the adoption of the Strategic Plan the IJB can issue directions to both the Council and NHS Shetland in relation to how community health and social care services are delivered.

3.6.12 The Council has powers to operate ports and harbours and this makes a significant contribution to the availability of funding to deliver Council Services. Income is generated from the fees and charges raised on users of those ports and harbour areas and accounted for in the Harbour Account. See section 5 for further details.

3.6.13 The Council owns social housing and the allocation and management of the properties are kept separately from those of General Fund Services. The Council housing is accounted for in the Housing Revenue Account (HRA), which has its own HRA Business Plan, and is underpinned by a 30 year financial model. The HRA is funded from the rental income generated from the tenants. See section 6 for further details.

3.7 Shetland Performance

3.7.1 Useful websites to help understand the Shetland context are gathered by the Council's Economic Development Service and can be accessed at the following website:

http://www.shetland.gov.uk/economic_development/ShetlandinStatistics.asp

3.7.2 Performance information is vital to understanding and providing data that supports the priority given to Council Services currently being delivered and for the outcomes that are important to the Council over the medium term. Access to the Council's performance information is through the website, where the latest and historic information is available:

http://www.shetland.gov.uk/about_performance/PerformanceReports.asp

4. The General Fund - Revenue

4.1 Introduction

4.1.1 A balanced General Fund Revenue Budget is achieved when the forecast expenditure required to meet the Corporate Plan and legal obligations and contribute to the Shetland Partnership Plan are matched by the resources available.

4.1.2 Based on the information gathered from the Medium Term Financial Plan planning process a General Fund Revenue Budget financial model has been developed that indicates the forecast matching of income and expenditure over the five year period. The detail is shown in Appendix A.

4.1.3 A balanced budget has been set for 2018/19 having benefited from the allocation by the Scottish Government of specific funding to support ferry operations to the value of £5m and an improved overall Local Government financial settlement that unexpectedly exceeded MTFP assumptions. Also integral to the balanced budget is the positive impact of the first savings generated by the Service Redesign Programme.

4.1.4 The challenges of sustaining current services in their current form have not gone away. If funding does not keep up with rising costs then there will always be a gap, unless changes are made.

4.1.5 Good financial management and high performing Councils are expected to focus on the future and the Council has done this for a number of years but implementing solutions that bridge a funding gap remains difficult.

4.1.6 The refreshed MTFP shows that over the next five years the gap is expected to grow to approximately £15.6 million by 2023/24, as shown in the table below.

Shetland Islands Council **Medium Term Financial Plan 2018/19 - 2023/24**	**2018/19** **£'000**	**Year 1** **2019/20** **£'000**	**Year 2** **2020/21** **£'000**	**Year 3** **2021/22** **£'000**	**Year 4** **2022/23** **£'000**	**Year 5** **2023/24** **£'000**
Total General Fund Net Service Expenditure	112,659	117,559	121,717	125,864	128,967	132,816
Total Trading Income	(7,081)	(7,407)	(7,507)	(7,607)	(7,607)	(7,607)
Total Core Revenue Funding	(89,814)	(88,300)	(87,614)	(87,248)	(86,314)	(86,108)
Ferry Funding	(5,000)	(7,940)	(8,158)	(8,381)	(8,591)	(8,805)
Additional Financing Requirement	**10,764**	**13,913**	**18,438**	**22,628**	**26,455**	**30,296**
Financed By:						
Affordable Draw from Investment Returns	(10,764)	(13,723)	(14,067)	(14,116)	(14,366)	(14,690)
One-Off Use of Reserves	0	0	0	0	0	0
Underlying future savings requirement (funding gap)	0	(190)	(4,371)	(8,512)	(12,089)	(15,606)
	(10,764)	**(13,913)**	**(18,438)**	**(22,628)**	**(26,455)**	**(30,296)**
Cumulative One-Off resources required would be…	**0**	**(190)**	**(4,561)**	**(13,073)**	**(25,162)**	**(40,768)**

4.1.7 Four observations from the above table:

- The increase in Net Cost of Services is estimated to be 18% higher in 2023/24 than in the current year if nothing is done about the underlying service delivery models;
- The “Ferry Funding” line reflects the assumption that the Scottish Government will deliver funding to support current costs of ferry operations on an ongoing basis. This amounts to almost £8 million in 2019/20 and due to the rising cost of services is anticipated to be inflation proofed. **The impact of this funding is fundamental to the affordability of services in Shetland, without it the Council would require approximately £8 million of savings in 2019/20 to balance the budget**;
- Looking at the progress since the last MTFP it shows that positive steps have been made. Firstly in securing funding for ferry operations which had not been built into the last plan, and secondly if the effect of that funding is eliminated then the gap at 2021/22 (year 5 of the last MTFP) is now approximately £4m less; and
- If the Council takes no action and all things being equal, then by 2023/24 the Council would have used an additional £41 million from its investments, which would undermine the value of the affordable draw from investments; compounding the problem.

4.1.8 The recommended response to the Council is to implement recurring savings, or securing recurring income or managing out demand and growth pressures to the value of between £15.6 million over the period to 2023/24. A strategic approach should be taken to this with prioritisation of outcomes and statutory duties and a plan should be produced that supports the delivery of the required savings, incorporating the Service redesign projects and take into account the Business Transformation Programme.

4.1.9 In the absence of a plan of this nature then the Council should seek to rely on delivering annual recurring savings of 3.4% from 2020/21, with options to deliver early should not be missed (Appendix B shows the impact of 3.4% savings being achieved in years 2 – 5 of the plan and balances income and expenditure overall at year 5).

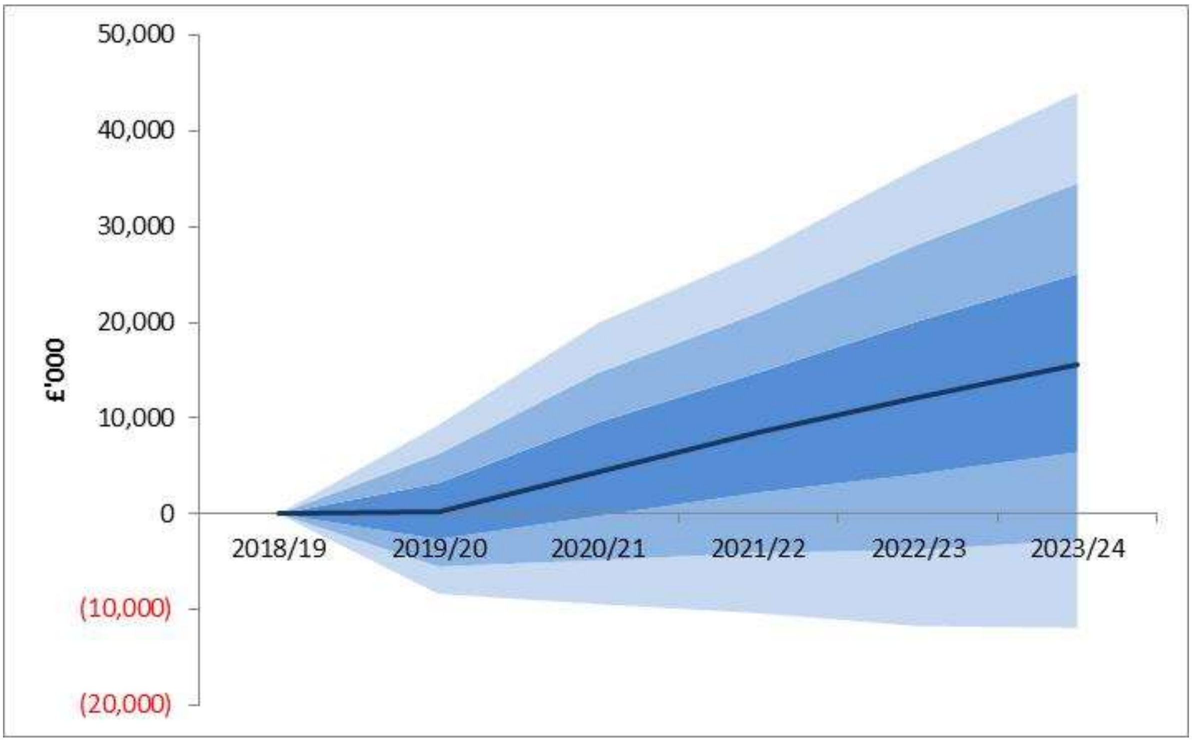
4.1.10 Based on the MTFP projections then the Council is fortunate to have 2019/20 to continue the work to organise the options, the business case options and to make decisions and implement change.

4.1.11 This does present the challenge of requiring one-off funding to manage the reduction over that time, but if delivered then an affordable annual budget of approximately £108 million per annum is possible. The one-off funding, £1.2

million, is affordable over that period because of the positive position from which it starts; underspending from previous years offers that opportunity.

4.1.12 It is clear that the uncertainty in forecasting all of the various factors brings a significant likelihood of error and therefore it is important to set the gap of £15.6 million in the context of the 'Best' and 'Worst' case scenarios. Chart 8, below, shows the extent of uncertainty and the potential scale of the challenge. There is a 80% likelihood of costs exceeding income over the term of the Plan. It takes significantly beneficial assumptions for the current budget to be sustainable over the 5 year term. Relying, for example, on the funding to support ferry operations and inflation being applied, a low inflation environment, Scottish Government funding increasing, increasing surplus on Harbour operations and strong throughput income from the Shetland Gas Plan and so on. The evidence doesn't suggest that this is likely to happen and the Council should prepare for a more challenging financial climate. It is worth noting that it remains unlikely that all of the worst case scenarios occur, which would result in a gap by 2023/24 of £44 million.

Chart 8: Shetland Islands Council, Medium Term Funding Gap to 2023/24.



4.1.13 The MTFP takes a prudent approach to the overall range of possible scenarios.

4.1.14 It is recommended that the Council now, urgently and robustly takes an overall strategic approach to ensure that the Corporate Plan objectives are given the highest priority, that the approved Business Transformation Programme is delivered alongside clear and focused Service redesign to address this gap.

4.1.15 The Business Transformation Plan has a range of work streams that focus on improving core business and ensuring that the environment is right for Service redesign work to be implemented. The Corporate Management Team has been working to prepare and present Business Cases that will set out the Service redesign projects alongside expected outcomes and financial implications, amongst other things.

4.1.16 Action has to be taken and detailed plans put in place so that the opportunity the Council has to reduce the cost base is not missed.

4.1.17 It is fully recognised that the assumptions made in this Plan require to be reviewed and refined on a regular basis.

4.2 Aligning Resources with Priorities

4.2.1 In most instances the Council is locked into service delivery models, staffing structures, ways of working, buildings and technology that makes it very difficult to make changes easily and quickly. Add to this rising costs, because of pay inflation, price inflation and contractual obligations as well as uncertainty about income sources that the Council relies on and it presents a particularly difficult task to shift resources, to do different things and to fund the transition.

4.2.2 The key to keeping rising costs in check is to look at the way Services are delivered and find alternatives ways of carrying them out at reduced cost or to reconsider the priority for the Council and to stop or reduce what is done. The Council in recent years has worked to increase income to support services rather than stopping and reducing what it does.

4.2.3 The last MTFP looked at the impact of simply protecting certain elements of the budget as currently organised and allowing those to continue as is. This would have the impact of skewing (or stopping) the delivery of Services in other parts of the Council which may not be possible for legislative reasons and quickly becomes disproportionate.

4.2.4 The Council, through the last two budget setting processes has aimed to avoid the ‘salami slicing’ approach to savings and to target savings on deliverable options. This led to £1.9 million of savings being included in the 2018/19 budget, with only £0.6 million allocated directly to services. The balance coming from corporate initiatives that aim to deliver savings without impacting on current frontline Services.

4.2.5 The other approach has been to increase political engagement at a national level and with Scottish Ministers in particular to secure funding for inter-islands transport and for the first time a one-year settlement was announced by the Scottish Government ahead of the 2018/19 Finance Order proceeding through Parliament. The £5 million received provided a lifeline for the Council budget.

4.2.6 The resources allocated to achieving that outcome and the ongoing dialogue and work that has been undertaken with Transport Scotland since then is an indication of the Council prioritising resources with a specific outcome in mind. It has taken a number of years to make the argument and get it on the agenda of Scottish Ministers therefore it should not be relied upon that new income streams can quickly be found for other priority activities – that should not of course stop the Council from making its case at every opportunity.

4.2.7 Aligning resources with strategic aims and objectives remains a very complex subject and this is demonstrated by the extent of strategies and legal duties and obligations that it has to address. The complexity of the task is illustrated by the extent of strategic documents that the Council either owns or is a participant in (see Appendix D and E).

4.2.8 There remains an underlying requirement for the Council, through the funding settlement from the Scottish Government, to deliver year on year efficiency savings and these in principle should apply to all Council Services.

4.2.9 If the Council is to address its priorities and arrange its financial and other resources to deliver on the key objectives with a view to achieving the long-term outcomes then the Council will need to take a long-term and robust approach to this. Gathering the necessary data and evidence that supports an outcome focus is not a straightforward or quick task but the Corporate Management Team has started to bring a programme of Service redesign together that is expected to deliver services using fewer resources.

4.2.10 Within the framework of this MTFP, rising cost and reducing income does not make this task any easier. However it is recommended that the work is put into defining the allocation of resources to support the strategic objectives and outcomes and to set a Council-wide recurring savings target of £15.6m by 2023/24 (the equivalent to 3.4% savings per annum from 2020/21 onwards).

4.2.11 In the absence of that strategic work being completed then the MTFP recommends an alternative 'salami slicing' approach. A Service focused financial target that essentially looks for each Directorate to deliver their budget proposals with no growth and set an efficiency target that requires to be delivered beyond that. The figures are indicated in Appendix C.

4.2.12 It is anticipated that this approach will not actually deliver the outcomes for the citizens of Shetland and will potentially target activities/Services that are needed in the medium to long term for the ultimate achievement of what is important. It does however ensure there is clarity in what is expected in event of a void of information and action.

4.3 Values and Behaviours

4.3.1 Improving the prospects of the Council meeting its financial target, identifying opportunities to make changes and implementing the final decision in an effective manner can be improved through a positive culture of working well together, excellent service and taking responsibility – thorough demonstration of Council Values.

4.3.2 From recruiting staff based on the Council Values where there the Council can build a shared understanding of what is important in the way that all staff go about their work, to empowering individuals and teams to take responsibility and enabling them to act, the Council Values are an important element in successfully achieving Council objectives, including the financial objectives.

4.3.3 For example, by delivering Excellent Service to customers and clients then the Council can reduce and ultimately eliminate failure demand, ensuring that issues and queries are addressed at the earliest point and that communication is effective where the activity is carried out over a period of time.

4.3.4 Failure demand arises when the Council has not completed tasks, where there has been insufficient communication on what is happening or when something will happen. This failure to communicate or complete tasks results in phone calls, emails, escalating to complaints and those circumstances ultimately potentially a review and involvement of the Scottish Public Service Ombudsman (SPSO).

4.3.5 The consequence is that failure demands cost money, a lot of money and increasingly expensive as the processes escalates through the stages.

4.3.6 It is therefore better and more cost effective to reduce and eliminate the cost of failure demand, it benefits the customers, increases capacity of staff not having to deal with extra phone calls and email messages, avoids involvement of supervisors, team leaders and executive managers in the handling, recording and preparing responses to complaints.

4.3.7 The recent adoption of the Customer Strategy and Customer Charter is a positive step, as part of the Business Transformation Programme, aimed at making these small but cumulatively significant improvements in the Council.

4.3.8 Excellent Service may of course come at a price and the balance between the cost of excellence and the cost of addressing demand failure that arises is no doubt a complex calculation but if the cost of excellence can be paid for by the reduction in failure demand cost then it would appear simpler to justify the cost of services to the citizens of Shetland and customers in general and it would signal a best value approach. It demonstrates that even the small stuff is important and should be utilised to deliver change through embedding it in the Council culture and demonstrating from the top down, day in day out that it makes a difference.

4.3.9 To further expand the subject the Council, within the Corporate Plan, strives to deliver on the high standards of governance, that is, the rules on how the Council is governed, as this will mean that the Council is operating effectively and the decisions that it takes are based on evidence and supported by effective assessments of options and potential implications. Linking this with taking personal responsibility and avoiding the failure demand of not meeting the high standards expected, similar to the earlier example, the challenge of working in a reactive rather than proactive way, impacting on other work as a consequence and inevitably involving escalation and time commitments that could have been avoided in the first instance.

4.3.10 Sound knowledge and use of information contained in key documents such as the Council constitutional documents, including the scheme of delegation and financial regulations; the Gateway process for Asset Investment proposals and five case building better business case methodology, legal obligations to best value, continuous improvement and community planning all can assist in minimising the cost of failure demand.

4.3.11 It is likely that similar examples can be described for each of the Values, the impact of getting this right should not be underestimated.

5. Ports and Harbour Account

5.1 Introduction

5.1.1 In 1974 the UK Parliament passed The Zetland County Council Act. This Act provided certain regulatory powers and placed duties of conservancy on the Council, over the seas around its coast line. The Act provides the Council certain financial powers to borrow, invest and participate in business.

5.1.2 Under the Act the Council now operates a number of harbours around Shetland, the primary operation taking place at Sella Ness (the Port). The levels of activity are entirely dependent on the tanker movements through the Sullom Voe Terminal (SVT).

5.1.3 All the harbour operations are accumulated and accounted for through the Harbour Account. All surpluses generated on the Harbour Account are transferred to the Reserve Fund – a specific Fund held within the Council's Usable Reserves.

5.1.4 The Act states the purposes of the Fund as:

- To cover losses on the Harbour Account;
- To meet any claim or demand against the Council arising from the Harbour Account;
- To meet any capital expenditure to maintain the Harbour Account;
- To meet any repairs and maintenance cost on the Harbour; and
- 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.

5.1.5 For many years the Council has drawn funds from the Reserve Fund to support the delivery of other Council Services, through a contribution equivalent to the annual surplus on the Harbour Account.

5.1.6 As a trading operation the Harbour Account is set up to make a return on the assets that are invested therein and to generate a surplus. It is recommended that the Council continue to adopt a robust pricing policy for the Port to ensure that a return on the investment made is achieved annually and that this surplus is used to deliver benefit to the Shetland public. This will be achieved by providing financial support to the Revenue Budget, thereby contributing to the delivery of Council Services.

5.2 Harbour Operations

5.2.1 Previously it was stated that that oil industry had announced its intention to remain at the SVT until around 2050.

5.2.2 The impact of low oil and gas prices on the industry has resulted in significant uncertainty, with widely reported cost reduction initiatives, including capital investment delayed or cancelled, job losses and operational changes. The full impact on SVT remains unclear and discussions are continuing in relation to the position and plans of the Council's customer.

5.2.3 The Terminal, in 2017, changed operator and now operational management is the responsibility of EnQuest. They have a view to maximising the economic life of the assets.

5.2.4 Recent discussions highlight the challenges for SVT and meeting the long-term aspiration of remaining operational beyond the medium term. The Council therefore must be conscious of the risks that arise from the uncertainty and to be aware that there is a likelihood that surpluses may end much sooner than previously thought likely.

5.2.5 That said, at present the Council's financial modelling continues to be reviewed in light of the volatile market conditions and it remains important that certain principles are retained in terms of operating the Port for the benefit of the oil industry. These include:

- The oil industry will never be subsidised by Shetland Council Tax payers;
- The pricing policy adopted will be full cost recovery plus a surplus, that reflects a suitable rate of return on investments;
- The customer has defined the service level required at the Port as "24/7", which has been assumed as the continuing operating model;
- The surpluses generated by the Port over the period to 2050 will be at least equal to the average investment return that would be generated had the capital instead been invested with the Council's Fund Managers;
- The cost of capital investment, associated lifecycle replacement and maintenance and decommissioning will be built into the full cost of operations.
- Where tanker numbers are such that additional surpluses are generated then these should be set aside to address the future costs and in preparation for the decommissioning of the operation and income to the Council being fundamentally reduced.

5.2.6 The MTFP maintains a prudent approach to the surplus that can be used for supporting Service costs and that a constant surplus of approximately £6 million will be generated annually. It appears reasonable that over the life of this MTFP that this is achievable.

5.2.7 This will provide a continuing level of income to the General Fund Revenue Budget to support Services and provide time for a greater level of information and knowledge to be obtained to inform future financial modelling and pricing policy.

5.2.8 Alongside working with the oil and gas industry on the future of SVT and the use of the Council Ports and Harbour infrastructure the Council should also explore the alternatives options that it has for the replacement, over the medium term, of the £6 million per annum that currently supports General Fund Services.

6. Housing Revenue Account

6.1 Introduction

6.1.1 The Council is the largest landlord in Shetland, responsible as at 31 March 2016, for the letting and management of 1,725 properties across Shetland.

6.2 Accounting Treatment

6.2.1 The Housing Revenue Account (HRA) is a statutory account that requires to be kept separate from the General Fund. As such, it has to be financially self-sustaining, drawing its income from rental income generated on the housing stock. All expenditure, revenue and capital, is funded from housing rents and the Housing Revenue Account Reserve. It is not possible for the General Fund to subsidise council house rents.

6.2.2 The HRA Reserve, which only the HRA can access is part of the Council's Useable Reserves. At as 31 March 2018 there was a balance of £17.3 million.

6.2.3 The HRA Reserve has been excluded from the Useable Reserves on which the investment returns are based upon, as from time to time expenditure will be incurred to support the Council's delivery of social housing. The HRA 5-year business plan is underpinned by a 30 financial model where the use of and contribution to the HRA Reserve is shown.

6.3 Housing Capital Investment

6.3.1 For a number of years the HRA was overburdened by the unsustainable level of debt that it had to service. However following a tripartite agreement between the Council, the UK Government and the Scottish Government the issue of historic debt has been successfully addressed. The reduced debt level has resulted in lower annual costs for the HRA.

6.3.2 The HRA will only be able to fund capital expenditure in line with the Capital Funding Policy (see section 8.4) and the Prudential Code. The Council's Annual Investment and Treasury Strategy includes details of the overall capital financing requirement and other Prudential Indicators, which includes the HRA. This will ensure prudence, sustainability and affordability in all future capital investment decisions which will avoid the HRA becoming financially unsustainable in the future.

6.4 Housing Revenue Account Financial Policy

6.4.1 In producing the HRA Business Plan, the 30 year financial modelling that has been undertaken to inform it, provides a detailed level of data upon which future year HRA budgets should be set. The overall objective of the Business Plan is to fully cost the operational requirements of letting, maintaining and managing the Council housing stock. It is expected that the Business Plan will ensure:

- Annual HRA budgets are financially sustainable;
- There is a focus on housing rent levels being affordable;
- Capital investment is targeted at maintaining the existing housing stock, ensuring the quality standards set nationally are met and will be in line with the Capital Expenditure Policy (see section 8.3);
- Capital investment will be funded in line with the Capital Funding Policy (see section 8.4). This may include in-year revenue funding from housing rent income and where necessary borrowing, subject to complying with the Prudential Code; and
- The HRA Reserve is managed effectively to have a long-term focus.

6.4.2 UK Government reform of welfare policy and specifically the change to Universal Credit alters the timing of payments and makes full payment of the housing related elements of benefits payable to the applicant. It is therefore their responsibility to pay their rent. The national and local position suggests that rent arrears have increased for the individuals that are receiving Universal Credit.

6.4.3 While this represents a very small number of people at present the position will have to be reviewed on a regular basis and where necessary incorporated within the modelling of the business plan.

6.5 Housing Activities Supported outwith the HRA

6.5.1 The Corporate Plan makes clear one of its top priorities is affordable housing. This in part is addressed through the proper and effective management of the Council's own HRA and housing stock, but is not the only mechanism that the Council has to achieve a better outcome in this area.

6.5.2 The HRA Business Plan states that the Housing Service operates within a strategic framework which links to local and national policies. These are contained in the Local Housing Strategy and underpinned by the evidence base presented in the Housing Need and Demand Assessment.

6.5.3 The five key themes of the Local Housing Strategy are Future housing supply; Homelessness; Housing Support/Housing needs of an aging population; Fuel poverty; and Private Sector.

6.5.4 These themes provide the framework for improving the housing outcomes. At the same time as seeking HRA solutions to support the Local Housing Strategy, the Council continues to work closely with Hjaltland Housing Association to increase the supply of houses, and access additional funding options, not readily available to the Council. Added to this are options in relation to mid-market rent properties, such as the National Housing Trust initiatives and working with developers to stimulate increased supply of affordable houses.

6.5.5 Income from the collection of Council Tax on 2nd homes, has, under legislation, had to be set aside for the purposes of delivering affordable housing solutions. The sum available in the Council's Usable Reserves as at 31 March 2018 was £1.3 million.

7. Reserves Policy and Investment Returns

7.1 Introduction

7.1.1 The value of long-term investments as at 31 March 2018 was £345 million, backed by earmarked and discretionary Usable Reserves of £250 million. Almost all of the Usable Reserves have been invested in the financial markets for many years. The Council retains a working cash balance to finance day to day expenditure, which is supplemented by income received during the current financial year. If this Council is living within its means, and not drawing cash from the investments, the Council is able to operate effectively from the funding that it receives in a single year.

7.1.2 To maintain the value of the Usable Reserves the Council must live within its means, avoiding overspending on its budget, and also actively managing and understanding the impact of its decisions. For example there are a number of earmarked useable reserves that over time will inevitably be used to achieve strategic outcomes and objectives, such as the Housing Revenue Account Reserve; the Insurance Fund; and the Council Tax Second Homes Receipts Fund. Recognising the timing and value of the use of these earmarked reserves must therefore be taken into account when considering the long-term investment returns that aim to be achieved.

7.1.3 The Council, through adoption of the current MTFP and the recommendations in the Long Term Financial Plan[15], has agreed the objective of maintaining the value of the Usable Reserves as it provides the cash upon which the long-term investments are based. This in turn is assumed to provide a long-term recurring funding stream to support the costs of delivering Services. This approach achieves the greatest long-term benefit for the delivery of Services in Shetland.

7.1.4 The value of investments can go down as well as up and therefore there needs to be a risk based approach taken in relation to withdrawing funds and the method upon which investment returns should be calculated. This is explained in the withdrawal policy below.

7.2 Investment Objectives

7.2.1 It is important that the Council recognises its investment return objectives and the risks that are associated with the investment structure that is implemented to deliver those objectives. These factors have been taken into account when reviewing the Investment Strategy presented to Council on 22 August 2018.

7.2.2 The Council has the following investment return objectives:

[15] Long-Term Revenue and Capital Planning: Council, 8 March 2017

- Achieve investment returns that are sufficient to enable an annual sum to be withdrawn to support the Revenue Budget;
- Achieve investment returns that protect the annual sum withdrawn from the impact of inflation; and
- Investment risk is mitigated by the diversification of asset classes, global coverage and a number of fund managers.

7.2.3 The current value withdrawn from investment returns is based on a targeted average gross return of 7.3% per annum.

7.2.4 To ensure that the Council continues to achieve the required 7.3% rate of return to support the Revenue Budget the Council has undertaken a review of the Investment mandates that currently exist. The report, Investment Strategy 2018, is on the same agenda as this Plan and provides recommendations to adjust the investment mandates and financial products that the Council invests in to increase the likelihood of delivering the required returns.

7.2.5 This has included comparing the current strategy with market forecasts and also looking at the likely volatility that will be experienced through the investments. Balancing return and risk, while dampening volatility have all been taken into account and the MTFP has assumed that there will be continued delivery of the 7.3% per annum over the long-term.

7.2.6 Structuring the Council's investment in the financial markets will be carried out in accordance with the decisions of Council and they take account of the approved Annual Investment and Treasury Strategy[16].

7.2.7 The Annual Investment and Treasury Strategy sets out the risks associated with it and the mitigating actions and controls that are in place to reduce the impact and likelihood of those risks.

7.2.8 In following this approach the Council aims to deliver additional funding for Services over the long-term.

7.3 Withdrawal Policy

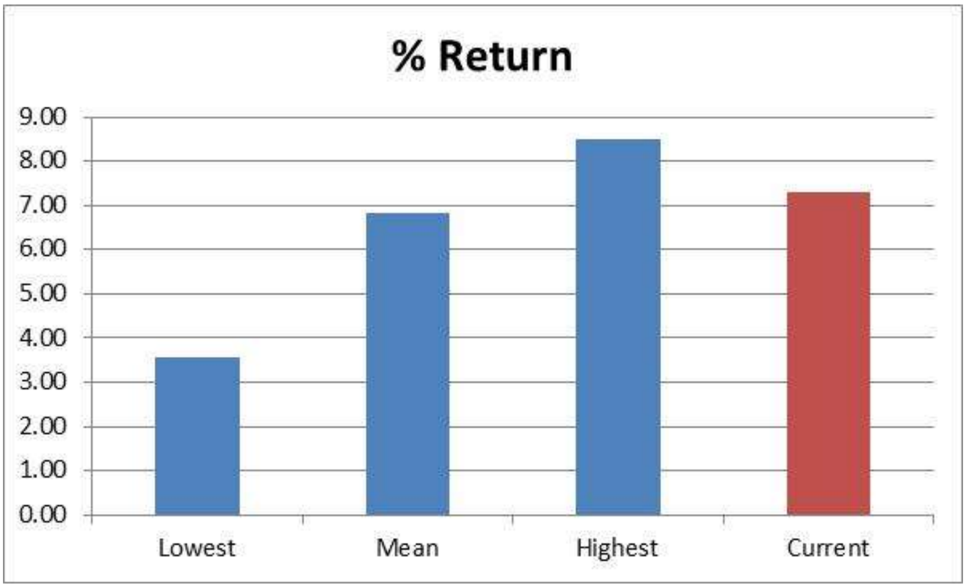
7.3.1 The Council has adopted an approach that the benefit that could be derived from the investments would be based on the long-term average performance of the investments and that the value of the investments would be protected from the impact of inflation. This is in line with the investment objectives set out in section 7.2 above.

7.3.2 The recommended sustainable withdrawal from the investments is 5.2%.

[16] The latest Annual Investment and Treasury Strategy 2018/19: Council, 7 March 2018

7.3.3 Reviewing the investment returns over the last 20 years reveals that a range of returns have been achieved and that within this the year to year performance has, not surprisingly, been volatile. Chart 9 shows that despite the future value of investments being unpredictable, the returns over time have been positive. The expectation is therefore that investment returns will continue to be positive, but should not be predicted to achieve the highest levels of return that have been achieved in the past.

Chart 9: Shetland Islands Council, Long-Term Investment Returns analysis.



7.3.4 The challenge that the Council has is predicting how healthy those investment returns will be in the future. The graph above shows four investment return averages, which have been taken from the last 20 years of data, collating all 10 year, 15 year and 20 year average returns. The lowest average annual investment return of those was calculated at 3.56%, while the highest was 8.49%. The mean was 6.82% and the Council currently adopts a 7.3% average annual investment return.

7.3.5 In reviewing the expectations of future returns it is recommended that 7.3% is retained.

7.3.6 An assumption as to the future value of inflation is available from government forecasts; although low in the recent past there have been rises, particularly on the back of rising fuel prices. The full effect of the falling value of sterling – increasing the price of imports – has not yet been seen.

7.3.7 The Office for Budget Responsibility shows government forecasts for CPI to return to 2% by 2020. Given the long-term nature of these assumptions, looking back over the last 20 years, UK CPI averaged 2.3% over the last 10 years, 2.1% over 15 years and 1.9% over 20 years.

7.3.8 Using all of this as a backdrop it is not unreasonable to forecast that CPI may exceed 2% in the long-term and as such to recommend using future inflation proofing of investments at 2.1%, the 15 year average.

7.3.9 This results in a withdrawal policy that equates to continuing affordable use of investment returns on annual basis of 5.2%.

7.3.10 The value upon which an affordable use of investment returns is calculated is vital and this should take into account the known withdrawal from investments of expected expenditure and known commitments. In doing this allows a degree of tolerance to be built into the calculations to mitigate the risk of investment fluctuations, such as those that were experienced in 2015/16, where investment values fell by 1.2%.

7.3.11 An investment returns base is therefore recommended to take account of the following items to ensure that the expectations of what can be affordably withdrawn from investment returns are prudent:

- Borrowing invested in the short-term ahead of its use on capital projects and the principal repayments made that have not yet been used to repay debt at maturity;
- Earmarked General Fund reserves, excluding the equalisation fund;
- Discretionary Spend to Save funds that expect to be used to deliver future savings.
- The cumulative sum that is equivalent to the value that the investment value is ahead of the returns forecast (commencing 2015/16). At 31 March 2018 this was £20 million.

7.3.12 Calculating the investment returns base as at 31 March 2018 results in a value of £264 million upon which investment returns are recommended to be based.

7.3.13 The financial outturn included in the draft 2017/18 annual accounts taken into account, as has the budget 2018/19 commitments to use reserves.

7.4 Affordable Use of Investment Returns

7.4.1 Based on the withdrawals policy above, the value of affordable use of investment returns forecast for 2019/20 will be £13.7 million.

7.4.2 This sum may be used to support revenue or capital; however, it can only be used once.

7.4.3 The challenges of rising costs, falling income and the time it takes to make structural changes to the delivery of Council Services means that maximising the level of income from the investment returns to support Services will help to avoid unnecessary savings proposals to balance the budget. This does place significant restrictions on the Asset Investment Plan however the flexibility and prioritisation of projects of a capital nature allows greater opportunity to adapt during the five year period to the changing public sector environment.

7.4.4 The affordable value across the period of the MTFP is subject to 2.1% inflationary increases, in line with the inflation proof approach being taken to the investment return base value.

7.4.5 It is recommended that the full value is allocated for use to support revenue service delivery costs throughout the life of the MTFP.

8. Capital Investment Planning

8.1 Introduction

8.1.1 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.

8.1.2 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 that is greater than these funding sources effectively has a cost – the cost of capital.

8.1.3 In the past the Council has used its Reserves to fund capital expenditure, which itself had a cost in that by using Reserves to fund capital expenditure, the value spent from Reserves was no longer be available to generate a long-term investment return. This cost was not accounted for and recognised as a cost in the past.

8.1.4 The Council's resources are precious and in recommending the Financial Strategy in section 2 the investment returns that can be generated by retaining Usable Reserves, invested for the long-term, will be targeted on supporting the Revenue Budget. The consequence of this is that by maintaining the Usable Reserves value to maximise those returns there they cannot also be used to fund capital expenditure.

8.1.5 Now and in the future it is important that the Council recognises the cost of capital expenditure so that it is not treated as a "free resource".

8.1.6 Borrowing money from within the Council, or externally is the same, it has to be repaid in full.

8.1.7 The Long Term Financial Plan (LTFP)[17] demonstrates that if the Council wishes to retain and operate the asset base that it currently has, there will have to be a significant transfer away from spending money on ongoing service delivery and will instead have to make savings in order to fund the cost of capital.

8.1.8 At present the Council is in another fortunate position where a substantial proportion of its revenue budget is not committed to annually funding the cost of borrowing.

[17] Long Term Revenue and Capital Planning: Council, 8 March 2017

8.1.9 The LTFP takes into account as part of its scenario planning the impact of long term asset management planning, as well as the current policy of focusing on what the Council has and needs for its organisational Service delivery.

8.1.10 A long standing issue that creates enormous uncertainty for the island communities is being unclear about the extent to which the Scottish Government will commit financial resources to fully support the aging ferry fleet and terminals. This is seen as a critical element of the commitment made by the Scottish Government to fund these services fairly.

8.1.11 The annual maintenance costs increases year on year and a programme of tens of millions is required over the next 20 years to protect that infrastructure. At present the funding the Council receives is not sufficient to fund this programme. The Asset Investment Plan makes the assumption that funding will be made available from the Scottish Government through Transport Scotland.

8.1.12 Following receipt of revenue funding in 2018/19 the continuing work with Transport Scotland et al has enabled progress to be made towards letting contracts for the Outline Business Cases that are required to support capital investment. It is expected that this initial work is delivered by the end of this financial year and the costs of carrying out the work is shared between the partners.

8.1.13 The Council continues to engage politically with Scottish Ministers and the Government and officers regularly meet with Transport Scotland to progress matters but the reality is that it cannot be certain that the necessary level of funding will be made available in the timescale the Council expects.

8.1.14 The Capital Expenditure and Capital Funding Policies recommended below (see sections 8.3 and 8.4) are applicable to the General Fund, Harbour Account and Housing Revenue Account

8.2 Future Capital Resources

8.2.1 The Capital Grant that the Council receives from the Scottish Government is the primary source of funding for capital expenditure. In the recent past the Scottish Government varied the value of capital grant available in 2016/17 and held it over until 2019/20.

8.2.2 Projecting forward is challenging due to the lack of data to support any specific forecasts of what the Scottish Government may do. It has been assumed that Shetland will have to manage its capital expenditure on the basis of reduced funding too. The value used as a base in the MTFP is £5.5 million annually.

8.3 Capital Expenditure Policy

8.3.1 To address the unaffordable capital expenditure requirements of the Council the following policy is recommended:

- No growth in the asset base;
- All capital expenditure to be focussed on the maintaining the existing assets (with the exception of the previously approved new Anderson High School and new Eric Gray Resource Centre);
- A gateway process will ensure strategic fit is demonstrated early and decisions are taken at key stages. This will be supported by a full business case, including projected future demand, and options and investment appraisal process 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;
- All capital projects must clearly demonstrate the revenue consequences arising from a capital spending decision to assist Councillors in understanding the full financial impact and funding arrangements; and
- The focus will be on effective asset management, driven forward through the Asset Strategy and Implementation Plan. This will ensure that the Council occupies a reduced number of properties in the future.
- The Executive Manager – Capital Programme will determine the opportunities for the maximisation of income from the Council's property estate, which may be in the form or revenue income or capital receipts.

8.4 Capital Funding Policy

8.4.1 To reflect the limited availability of capital funding and the cost associated with the use of capital the following policy is recommended:

- Scottish Government Capital Grant will be applied initially to short life assets (e.g. vehicles, ICT, certain maintenance);
- Capital Receipts will be targeted at core capital maintenance costs;
- Capital Funded from Current Revenue (CFCR) will be used were appropriate to fund low value, shorter life capital expenditure;
- Where available and determined as appropriate by the Executive Manager – Finance, other assets may be funded from Capital Grants, Capital Receipts and CFCR;
- All other capital expenditure will be financed by borrowing. If interest rates are lower than the return on long-term investments described in the MTFP (see Withdrawal Policy in section 7.3), external borrowing will be undertaken.

If interest rates are higher than investment returns, internal borrowing will be undertaken;

- The Service(s) that benefit from the capital asset will be required to make sufficient revenue savings to free up budget to pay for the cost of capital (interest charges and principal repayment of debt). This will be calculated based on the amount borrowed. Revenue implications of the capital project also require to be funded by the relevant Service;
- Capital financing products are affected by external and financial market factors and can develop in a way that may enable the Council to achieve its Corporate Plan outcomes through alternative means. Where new capital financing opportunities arise, such as Scottish Government initiatives like the National Housing Trust models, then the Executive Manager – Finance will give consideration to such products, subjecting them to financial viability, affordability and risk tests, and make a recommendation prior to proceeding.
- 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.

MEDIUM TERM FINANCIAL PLAN – QUANTIFICATION OF THE FUNDING GAP – APPENDIX A

	Shetland Islands Council						
	Medium Term Financial Plan 2018/19 - 2023/24		**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
		2018/19	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24**
		£'000	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Service Expenditure and Income	General Fund Service Expenditure	140,940	145,971	150,440	155,037	158,699	162,467
	General Fund Service Income	(27,360)	(28,808)	(29,763)	(30,786)	(31,843)	(32,238)
	Other Account Recharges	(1,675)	(1,725)	(1,777)	(1,830)	(1,867)	(1,904)
	Net Income from Integration Joint Board	(1,263)	(1,301)	(1,341)	(1,382)	(1,409)	(1,434)
	Economic Development Investments Income	(1,080)	(1,134)	(1,134)	(1,134)	(1,134)	(1,134)
	Capital Financing Costs	1,580	1,573	1,590	1,589	1,589	1,565
	Recurring Budget Pressures	567	2,034	2,752	3,420	3,982	4,545
	Non-Recurring Contingency Provision	950	950	950	950	950	950
	Total General Fund Net Expenditure (exc. Ferry Funding)	**112,659**	**117,559**	**121,717**	**125,864**	**128,967**	**132,816**
Trading income	Shetland Gas Plant Income	(1,024)	(1,350)	(1,450)	(1,550)	(1,550)	(1,550)
	Harbour Account Surplus	(6,057)	(6,057)	(6,057)	(6,057)	(6,057)	(6,057)
	Total Trading Income	**(7,081)**	**(7,407)**	**(7,507)**	**(7,607)**	**(7,607)**	**(7,607)**
Core Funding	GRG & NNDR	(80,451)	(78,562)	(77,489)	(76,724)	(75,378)	(74,747)
	Council Tax	(9,363)	(9,738)	(10,124)	(10,523)	(10,936)	(11,361)
	Total Core Revenue Funding	**(89,814)**	**(88,300)**	**(87,614)**	**(87,248)**	**(86,314)**	**(86,108)**
	Budget Deficit	**15,764**	**21,853**	**26,596**	**31,009**	**35,046**	**39,101**
Deficit Funding	**Financed by:**						
	Affordable Draw from Investment Returns	(10,764)	(13,723)	(14,067)	(14,116)	(14,366)	(14,690)
	Savings and/or Income Generation (Ferry Funding)	(5,000)	(7,940)	(8,158)	(8,381)	(8,591)	(8,805)
	One-off Use of Reserves	0	0	0	0	0	0
	Underlying future savings requirement (Funding Gap)	0	(190)	(4,371)	(8,512)	(12,089)	(15,606)
		0	**0**	**0**	**0**	**0**	**0**

MEDIUM TERM FINANCIAL PLAN SCENARIO 1 – APPENDIX B

AFFORDABLE BUDGET REACHED BY YEAR 5

(£15.6M RECURRING SAVINGS BY 2023/24 - EQUIVALENT TO STRAIGHTLINE SAVINGS OF 3.4% FROM YEAR 2)

Council Savings Model Target set at… £15.6m recurring by Year 5	2018/19 £'000	Year 1 2019/20 £'000	Year 2 2020/21 £'000	Year 3 2021/22 £'000	Year 4 2022/23 £'000	Year 5 2023/24 £'000
Based on Approved Budget 2018/19	**112,659**	**107,659**	**109,619**	**113,559**	**117,483**	**120,376**
Growth (Costs)		4,900	4,157	4,148	3,103	3,849
Change in Ferry Funding	(5,000)	(2,940)	(218)	(224)	(210)	(215)
Forecast Net Expenditure	**107,659**	**109,619**	**113,559**	**117,483**	**120,376**	**124,010**
Savings Generated by Target		**0**	**0**	**0**	**0**	**0**
Target Net Expenditure Budget	**107,659**	**109,619**	**113,559**	**117,483**	**120,376**	**124,010**
Affordable Budget Forecast		**109,430**	**109,188**	**108,971**	**108,287**	**108,404**
One-off Use of Reserves Required	**40,768**	**190**	**4,371**	**8,512**	**12,089**	**15,606**

Recommended approach to prioritisation	2019/20 £'000	2020/21 £'000	2021/22 £'000	2022/23 £'000	2023/24 £'000
Service Area - Project (Example 1)			x	x	x
Service Area - Project (Example 2)		x	x		
Service Area - Project (Example 3)	x				x
Service Area - Project (Example 4)				x	
Service Area - Project (Example 5); etc				x	x
Total	**Total**	**Total**	**Total**	**Total**	**Total**

MEDIUM TERM FINANCIAL PLAN SCENARIO 2 – APPENDIX C

AFFORDABLE BUDGET REACHED BY YEAR 5

(3.4% SAVINGS TARGET WITH STRAIGHTLINE DIRECTORATE TARGETS IN THE ABSENCE OF STRATEGIC SERVICE REDESIGN PLAN)

Council Savings Model Target set at... 3.4%	2018/19 £'000	Year 1 2019/20 £'000	Year 2 2020/21 £'000	Year 3 2021/22 £'000	Year 4 2022/23 £'000	Year 5 2023/24 £'000
Based on Approved Budget 2018/19	**112,659**	**107,659**	**109,430**	**109,498**	**109,549**	**108,603**
Growth (Costs)		4,900	4,157	4,148	3,103	3,849
Change in Ferry Funding	(5,000)	(2,940)	(218)	(224)	(210)	(215)
Forecast Net Expenditure	**107,659**	**109,619**	**113,369**	**113,422**	**112,442**	**112,237**
Savings Generated by Target		**(190)**	**(3,871)**	**(3,873)**	**(3,840)**	**(3,833)**
Target Net Expenditure Budget	**107,659**	**109,430**	**109,498**	**109,549**	**108,603**	**108,404**
Affordable Budget Forecast		**109,430**	**109,188**	**108,971**	**108,287**	**108,404**
One-off Use of Reserves Required	**1,204**	**0**	**310**	**578**	**316**	**(0)**

Based on 2018/19 Percentage of Budget per Directorate Indicative 'Salami Sliced' Budgets		2019/20 £'000	2020/21 £'000	2021/22 £'000	2022/23 £'000	2023/24 £'000
Children's Services	40.1%	(76)	(1,553)	(1,554)	(1,540)	(1,538)
Community Health & Social Care	19.9%	(38)	(770)	(770)	(764)	(762)
Corporate & Executive Services	9.0%	(17)	(347)	(347)	(344)	(343)
Development	11.6%	(22)	(448)	(448)	(444)	(443)
Infrastructure	19.5%	(37)	(754)	(754)	(748)	(746)
Total	**100.0%**	**(190)**	**(3,871)**	**(3,873)**	**(3,840)**	**(3,833)**

STRATEGIC PLANS – APPENDIX D

Relevant to the effective delivery of services and progress towards achieving the outcomes that the Council seeks deliver are a range of strategic documents. It is important that the financial consequences of how outcomes will be achieved are understood and that the financial constraints are known when allocating resources to ensure that a balance is struck in terms of actions and cost.

Key documents are:

Corporate Plan: Our Plan 2016-2020 describes the vision and priorities for the Council at a strategic level.

Partnership Plan: The Shetland Partnership Plan 2018-2028 an overarching plan identifying the vision and priorities of the Community Planning Partners in Shetland. This is another strategic document, recently agreed by the Council, to which it is expected to contribute over the 10 year life of the Plan. Delivery plans will provide a more detailed level of how outcomes will be achieved.

10 Year Plan to attract people to live, study, work and invest in Shetland: an ambitious plan to enable growth of the Shetland economy, private sector jobs and boosts industry.

Directorate and Service Plans: focus on the immediate and shorter term, set out what the Council will do to achieve the strategic outcomes and priorities. The decisions taken in shaping these plans have a direct link to the allocation of resources in the annual budget setting process.

Business Transformation Programme: a range of work streams provide the basis for ensuring that the Council is organised to deliver the most effective and efficient services it can, focusing on crucial elements of Council business such as the workforce, data and privacy, asset management, digital readiness, commissioning and procurement, as well as embedding the Council values such as Excellent Service, with the recently adopted Customer Strategy and Charter.

Service Redesign Programme: a wide range of projects being developed by the Corporate Management Team, specifically targeted to review and consider options for future service delivery with a focus on outcomes and financial constraints. Also included are appropriate projects that address early intervention and prevention opportunities that have been identified. All the projects have a major contribution to achieving the change required and to balance future budgets and the Building Better Business Case approach will be used to ensure that decisions are made with the appropriate work having been carried out and information presented.

Strategic Housing Investment Plan: this is prepared to set out the strategic investment priorities for affordable housing over a 5 year period to achieve the outcomes described in the local housing strategy.

Asset Investment Plan: this too is a 5 year plan designed to manage the financial constraints on capital resources of the Council, to prioritise the asset investment projects that have successfully been supported and evidenced by a Building Better Business Case. It is refreshed as part of the annual budget setting process. The capital financing requirement has to be set in the context of the Prudential Code, ensuring that the capital investment plan is affordable, prudent and sustainable.

This is not intended to be an exhaustive list of strategic plans against which the Council will be judged.

DIRECTORATE PLANS - CORPORATE PRIORITIES AND JOINT WORKING – APPENDIX E

Corporate Priorities and Joint Working:

There is a specific objective in the Corporate Plan that the Council will have excellent financial management arrangements to ensure that it continues to keep a balanced and sustainable budget, and is living within its means; and that the Council continues to pursue a range of measures which will enable effective and successful management of its finances over the medium to long term. This involves correct alignment of the Council's resources with its priorities and expected outcomes, and maintaining a strong and resilient balance sheet.

Despite the work done so far, sustainability in particular is extremely challenging at this time with reducing Scottish Government funding being the trend since 2011/12. It is expected that this will continue while the UK and Scottish Government's seek to balance their budgets and prioritise their spending. In order to take action on improving the Council's approach to identifying and implementing sustainable solutions for the future Directorate plans identify core priority areas for action up to 2020, which can be summarised as follows;

Policy & Resources Committee - Community Health & Social Care

- Keeping people safe from harm, protecting vulnerable people;
- Delivering integrated health and care pathways and a single point of entry to services by continuing to shift resources to primary and community care;
- Strengthening and working in partnership with individuals, their families and communities;
- Reducing avoidable admission to/inappropriate use of hospital services;
- Developing primary care and community responses through multi-disciplinary teams;
- Supporting unpaid carers;
- Tackling inequalities, with a focus on health inequality;
- Prevention and early intervention;
- Promoting healthy lifestyles;
- Improving mental health and wellbeing;
- Promoting self management and independence.

Policy & Resources Committee - Corporate and Executive Services

- Manage and implement a programme of transformative projects designed to take advantage of current and future technology that means our customers and staff are able to help themselves to services and information through electronic means.
- Protect the Council's interests.

- Explore and take advantage of the options and opportunities that the council asset base offers and to reduce the floor area of the operational buildings we use in the delivery of our services.
- Recognising the importance of workforce planning, provide the framework for doing this across the council and to carry out a review of the workforce requirements in Corporate and Executive Services, to meet future skill gaps, age profile and the impact of transformation projects.
- Embed a culture of robust, effective and efficient procurement and commissioning that delivers best value in relation to the goods and services the council needs.
- Collect, analyse and report on core data required for good decision making, including performance, financial and workforce information.

Development Committee

- continue to progress the Shetland Tertiary Education, Research and Training Project, by completing the second tier management team restructure, exploring options to increase external and Scottish Funding Council funding opportunities, and review and identify options to reduce the cost of the Tertiary Education Sector estate 2017 - 2020;
- progress opportunities to share services with community partners and other local authorities;
- review funding of external organisations, and the Museum and Archives Service by 2020; and
- review and identify the level of service to be provided by Development Services by 2020, and develop a workforce plan to meet future skills gaps, considering retirements, redeployments, extended use of career grades and Modern Apprentice placements 2018 – 2019.

Education & Families Committee

- the completion of the new Anderson High School and Halls of Residence and the subsequent move into the new facilities;
- the closing of the attainment gap for children in Shetland;
- the development of the emotional wellbeing project;
- the development of a strategic outline case for the provision of residential care for submission through the gateway process;
- progress opportunities to share service with community partners and other local authorities;
- workforce review – establish requirements for level of service in Development Services by 2020 and develop workforce plans to meet future skills gaps, considering

retirements, redeployments, extended use of career grades and Modern Apprentice placements 2018-19.

Environment & Transport Committee

- achieve Fair Funding for Ferries, or review ferry services to deliver future services at the affordable level based on Scottish Government funding, or stop running ferry services and let the Scottish Government deliver ferry services - priority 2017/18;
- develop Ferry Replacement Programme - secure funding for capital replacement of ferries and terminals and start delivering the replacement programme - 2017/18 onwards beyond 2020;
- undertake Waste Services review - 2017/18 - service change by December 2017 and feed into 2018/19 budgets;
- undertake full review of Estate Operations and facilities management function using telemetric data and consider redesign - 2018/19;
- establish workforce requirements for level of service by 2020 and develop workforce plan to meet future skill gaps, considering retirements, redeployments, extended use of career grades and Modern Apprentice placements - 2018/19; and
- negotiate Government funding of internal air service - 2018/19

Harbour Board

- maximise income from Sullom Voe and other port infrastructure investments - 2017-2020;
- redevelop Scalloway Fishmarket - 2017-2019; and
- establish workforce requirements for level of service by 2020 and develop workforce plan to meet future skill gaps, considering retirements, redeployments, extended use of career grades and Modern Apprentice placements - 2018/19.

Shetland College Board

- continue to progress the Shetland Tertiary Education, Research and Training Project, by completing the second tier integrated management team restructure;
- continue to explore options to increase external and Scottish Funding Council funding opportunities; and
- review and identify options to reduce the cost of the Tertiary Education Sector estate.

Development Committee - Housing Revenue Account

- to ensure that annual HRA budgets are financially sustainable into the future;
- to focus on keeping housing rents at affordable levels;
- to focus capital expenditure on maintaining the existing housing stock;

- to ensure that all capital expenditure funded through borrowing complies with the Prudential Code and its key principles of prudence, affordability and sustainability; and
- to ensure that only a sustainable draw is made on the Housing Repairs and Renewals Reserve each year.

MANAGEMENT OF THE BUDGET AND BUDGET FLEXIBILITY INITIATIVES – APPENDIX F

Management of the Budget:

The Council now has a history of delivering its budget outturn at or below budget. It is inevitable that significant demands will be placed on the Council and its future capacity and as such the Council will need to continue delivering robust control of its budget. This is done through devolved budget ownership (Budget Responsible Officers) and a monthly reporting process to the Corporate Management Team. It culminates in quarterly budget monitoring reports to the Council Service Committees and Policy and Resources Committee.

The Council's budget monitoring and performance reporting process includes monitoring progress in relation to the savings identified as part of the annual budget setting process. This enables management action to be taken as early as possible including corrective actions and the identification of alternative approaches.

The Council has made progress in financial decision making, using evidence based reporting, following the Building Better Business Cases methodology and demanding fully costed options. There is also a much stronger understanding of the cost of using resources and this being taken into account when making decisions. It is recommended that the Council continue to build upon the financial management improvements that have already been made.

The Council, through the work with CMT and Directors, is positively positioned to respond to moving and prioritising financial resources it has available. To promote and support a robust approach to budget management now and in the future a number of initiatives are in place to assist officers.

9.1.1 Funding for Change:

9.1.2 The MTFP in its current form indicates the impact on expenditure and income of delivering Services in their current form through the next five years. To continue to deliver Services in the same way over the next few years will only result in overspending and a failure to address the unaffordable cost base in place for providing Council Services.

9.1.3 Without continuing to press for savings year on year the costs and uncertainty of existing income streams will make it impossible to provide the assurance that the Council will require, that it will balance its budget in the future.

9.1.4 What is clear is that the models of service delivery that the Council has cannot be afforded if nothing changes. The Local Government Benchmarking Framework as developed by the Improvement Service, in conjunction with the Scottish branch of the Society of Local Authority Chief Executives (SOLACE Scotland) and Convention of Scottish Local Authorities (COSLA), has been developing for the last four years to establish a common approach to benchmarking and this shows Shetland Islands

Council as a high cost, high quality Council. Reference was made earlier (section 2) to data that supports this.

9.1.5 To deliver the Corporate Plan objectives and make the difference to the outcomes that are valued and of the highest priority change is necessary.

9.1.6 The Directorate Plans that have been approved for 2018/19 focus on taking key strategic projects forward, and these must be done in the context of the challenging financial forecast in this MTFP.

9.1.7 This includes the greatest benefit from Service redesign that can be achieved within a framework of business transformation, capturing the benefits of alternative ways of working and technology, to implement a more cost effective model of Service delivery, or to redirect resources to improve the outcomes that can be achieved overall.

9.1.8 Making the shift of resources to be more outcomes focused so that the result is the priority rather than the status quo is a crucial and very complex issue to address. In part it is anticipated that the work on Community Choices in mainstreaming will reveal new opportunities.

9.1.9 The Council acknowledges that Services themselves do not always have sufficient resources to fund the initial costs of implementing change, and the MTFP provides for continued funding to be set aside from the Revenue Budget Contingency to support this, to invest in the work that will be required. The MTFP incorporates a sum of £0.5 million annually to facilitate change.

9.1.10 It is recommended that decisions on the use of this funding will be approved by the Director of Corporate Services in conjunction with the Executive Manager – Finance. To ensure that the funding is allocated to work that will progress the achievement of the Council's Corporate Plan priorities and there is a clear link to the achievement of the long-term outcomes as well as to establish the financial baseline and future projections a Business Justification Case will be required.

9.1.11 Budget Carry Forward Scheme

The MTFP makes provision for a budget carry forward scheme in order to offer an incentive to Directorates to effectively manage their budgets.

9.1.12 If a Directorate 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.

9.1.13 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.

9.1.14 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.

9.1.15 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.

9.1.16 The conditions of the scheme are:

- A Service will only be granted revenue carry forward if it’s Directorate has 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.
- Following a review of the Cost Pressure and Contingencies budget, with effect from financial year 2017/18 there will be no access to this budget when calculating the carry forward. Any underspend of this budget will be retained for the overall benefit of the Council.

9.1.17 Spend to Save and Improvement Fund:

9.1.18 The Council has in place a Spend to Save scheme. The purpose of the 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.

9.1.19 It is expected that the 'Funding for Change' described in section 11.4.5 will work in conjunction with this scheme to facilitate options identification and feasibility work that may be required in advance of specific actions required to deliver the change and reduce expenditure.

9.1.20 Due to the requirement for savings now and into the future the scheme has been reviewed to take a longer term view of how quickly the savings achieved from the use of the scheme are recouped. The underlying principle of the scheme therefore is that any funding awarded has to have a payback period no greater than 5 years.

9.1.21 The Executive Manager – Finance has the authority to increase this payback period to 7 years in exceptional circumstances, which may exist where additional resource benefits beyond financial savings or where the evidence of the impact on priority outcomes is compelling.

9.1.22 It is possible to apply for Spend to Save funding to undertake specific feasibility and option identification work if the revenue 'Funding for Change' is fully committed. In this circumstance any expenditure will be included in any subsequent request for Spend to Save funding and factored into the payback calculation.

9.1.23 Savings that may be derived from a Spend to Save investment can include future cost avoidance, for example waste, energy or carbon taxes, fines, penalties or charges that will improve the Council's control of future cost pressures. In this situation clear and robust evidence of the cost avoidance will have to be provided and be approved by the Executive Manager – Finance.

9.1.24 The Spend to Save funding can be used to support Revenue or Capital expenditure.

9.1.25 Due to the requirement for the Council to deliver actual savings in the revenue budget the Spend to Save funding will be provided on the following basis:

- That no interest will apply when repaying the sum invested by the Spend to Save fund;
- Where payback is calculated as 2 years or less, 100% of the sum invested will be repaid to the Spend to Save fund; and
- Where payback is calculated as more than 2 years, 50% of the sum invested will be repaid to the Spend to Save fund.

9.1.26 This will deliver earlier cashable savings into the Revenue Budget rather than having to wait until the payback period has been reached.

9.1.27 An example would be £0.5 million Spend to Save application for investment will generate £0.125 million of savings per annum. Payback period 4 years. If the full value of the investment has to be repaid into the fund then the saving that has been generated will only impact in year 5. By only repaying into the fund half of the investment the Service will be able to impact on the Revenue Budget in year 3.

This enables the timescales for generating an impact on the Revenue Budget to be substantially improved, providing an incentive to effect the savings quickly.

9.1.28 The other impact is that the Spend to Save fund will reduce and not be self-sustaining meaning that fewer future opportunities will be able to be funded.

9.1.29 It is recommended that a sum, to be determined by the Executive Manager – Finance, is set aside in the annual budget to enable projects to be implemented and to allow new applications to be considered.

9.1.30 The Spend to Save scheme will be regularly reviewed to ensure it remains relevant to current funding levels and the financial climate.

REVENUE FUNDING ASSUMPTIONS – APPENDIX G

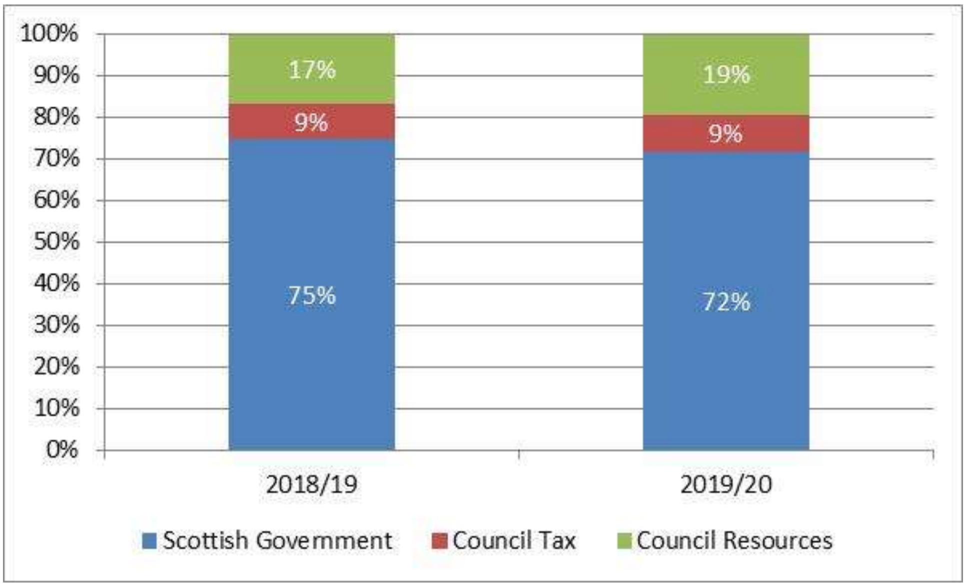
10.1.1 Introduction

10.1.2 The Council receives a number of funding streams that enable it to deliver its full range of services. These include Scottish Government specific grants, Council Tax, fees and charges and in certain circumstances external funding, which has been applied for.

10.1.3 The General Fund revenue budget is normally structured to take account of income from fees and charges and specific external funding grants deducted from the cost of Services expenditure, therefore leaving Net Revenue Expenditure that is funded by the other income streams – Scottish Government Grant (General Revenue Grant), Council Tax and the Council's own resources.

10.1.4 In 2018/19 the Council will receive approximately 75% of its Net Revenue Expenditure funding from the Scottish Government.

Chart 10: Shetland Islands Council, Where Revenue Funding comes from 2018/19 and forecast for 2019/20.



10.1.5 The chart highlights the extent to which the General Fund requires Council resources to balance the budget. Those resources include, in 2018/19 Harbour Account surplus; Shetland Gas Plant income; and a withdrawal of investment returns.

10.1.6 Scottish Government Grant

10.1.7 The table below shows the projected future revenue resources available to the Council over the period of the MTFP.

Scottish Government (General Revenue Grant & National Non Domestic Rates)	**2018/19** **£'000**	**2019/20** **£'000**	**2020/21** **£'000**	**2021/22** **£'000**	**2022/23** **£'000**	**2023/24** **£'000**
Best Case Scenario		81,555	82,301	82,517	82,101	82,644
Medium Term Financial Plan	80,451	78,562	77,489	76,724	75,378	74,747
Worst Case Scenario		76,326	73,207	71,936	70,134	68,845

10.1.8 The assumptions associated with this projection are:

- The starting point of 2019/20 is the actual value of revenue grant allocated, covering General Revenue Grant (GRG) and National Non-Domestic Rates (NNDR).
- The 2019/20 value is then modelled to take account of three scenarios that are based upon different levels of reduction in funding, recognising that Shetland has recently been hit more severely than some other Local Authorities.
- The values include the diminishing amount of the Notional Loan Charge support provided by the Scottish Government, which is understood to continue at approximately £0.6 million per annum.
- Specific initiatives that may attract Scottish Government funding in the future have not been included in the projections as any specific initiative will undoubtedly generate a specific cost pressure of at least equal value. An example of this is funding being allocated for the national expansion for Early Learning and Childcare commitments.

10.1.9 The assumption used in the MTFP is the 'medium' estimate.

10.1.10 The year on year changes in grant funding available amount to a reduction 7.29% in cash for the next five years of 2.35%; 1.37%; 0.99%; 1.75%; and 0.84% respectively. This forecast has been made as it aligns with publicly available information and independent commentary on future public sector funding.

10.1.11 Included within the total Scottish Government Grant funding is the annual value of the National Non-Domestic Rates (NNDR) pool. The value in 2018/19 is £2.6 billion. The pooling arrangement means that risk of a shortfall rests with the Scottish Government, giving greater certainty to the receipt of that element of the grant.

10.1.12 The Scottish Government has created a Business Rates Incentivisation Scheme (BRIS) that provides an opportunity for local authorities to increase its NNDR income stream. The Scheme is based on targets.

10.1.13 Should the Council exceed its target NNDR, it would retain 50% of the additional rates income generated (where there was a corresponding increase in rateable value). The Scottish Government would retain the other 50%.

10.1.14 The assumption in the MTFP is that there will be limited opportunity for the Council to benefit from the scheme at present and as such no additional income has been assumed in any future years.

10.1.15 Specific grant funding to be received from the Scottish Government in 2017/18 includes Criminal Justice Social Work funding and attainment funding for schools. It has been assumed that that funding will be spent and no further subsidy will be provided by the Council so that it is cost neutral to the Council throughout the MTFP.

10.1.16 During any financial year the Scottish Government may issue revenue grants to Local Authorities for a particular purpose. In general these grants will be distributed for reasons described in a letter from the Government Department however will come with no specific criteria attached to incurring the expenditure. These are referred to as non-specific grants.

10.1.17 The number and value of these grants is not known in advance and as such has not been incorporated into the MTFP. Any receipt of non-specific grant funding will be accounted for in the year it arises.

10.1.18 Due to the non-specific nature these grants provide the Council with the opportunity to determine the exact nature of how it will respond to the particular purpose, and how it will make use of the funding. As the Council has met its budget targets in recent years Services have not required such funding to meet the particular purpose, resulting in the funding being treated as a corporate resource. It is recommended that this practice continues.

10.1.19 Council Tax

10.1.20 Council Tax is the local taxation element of the Council's funding and as shown in the chart at section 10.1.4 represents 9% of the income the Council collects. Compared to other local authorities, with larger populations, this amounts to a relatively small share of the total required to fund services. This also reflects the high cost of service delivery in a remote and rural location, and the need for a higher proportion of Scottish Government grant funding.

10.1.21 Council Tax is expressed as a value per 'Band D' dwelling, this being the value charged against a dwelling that has been placed in that particular banding, on a scale of A to H. The value is calculated after converting all dwellings into Band D equivalents. All other dwellings are charged a proportion of that Band D value.

10.1.22 Through Council Tax reform in December 2016 the multiplier values for bands E-H were increased thereby increasing the value that will be charged. These new multipliers apply from 1 April 2017 and generate approximately £0.15 million for the Council per annum. The MTFP assumes this will be continuing income.

10.1.23 The Band D value for Shetland was £1,053 per annum for nine years under the condition to freeze Council Tax however this condition has been altered and a cap has been placed on increases, 3%. A 3% increase generates approximately £0.28 million per annum.

10.1.24 In the budget for 2018/19 a 3% increase was approved and the new Band D value for Shetland is £1,117.13.

10.1.25 The assumption in the MTFP is that the value will continue to increase by 3% per annum.

10.1.26 A year on year increase in the number of dwellings is also forecast, with the historic trend being for these to continue to increase as well as households forecast to increase year on year. The rate of increase has been assumed to be 1% per annum.

10.1.27 The table below shows the projected future Council Tax resources available to the Council over the period of the MTFP, the MTFP following the 'Best Case' scenario forecast.

Council Tax	2018/19 £'000	2019/20 £'000	2020/21 £'000	2021/22 £'000	2022/23 £'000	2023/24 £'000
Best Case Scenario		9,738	10,124	10,523	10,936	11,361
Medium Term Financial Plan	9,363	9,738	10,124	10,523	10,936	11,361
Worst Case Scenario		9,457	9,551	9,647	9,743	9,841

10.1.28 Fees and Charges

10.1.29 The Council can raise income from charging fees for a wide range of services, ranging from fares on ferries and buses to adult social care, from libraries to quarry products.

10.1.30 Income generation is a key strategic priority for some Services, where it can offset all or a substantial proportion of the costs associated with it. However, in adult social care for example, the Council has a statutory duty to meet assessed needs, free personal care provisions apply and charges are means tested therefore income will only ever assist with recovering a proportion of the costs.

10.1.31 In 2018/19 the value to be generated is £27.4 million and therefore represents a significant and important element of the Council's funding strategy.

10.1.32 In general for every 1% increase in those charges it would have the impact of increasing income by £0.274 million. This helps to address the rising costs of pay and price inflation and the real cost of delivering Council services, as such it is essential that prices are reviewed regularly.

10.1.33 The Council approved a Charging Framework on 3 November 2016 and this provides the purpose and approaches that must be taken when considering how and why a charge is being applied.

10.1.34 Raising income through charging may be an option to ensure services continue to be delivered, however caution must be observed in ensuring that the Council's involvement in a Service is not simply on the basis that a charge can be applied.

10.1.35 External Funding

10.1.36 The Council has a partnership agreement with the Shetland Charitable Trust, whereby it provides funding to the Council to enable the delivery of the Rural Care Model. The funding that the Council has secured from this source has been approximately £2.5 million per annum. In 2015/16 the Trust approved a reduction in income to the Council and signalled the intention to reduce this further by approximately £0.5 million over the following four years, this reduction has been confirmed year on year to date.

10.1.37 The Council has engaged politically with Scottish Ministers and the Council is working directly with Transport Scotland to secure a long-term financial commitment for the inter-island transport services that the Council operates. The success of the continued political engagement was seen in the 2018/19 financial settlement, with £5 million of new money being added to Council resources on the basis of a one-year deal. The continued work with officers at Transport Scotland, political engagement and political commitment to find a mutually acceptable solution provides assurance and expectation that further funding will be received in the future.

10.1.38 The funding requirements of the Council have been stated to Transport Scotland, for 2019/20. Transport Scotland has scrutinised the requirements and are preparing their budgets for Ministerial consideration in light of Council requirements. While the final decision is later in the year the Council has also stated to Transport Scotland that it will now rely on the receipt of that funding for next year. A sum of £7.940 million. Ultimately the decision on how much the Council receives rests with the Scottish Government Ministers and the Scottish Parliament.

10.1.39 Beyond this the expected inflation proofing of that funding has been incorporated, with the MTFP following the 'Best Case' scenario forecast.

Ferry Funding	2018/19 £'000	2019/20 £'000	2020/21 £'000	2021/22 £'000	2022/23 £'000	2023/24 £'000
Best Case Scenario		(7,940)	(8,158)	(8,381)	(8,591)	(8,805)
Medium Term Financial Plan	(5,000)	(7,940)	(8,158)	(8,381)	(8,591)	(8,805)
Worst Case Scenario		(5,000)	(5,000)	(5,000)	(5,000)	(5,000)

10.1.40 Beyond these income streams for Shetland, limited opportunities exist for the Council to access external funding streams directly. The most significant area however is Europe, where various thematic Funds exist, offering opportunities to local authorities and partners to apply at various times and for different time periods.

10.1.41 Since the last MTFP the UK has voted to exit the European Union (Brexit) and as such this increases the uncertainty of funding from this source. Additionally there is no information on any replacement or alternative UK based funding that may become available.

10.1.42 The MTFP has not included specific external funding that may be applied for.

10.1.43 Shetland Gas Plant Income

10.1.44 The Shetland Gas Plant became operational in early 2016 and the Council has agreements with the partners in the project that will generate medium to long-term revenue income based upon a ground rent and pipeline throughput calculation based on gas and oil prices.

10.1.45 The gas and oil prices have triggered throughput income from the Gas Plant and while the value of this has been considerably lower than originally forecast the increase volumes expected in the medium term provide a welcome funding stream to support the General Fund Services.

10.1.46 The table below shows that if the gas and oil prices rise further and throughput is good then up to £9.8 million could be generated, but if prices drop again and stagnate then limited additional income may be achieved above the ground rent value. A medium case scenario has been included in the MTFP.

Shetland Gas Plant	2018/19 £'000	2019/20 £'000	2020/21 £'000	2021/22 £'000	2022/23 £'000	2023/24 £'000
Best Case Scenario		(1,601)	(1,774)	(2,050)	(2,050)	(2,300)
Medium Term Financial Plan	(1,024)	(1,350)	(1,450)	(1,550)	(1,550)	(1,550)
Worst Case Scenario		(950)	(1,150)	(1,150)	(1,150)	(1,150)

10.1.47 Economic Development Activities

10.1.48 The Council has a history of lending to businesses in order to deliver on its Economic Development objectives. This was further extended by the transfer of Shetland Development Trust (SDT) assets to the Council in the months leading up to the formal winding up of the Trust in February 2015.

10.1.49 In addition to lending to businesses the SDT assets included fishing quota that is managed on behalf of the Council by the Shetland Fish Producers Organisation (SFPO).

10.1.50 Through the lending service and the management of the fishing quota the Council receives an income which has been included in the MTFP.

10.1.51 The returns that are received from these activities reflect the arrangements that are in place and the MTFP takes account of the financial impact of holding the assets. It is recognised that other benefits are generated by such assets and in working with Shetland businesses, however this has not been quantified for the purposes of this MTFP. Socio-economic and other benefits that Shetland derives from these assets would be reported on separately by the Development Directorate.

10.1.52 The Council has approved a sum of £15 million to be set aside to support the Commercial Lending Service. Lending is based on a set of criteria and a detailed process and procedure is followed in approving new lending. Basic criteria include:

- 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.

10.1.53 Summary of Revenue Assumptions

10.1.54 The following points are a reminder of the headline assumptions made in estimating resources for the future:

Council Tax	Band D rate increased annually by 3%;
	Tax base increase 1% per annum (c.80 Band D equivalent properties)
SG Revenue Funding	Cash reduction in General Revenue Grant will apply for each of the next 5 years (7.29% reduction by 2023/24);
	The reduction includes the continued fall in Notional Loan Charge Support at approximately £0.6m per annum
Fees and Charges	general assumption due to higher inflation and pay award assumptions 2.98% in 19/20; 2.74% years 2 and 3; 2.5% years 4 and 5
Shetland Gas Plant	Modest increase to income based on anticipated increased production levels
Harbour Surplus	Retain surplus of £6m annually for services
Shetland Charitable Trust	Cash reduction of £0.5m by 2019/20
Investment Returns	Total value at April 2018 £345m;
	Set aside £82m as committed for future use and requires the cash to be available so that the Council can respond when necessary. This includes the impact of financial year 2018/19 funding requirement;
	Investment Return Base of c. £263m against which the sustainable draw from investments is calculated;
	Expected Gross 7.3% annual return year on year = £19.2m;
	Inflation proofing at 2.1% year on year = £5.5m;

	Net return (sustainable draw from investments at 5.2% per annum = £13.7m for 2019/20.
SG Capital Funding	£5.5m Capital Grant per annum, with additional funding in 2019/20 because of hold back in 2016/17.

REVENUE EXPENDITURE ASSUMPTIONS – APPENDIX H

11.1.1 Introduction

11.1.2 The Council's financial and service environment is continually changing and therefore its priorities are updated regularly in response to levels of demand and emerging need.

11.1.3 A number of factors create a demand for resources. The most significant of these include:

- The cost of maintaining services at current levels in current form, i.e. pay and price inflation;
- External factors that impact on Council income levels;
- The cost of additional demand for services arising from increased need or changing populations; and
- Changes in government policy that have an impact on Council expenditure or income, e.g. apprenticeship levy, landfill tax, early years provision, the Community Empowerment Act.

11.1.4 Each of these is considered in more detail below.

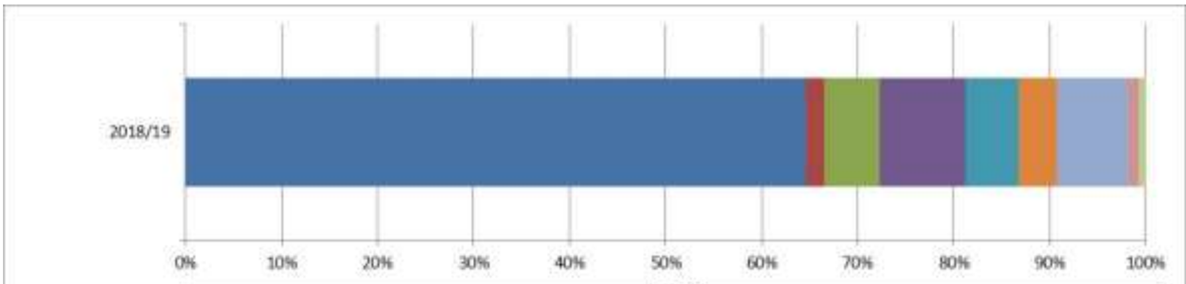
11.1.5 Pay and Price Inflation

11.1.6 One of the most significant factors creating a demand for extra resources is inflationary pressure – price rises caused by national macro-economic conditions.

11.1.7 Specific price inflation uplifts have been estimated on the basis of a scale of high, medium and low to refine the forecasting of costs that the Council will face. This will enable the projections in the MTFP to define the challenge that exists and not simply assume that these costs will be met from general efficiencies. There will be an expectation of savings being a contributory factor to closing the budget gap.

11.1.8 The Council budget is made up of different categories of cost and, as shown in Chart 11, the predominance of employee costs is clear.

Chart 11: Shetland Islands Council, Gross Revenue Expenditure 2017/18.



	2018/19
Employees	65%
Administration	2%
Property	6%
Transport	9%
Supplies & Services	6%
External Providers	4%
Grants	7%
Capital Financing	1%
Contingency	1%

11.1.9 The most significant inflationary pressure is therefore pay-related inflation, which is agreed nationally between employee and employer organisations and applied across local government.

11.1.10 In Cabinet Secretary for Finance and Constitution, in December 2017, introducing the Scottish Governments budget for 2018/19 lifted the pay cap that had been place. This has had the impact of increasing expectation of pay awards greater than the 0% - 1% experienced for the last number of years. The Council approved its budget for 2018/19 on the basis of the pay award structure that the Cabinet Secretary had outlined. It is clear that the Unions seek considerably more than this.

11.1.11 The cost of pay related inflation has been included and forecast on a recurring basis at higher levels than had previously been forecast. In years 1 to 3 an uplift of 3% has been used (with 2% in years 4 and 5) to take account of current situation. This includes, continued support of the local government national living wage rates and the assumption that from 2021/22 there will be nor further increase in pension contribution rates following the next revaluation exercise.

11.1.12 This does lock in a cost burden of around £2.3 million per annum.

11.1.13 In addition to this the new cost of introducing sleepover rates at local government national living wage rates from 1 September 2018 at a recurring cost of £0.3 million, has also been incorporated into the Plan.

11.1.14 External Factors Impacting on Additional Income

11.1.15 In 2018/19 £17.8 million (17%) of the Council's budget is based on the assumption that additional income will flow into the Council from its own resources, and this is expected to rise to 19% of the budget in 2019/20, a total sum of £21.1 million.

11.1.16 The receipt of certain additional income is dependent upon global financial market conditions and commodity prices, volumes of production, tanker movements, and so on, all of which are outside the control of the Council.

11.1.17 While the MTFP has already described the approach to long-term investments and the income that it will seek to achieve, these assumptions need to be constantly reviewed, and a major restatement in the previous MTFP for Shetland Gas Plant income is a clear example of how fragile significant income sources can be adversely affected.

11.1.18 Low oil prices also has the potential to impact on the harbour operations, as media coverage of savings and cost cutting across the oil and gas sector strongly indicates the likely impact here in Shetland as well as elsewhere. The recent change of operators at the Sullom Voe Terminal (SVT) is a clear example of this. It is also clear that the future operations and activity at SVT needs to be cautiously considered as the longer term impact of changes and options for the industry should be expected to have an impact on Harbour activity and income.

11.1.19 The Council needs to seek ways to protect and maximise its return from the assets that it deploys to operate the harbour operation. The Council is heavily engaged in protecting its interests during this change. As discussions continue to establish a greater understanding of the various factors that exist it has been prudent to continue to forecast an income stream that reflects the current reliance on surpluses, £6 million per annum. Further detail is included in section 5.

11.1.20 The decision making of other external bodies is another factor that the Council requires to take into account as it places additional financial pressure on specific Service areas. Particularly significant is the Shetland Charitable Trust, and its financial contribution to the partnership agreement for the delivery of the Rural Care Model. The Trust signalled its intent to reduce funding by 20% over a five year period, commencing 2015/16.

11.1.21 While the Council seeks to secure the funding required for the delivery of the Rural Care Model it is prudent to take account of the intended funding reductions as ultimately the Council does not determine the value of funding it will actually receive. This amounts to a cost pressure of £0.5 million over the period to 2019/20.

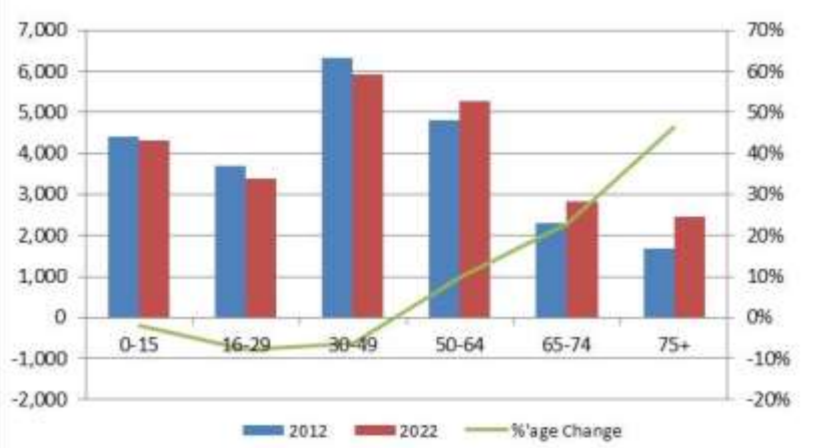
11.1.22 The overall uncertainty over the security of income that is expected from our investment, trading opportunities and external bodies has the potential to impact positively and negatively on the MTFP. It is therefore essential that the MTFP does not over commit the Council to income that it hopes to achieve simply to balance the budget. The evidence presented in this MTFP supports a prudent and appropriate approach to forecasting the income that can be achieved taking account of the appetite for risk that has been discussed with Councillors.

11.1.23 Increased Need and Changing Populations

11.1.24 Increases in the number of people using a Service creates demands for additional resources, and these must be planned appropriately to ensure that the needs of each group can continue to be catered for in line with corporate priorities.

11.1.25 The Council recognises the forecasts made for Shetland by the National Records of Scotland in relation to population, and during the life of this MTFP the projection is that a shift will occur in the population, from a base in 2012, towards an older overall population. This is reflected in Chart 12.

Chart 12: Demographic projections for Shetland 2012 – 2022.



Source: National Records of Scotland: Shetland Islands Demographic Factsheet, July 2015

11.1.26 The Council has made it clear in its Corporate Plan that while it is generally felt that higher demand will increase the total cost of providing care, the outcome that the Council is seeking is one where efforts are centred on encouraging healthy and active lifestyles that will help people to be independent and reduce the need for care as they get older. This promotes a positive way to approach the challenge of a changing population.

11.1.27 The Improvement Service has recognised the Council as a high quality and high cost provider of Services and therefore further opportunities exist to identify and implement alternative models of service delivery that reduce the individual / unit cost thereby allowing costs associated with rising numbers to be accommodated within the same total budget. These are actions that need to be considered, particularly when facing the added pressures from the intended reduction in income for social care services from SCT. It is essential when looking at alternative models that the longer term impacts of any change are considered; in particular, the lifetime costs of care for people rather than the traditional measure of service unit costs.

11.1.28 In comparison to other Local Authorities, Chart 13, Shetland has the greatest number of high cost services per head of population, which illustrates the point made by the Improvement Service.

Chart 13: Comparison of cost of services per head of population 2016/17 (budget) 1=Highest Cost; 32=Lowest Cost per capita.

	Authority							
Data	Aberdeenshire	Argyll & Bute	Dumfries & Galloway	Eilean Siar	Highland	Orkney	Scottish Borders	Shetland
Education	16	6	21	2	9	3	19	1
Social Work	28	6	16	2	19	3	10	1
Roads & Transport	12	4	15	3	7	2	5	1
Environmental Services	11	2	23	1	4	6	10	7
Planning & Development Services	28	11	15	4	30	2	32	1
Cultural & Related Services	29	19	26	6	25	2	13	1
Central Services to the Public	32	18	15	8	30	16	26	13
Housing (non-HRA)	15	6	8	3	12	1	28	2
General Fund Contributions to Trading Serv	6	1	10	2	4	10	10	10
Other Expenditure	26	2	10	1	6	30	17	32
Total Service Expenditure	**30**	**4**	**12**	**2**	**10**	**3**	**11**	**1**

11.1.29 The MTFP recognises that Services will need to change, to adapt and take appropriate action to enable the outcomes to be achieved and the Council is focused on business transformation and Service redesign to enable that change to take place.

11.1.30 Recent development of Spend to Save options in the pipeline include prevention and early intervention in Children's Services and in Social Care Resources, targeting work that reduces the need for crisis and intensive Services and others that usually incur high costs.

11.1.31 UK and Scottish Government Policy Changes

11.1.32 Policy changes can arise from Europe, UK or Scottish parliamentary or regulatory changes and this can place new burdens on local government. Recent changes announced, in the process or being implemented or due to be implemented include European air quality standards, energy efficiency and working time directives; UK Treasury introduction of the apprenticeship levy; and Scottish Government Community Empowerment (Scotland) Act2015, Children and Young People (Scotland) Act 2014.

11.1.33 Financial pressures placed on the Council by these vary with funding being attached to some policy changes, such as the expansion of Early Learning and Childcare but for others the Council will have to address its responsibilities and find the means of funding the obligation or duty.

11.1.34 Summary of Cost Assumptions

11.1.35 The following points are a reminder of the headline assumptions made in estimating expenditure for the future:

Inflation Pay award / Living Wage / Pension Increases / other:

	3% Years 1-3; 2% Years 4 & 5
	Price inflation:
	ranging from 2% to 4.1% over various categories
	fuel and energy costs 7% applied
Population Changes	Contingency for the impact of population changes:
	£0.4m per annum recurring
Policy Changes	Sleepover Scottish Local Government National Living Wage:
	£0.3m in 2018/19 recurring
	Children and Young People (Scotland) Act 2014 (expansion of Early Learning & Childcare):
	Funded in full by Scottish Government
Debt	No new external borrowing is taken beyond projects already identified

RISK MANAGEMENT AND FINANCIAL STABILITY – APPENDIX I

12.1.1 Introduction

12.1.2 The MTFP process not only takes account of the resources available and cost pressures that arise from day-to-day activity, it also has to make provision for the unexpected. This helps protect services against short-term fluctuations in resources or demands, which would otherwise require changes to be made to on-going service provision.

12.1.3 The key mechanism for managing such uncertainty and delivering financial stability is having Cost Pressure and Contingency budgets and the availability of uncommitted General Reserves.

12.1.4 In the context of the MTFP, the financial risks can be broadly grouped into 3 categories:

1. Cost Pressures - Risks that can be identified with some certainty and for which a reasonable estimate of impact can be made, e.g. pay and price inflation. Where possible, key service base budgets have been adjusted to reflect the impacts as described in section 12.1.6, future revenue demands and pressures above;
2. Contingencies - Risks that can be identified that are more certain to materialise but for which the size and scale of the risk is subject to some unknowns e.g. the uncertainty of numbers of children requiring additional support outside Shetland or the frequency and scale of ferry repairs. As such it is difficult to justify full provision within service budgets;
3. Uncommitted General Reserves - Risks that can be identified, but for which the likelihood of occurrence, timing or impact are very uncertain. In these cases, the most appropriate means of delivering financial stability is through reserves and balances to ensure that significant in-year pressures do not destabilise ongoing services.

12.1.5 The level at which the Cost Pressure and Contingency Budgets and General Reserves should be set at needs to take account of the financial risks facing the Council. The greater the level of uncertainty and the higher the potential financial impact of risks, the greater the need for provisions and reserves. Ensuring that they are maintained at a healthy level in order to manage risks is therefore an important aspect of Medium Term Financial Planning.

12.1.6 General Revenue Contingency Budget

12.1.7 The Council will manage Category 1 and 2 risks through a Cost Pressure and Contingency Budget. In assessing the level of this, the key risks have been identified and estimated. Cost Pressures are recurring in nature and increase the base cost of the service being delivered (cumulative effect) whereas contingency items are deemed non-recurring and are likely to vary year on year. Items which have been taken account of are:

1. Cost pressures - This includes pay award, the implementation of holiday pay, the impact of employer pension contribution increases, the introduction of the apprenticeship levy and the potential for additional pension contributions arising from auto-enrolment. Policy changes that include the loss of income e.g. charges for carers/respite and working time/sleep-in arrangements.
2. Contingencies - This includes items for fuel price fluctuations, ferry breakdown costs, winter maintenance and storm damage and supply teacher costs.

12.1.8 It is expected that not all of the forecast cost will arise in every year therefore the provision does not provide for 100% of the identified cost pressures and contingency items. Due to the Council's recent history of delivering on budget or below there has been flexibility for Services to absorb a proportion of cost pressures in year where they arise, without requiring an allocation of budget from contingency.

12.1.9 Each year there will be a need to review and refine the provision in light of new and improved information on the scale and timing of cost pressures and contingencies. Where possible recurring items, once known, will be built into the Service base budgets.

12.1.10 Uncommitted General (Revenue and Capital) Reserves

12.1.11 Category 3 risks will need to be managed through General Reserves. This will provide capacity for the Council to manage the more significant and unexpected events that it may face. Three main risks aim to be mitigated by holding uncommitted reserves, namely Major Incidents, Major Disasters (e.g. Natural) and the General Financial Climate. There may be other risks that are also pertinent to be mitigated through these reserves.

Major Incident – potential for significant unplanned expenditure in support of specific circumstances;

Major Disaster – service delivery affected and resources diverted (e.g. buildings being in accessible or disaster recovery plan / emergency plan being set in action);

Financial Climate – wider knock-on effects All General Reserves form a part of the market changes, Brexit, austerity, and / or lower growth and the consequential impact on UK and Scottish Government budgets. There is uncertainty both in relation to the totality of resources available for the public sector and the distribution of those resources. This uncertainty applies both to Capital and Revenue resources.

12.1.12 The Council, as at 31 March 2018, held an uncommitted General Fund Reserve of £22.9 million which could be used to defray such expenditure.

12.1.13 Usable Reserves of the Council and as such form part of the overall Reserves Policy that has been discussed in detail in section 7 above. The risk that arises in relation to Reserves is a failure to recognise that Reserves are usable only once. The Reserves Policy sets out to maintain the level of Usable Reserves and this includes the values currently held within General Reserves. In doing so the value is committed to the long-term investment returns withdrawal policy of the Council which allows a sustainable draw from the investment returns to support the Revenue Budget annually.

12.1.14 By committing to the long-term investment it relies upon the discretionary Usable Reserves, such as the Equalisation Fund, Repairs and Renewals Fund, Capital Fund and Harbour Reserve Fund remaining unspent and uncommitted.

12.1.15 Financial Stability

12.1.16 A careful balance needs to be maintained between holding too much and too little money in Reserves. If Reserves are too small, this increases the Council's exposure to risk and endangers its capacity to deliver priorities in a planned and prudent fashion. Demand-led services and an environment of ever changing legislative requirements, an increasingly litigious society, combined with reduced funding from the Scottish Government all threaten financial stability. Planning to increase Reserves beyond current levels (by delivering a surplus) prevents in-year funding from being allocated to Service budgets.

12.1.17 It is important to remember that Council cash is not idle. The money the Council has in Reserves is invested long-term and the Council benefits from the positive results that the Council's investment strategy delivers (see section 7). Investment return generated through the management of Council cash is used to pay for additional Service provision.

Shetland Islands Council

Agenda Item

3

Meeting(s):	Shetland Islands Council	22 August 2018
Report Title:	Public and School Transport Networks 2019 to 2024 – Strategic Outline Case	
Reference Number:	DV-31-18-F	
Author / Job Title:	Michael Craigie – Executive Manager Transport Planning	

1.0 Decisions / Action Required:

1.1 That the Council **Resolves** to: -

1.1.1 NOTE that the preferred way forward for public and school bus transport in Shetland detailed in the Strategic Outline Case (SOC) in Appendix 1 comprises two components; namely: -

- For School Bus Transport – a network of dedicated services and public transport based services that provides transport to entitled pupils in compliance with the Council's prevailing policy criteria described on the Council's School Transport Policy.
- For Public Bus Transport –a network of services based on the current network with refinements to take advantage of opportunities for efficiency, with a framework to support any decisions to modify the network to meet any financial constraints based on a hierarchy of travel needs factors arising out of consultation with users, the Shetland community and wider stakeholders.

1.1.2 Delegate authority to the Director of Development Services, working with the Lead Officer of ZetTrans where required, to take any decisions and action required to develop the Full Business Case for the preferred way forward described in section 1.1 for each of the Public and School Bus Transport Networks. to be implemented after the current set of service contracts expire on 18 August 2019.

2.0 High Level Summary:

2.1 The current contracts for the network of School and Public Bus Services expire on 18 August 2019.

2.2 In order to ensure continuity of services it is necessary to have in place new contracts from 19 August 2019. Contracts will be called off from a Framework Agreement concluded in July 2018 with a number of service providers in anticipation of the School and Public Bus Service requirements. The Framework Agreement is designed to cater for the outcomes of the Full Business Case. With the Framework Agreement in place it means contracts can be called off in good time and continuity of required services is ensured.

2.3 Transport is referred to in a range of community planning policy and strategy contexts in Shetland, which collectively describe what is required of Shetland's transport network. These are described in detail in the SOC in Appendix 1.

2.4 In addition the Council's School Transport Policy defines the policy on entitlement to School Transport.

2.5 The SOC builds these policies, along with a range of other parameters, into a process to: -

- Establish the strategic context for the project.
- Make the case for change.
- Identify and agree Critical Success Factors.
- Identify and agree a long list of options.
- Review the long list of options against the Critical Success Factors.
- Agree the preferred way forward.
- Establish the options to be taken forward to the Outline Business Case (OBC).

2.6 The SOC has established the preferred way forward as being a minimum of a network of services broadly similar to the current circumstances. The options to achieve this were arose from a comparison of options against the Critical Success Factors. The Critical Success Factors were derived from the community planning policies and strategies currently in place. These will be verified with users, communities and stakeholders over the course of the Business Case process.

2.7 A delivery plan to achieve the Full Business Case is given in Appendix 2. From this it can seen that the intention is to present the Outline Business Case to Council and ZetTrans for approval on 15 October 2018 and the Final Business Case in by mid-January 2019.

3.0 Corporate Priorities and Joint Working:

3.1 The Council's Corporate Plan states as one of its five top political priorities, "Provide quality transport services within Shetland, and push for improvements in services to and from Shetland" (Our Plan – 2016 – 2020).

3.2 The Council works closely with ZetTrans, as the main partner, to deliver its transport priorities along with NHS Shetland and Highlands and Islands Enterprise.

4.0 Key Issues:

4.1 The main issue arising out of this report are: -

- Presentation of a Strategic Outline Case for the provision of a network of public and school bus services throughout Shetland.
- Establishment of a set of Critical Success Factors, to be verified and/or refined through stakeholder engagement, to measure performance of service options.
- Approval of a preferred way forward that addresses the Critical Success Factors.

- The preferred way forward is the provision of a network of services broadly similar to the current network.

5.0 Exempt and/or Confidential Information:	
5.1 None.	
6.0 Implications :	
6.1 Service Users, Patients and Communities:	Through various means service users, communities and stakeholders have been involved in establishing the needs to be addressed by the public and school bus networks. As the Business Case process continues there will be further engagement with a wide range of stakeholders to inform the refinement of the investment objectives, benefits criteria and Critical Success Factors.
6.2 Human Resources and Organisational Development:	There are no human resources or organisational development issues arising immediately out of this report.
6.3 Equality, Diversity and Human Rights:	An Integrated Equalities Impact Assessment will be carried out as part of the Business Case process.
6.4 Legal:	A legally compliant European Union procurement exercise was carried out and a Framework Agreement entered into with a number of successful service providers. Contracts for specific services shall be concluded in accordance with the procedures specified in the Framework Agreement.
6.5 Finance:	The Council's Policy and Resources Committee has approved a Service Redesign Programme that has within it a target to reduce the costs bus contracts by £500k per annum (min. ref. 46/18). This target is included as one of the Critical Success Factors in the Business Case.
6.6 Assets and Property:	There are no Assets and Property issues arising immediately out of this report.
6.7 ICT and New Technologies:	There are no ICT or New Technologies arising immediately out of this report.
6.8 Environmental:	There are no environmental issues arising immediately from this report.

6.9 Risk Management:	Shetland's public and school bus network is important to the social and economic wellbeing of Shetland. Failure to conduct a thorough Business Case approach to the making decisions on the future network of services would undermine the capacity of the Council and ZetTrans to make informed investment decisions that can be shown to be based on policy aims and objectives. This could lead to unintended or unexpected consequences in terms of effective delivery of community planning objectives and outcomes. Furthermore, the Business Case approach will mitigate risk of unsustainable financial consequences that may arise out of inadequate account being taken of Shetland Islands Council's financial position and priorities.	
6.10 Policy and Delegated Authority:	Section 51 of the Education (Scotland) Act 1980, as amended, requires the Council to make such arrangements as they consider necessary for the provision of school transport and transport facilities on such terms and conditions as may be arranged, and to pay all or part of reasonable travelling expenses for school pupils residing in their area and attending designated schools. ZetTrans has functional responsibility to secure transport services in Shetland under the Transfer of Functions to the Shetland Transport Partnership Order 2006.	
6.11 Previously Considered by:	None.	

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17 August 2018
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Appendices:
Appendix 1 – Strategic Outline Case for the Public and School Bus Network 2019 - 2014
Appendix 2 – Timeline for the project

Background Documents: None.

STRATEGIC OUTLINE CASE (SOC)

Public and School Bus Network

2019 - 2024

Version no: V0.1

Issue date: 15/08/2018

VERSION HISTORY

Version	Date Issued	Brief Summary of Change	Owner's Name
Draft V0.1	15/08/2018	Draft Version	Michael Craigie

1. Executive summary

1.1 Introduction

This Strategic Outline Case (SOC) is for Public and School Bus Network 2019 to 2024. The proposed development is to establish the next generation of public and school bus networks after current network of network contracts expire in August 2019 and to establish means of reducing the costs of providing bus services in Shetland.

This SOC has been prepared using the HM Treasury Five Case Model which is the standard adopted by Shetland Islands Council in the preparation of Business Cases.

This document will address each of the Five Cases and covers the strategic case, the economic case, the commercial case, the financial case and the management case.

The scope includes:

- Public Bus Services across Shetland;
- School Transport Services across Shetland.

1.2 Strategic Case

1.2.1 Strategic Context

The strategic drivers for this investment are associated strategies, programmes and plans and the statutory duties placed on ZetTrans with regard to public bus services and on Shetland Islands Council in relation to School Transport, the Shetland Transport Strategy. The main drivers are described in the following paragraphs and further strategic policy and strategy is given in Section 2.3.

STATUTORY DUTIES

Under Sections 63 and 64 of the Transport Act 1985 there is a duty on ZetTrans *"to secure the provision of such public transport services as ZetTrans considers it appropriate to secure to meet any public transport requirements within their area which would not in their view be met apart from any action taken by them for that purpose"*.

Section 51 of the Education (Scotland) Act 1980, as amended, requires the Council to make such arrangements as they consider necessary for the provision of school transport and transport facilities on such terms and conditions as may be arranged, and to pay all or part of reasonable travelling expenses for school pupils residing in their area and attending designated schools.

Section 42(4) of the 1980 Act defines the statutory walking distance for school pupils as being 2 miles for any pupil under the age of 8 years of age and 3 miles for any other pupil.

SHETLAND TRANSPORT STRATEGY

The Shetland Transport Strategy (Refresh) contains a specific intervention to review the public bus network in line with ZetTrans' 3 strategic objectives:

- **Strategic Objective 1** - To underpin Shetland's economy by enabling individuals to access employment and training and businesses to access labour markets, customers and suppliers.
  This strategic objective broadly aligns with the Money priority of Shetland's Partnership Plan – "All households can afford to have a good standard of living";

- **Strategic Objective 2** - To support Shetland's communities by enabling individuals, families and localities to thrive socially, physically and economically.
  This strategic objective broadly aligns with the People priority of Shetland's Partnership Plan – "Individuals and families can thrive and reach their full potential";

- **Strategic Objective 3** - To conserve Shetland's environment by enabling the reduction of detrimental transport impacts on Shetland's unique natural resources.
  This strategic objective broadly aligns with the Place priority of Shetland's Partnership Plan – "Shetland is an attractive place to live, work, study and invest".

SIC MEDIUM TERM FINANCIAL PLAN

The Council's Medium Term Financial Plan outlines the Council's financial position and notes that there is a projected shortfall in funding from 2019/20 an onwards. A report presented to Council on 14 February 2018 said, "The Council must address the underlying challenges that have already been highlighted in the Medium Term Financial Plan, including the anticipation of continued reductions in grant funding, to reduce expenditure and to recognise the need for service redesign that successfully responds to the financial realities that it faces. The report recommends that the Council instruct the Corporate Management Team to develop proposals and options for Service redesign/change in the form of Strategic Outline Cases to address the continuous improvement and financial challenges that lie ahead. This should be done in the context of Council priorities and its contribution to local outcome aspirations, national policy and statutory duties, in a timescale of no more than 3 months."

SIC CORPORATE PLAN

Our Plan 2016/20 states,

- "There will be transport arrangements in place that meet people's needs and that we can afford to maintain in the medium term"
- "Our communities will feel better connected using new community transport solutions developed by communities themselves"
- "We will have a clearer understanding of the options and investments needed to create a sustainable internal transport system over the next 50 years".

These Business Strategies must be viewed in the context of other Organisational Strategies to which the Council and ZetTrans are committed as community planning partners. These include the Council's Core Values, the Shetland Partnership Plan, Shetland Place Standard, 10 Year Plan to Attract People to Live and Work in Shetland, On Da Level and the National Transport Strategy.

1.2.2 The Case For Change

The fundamental driver for change is the need to re-procure public and school bus services to ensure continuity of services after the current contracts expire in August 2019.

The existing arrangements are as follows: -

The current public bus services network is made up of mainline and feeder services, with dial-a-ride services providing demand responsive provision. School Transport is provided by a mix of dedicated services and use of public services where compatible.

Lerwick is the main service centre in Shetland and it is possible to commute to Lerwick by bus for a 9-5 work-day, and at lunch times, 6 days a week from most parts of Shetland, including the Northern Isles. Outwith Lerwick, the main service centres are Brae, Scalloway and Sandwick and it is possible to commute locally to these centres by bus for a 9-5 work-day, and at lunch times, 6 days a week. Most outlying rural areas have a local, sometimes demand-responsive, shopping service 1 or 2 days a week. In addition, there is a regular bus service linking Lerwick to the airport at Sumburgh.

This network of public and school transport services comprises 174 contracts covering 63 public services and 111 dedicated school services. The public network covers a range of travel needs related to the following hierarchy of travel needs factors, which were established from engagement with users and communities:-

- Journey to work
- Access to training and further/higher education

- Access to Healthcare
- Access to shops (rural and Lerwick)
- Access to social and leisure opportunities
- Access to external transport link
- Access to tourist attractions/destinations

The existing public bus service network in Shetland has a gross budget of £2.5m and the existing cost of school transport services has a gross budget of £2.2m.

These figures all relate to contract costs and are revenue budgets.

There are currently no capital budgets related to bus services in Shetland.

All current contracts covering public bus services and school transport services expire on 18 August 2019.

The business needs are based on the fundamental requirement to provide public and school bus services arising from the statutory duties noted in Section 1.2.1. There has also been further research done to inform strategy and policy development. This has established that there are areas that communities would like to see addressed, largely down to coverage, frequency and the length of the operating day. It is clear from the evidence gathered that the current network of services must form the basis of the consideration of options for the next generation of public and school bus services.

1.3 Economic Case

1.3.1 The Long List

The long list of options have been derived from the scope, service solution, service delivery and implementation options available. The verification of this long list will form part of the stakeholder engagement exercise which will be undertaken to inform the Outline Business Case for report to Shetland Islands Council and ZetTrans in October 2018.

SCOPING OPTIONS

- **Option 1.1: Do Nothing**
  Allow current contracts to run out and see if the market meets the service gap.

- **Option 1.2: Do Minimum A (status quo public / legal minimum schools)**

Provision of the current network of public service provision and the legal minimum of school transport service provision.

- **Option 1.3: Do Minimum B (status quo)**
  Provision of the current network of public and school transport service provision.

- **Option 1.4: Intermediate**
  The current network of services provision with gaps in service being filled in the longer term.

- **Option 1.5: Maximum**
  Immediately address gaps in current service provision and run a dedicated public transport service alongside a dedicated school transport service.

SERVICE OPTIONS

- **Option 2.1: Only Tendered Services**
  All services provided through a tender process with SIC as the operator of last resort.

- **Option 2.2: Only Directly provided services**
  All services are provided by SIC/ZetTrans.

- **Option 2.3: Combination of Tendered and Directly Provided**
  Some services are provided through a tender process, and some by SIC/ZetTrans.

- **Option 2.4: Combination of Tendered and Community**
  Some services are provided through a tender process and some by community organisations that wish to do so.

- **Option 2.5: Combination of Direct and Community**
  Services are provided by SIC/ZetTrans and some community organisations that wish to do so.

- **Option 2.6: Community Transport Alone**
  All services are provided by community organisations that wish to do so.

- **Option 2.7: Combination of Direct, Tendered and Community**
  Some services are provided through a tender process, some by SIC/ZetTrans and some by community organisations that wish to do so.

- **Option 2.8: De-regulation of some transport services**
  SIC can decide not to regulate taxi drivers/vehicles.

- **Option 2.9: Private Sector Car Club**
  Have a pool of cars available to community members that opt in.

- **Option 2.10: Personal subsidy to travel**
  Every individual in Shetland is given an annual budget to arrange their own travel.

SERVICE DELIVERY OPTIONS

- **Option 3.1: Shetland Islands Council**

- **Option 3.2: ZetTrans**

- **Option 3.3: Private Sector**

- **Option 3.4: Community Enterprise**

- **Option 3.5: Voluntary Sector**

- **Option 3.6: Public/Private Partnership**

IMPLEMENTATION OPTIONS

- **Option 4.1: Immediate**
  Implement new services from 19th August 2019.

- **Option 4.2: Short Delay**
  Extend current contracts for an agreed period based on the next suitable date to introduce new services after 19th August 2019.

- **Option 4.3: Delay by One Year**
  Extend current contracts and aim to introduce new services in August 2020.

- **Option 4.4: Delay by Two to Five Years**
- Extend current contracts and aim to introduce new services in August of 2021, 2022, 2023 or 2024.

- **Option 4.5: Phased**
  Extend some contracts and introduce new services in stages.

1.3.2 The Preferred Way Forward

The preferred way forward was identified from the individual assessment of which of the options listed in the four sections above would satisfy the most Critical Success Factors and the Investment Objectives.

The preferred way forward is as follows:

Scope – Do Minimum B

Service Solution – Tendered Services Only

Service Delivery – Private Operators

Implementation – Immediate

1.3.3 The Short List

On the basis that the preferred way forward is agreed, we recommend the following options for further, more detailed evaluation within the Outline Business Case (OBC):

- **Option 1** – Do nothing – extend contracts for five years.
- **Option 2** – Implement the 'Do Minimum B' scope, tender all services to private operators with an implementation date for new services of 19th August 2019.
- **Option 3** – Implement the 'Intermediate' scope, tender all services to a combination of private and community operators with an implementation date for new services in August 2020.
- **Option 4** – Implement the 'Do Minimum A' scope, tender all services to private operators with an implementation date for new services of 19th August 2019.

Consequently, the preferred option will be identified and recommended for approval within the OBC.

1.4 Commercial case

1.4.1 Procurement strategy

It is anticipated that the procurement strategy will be based on that which was successfully utilised when tendering the existing services.

It is anticipated that, subject to the approval of the SOC, the implementation be conducted to the following timescale:

September 2018 – Tender Documents Drafted

October 2018 – Tender Documents Finalised (following completion and approval of the OBC)

22 October 2018 – Issued Tender Documents

19 November 2018 – Tender Submission Deadline

November – December 2018 – Analysis of Submissions

January 2019 – Report to ZetTrans and Shetland Islands Council

February 2019 – Award Contracts

19 August 2019 – New Contracts Begin

1.4.2 Required services

The required products and services in relation to the preferred way forward are those of the level of public bus services currently in operation across Shetland and the level of school transport services to be tendered is in line with provision under the current SIC School Transport Policy.

1.4.3 Potential for risk transfer and potential payment mechanisms

The potential for risk transfer will be fully developed in the OBC stage of the process.

1.5 Financial case (to be completed in conjunction with Finance Services)

The Financial Case will be completed with colleagues in Finance Services following the procurement exercise as will be set out in the Outline Business Case and presented to Shetland Islands Council and ZetTrans in October 2018.

The procurement exercise will provide accurate financial information with which to cost each option.

Due to the changing landscape of passenger transport service provision in Shetland over the past few years, it is not possible to provide costed options ahead of the tender exercise as all contract information held is four years out of date. The necessary detailed knowledge of the specific circumstances, strategies and financial models of each member of the Framework Agreement that would be required to produce accurately costed models of each option are not held by the Council.

1.6 Management case

1.6.1 Project management arrangements

The project is an integral part of the portfolio of projects currently being undertaken to ensure a sustainable network of public transport services in Shetland.

The project is overseen by the Shetland Transport Programme Board.

1.7 Recommendation

It is recommended that the preferred way forward described in Section 1.3.2 is adopted as the basis for the development of the Outline and Final Business Cases.

2. The Strategic Case

2.0 Introduction

This Strategic Outline Case (SOC) is for Public and School Transport Network 2019 – 2024.

Structure and content of the document

This SOC has been prepared using the agreed standards and format for business cases.

The approved format is the Five Case Model, which comprises the following key components:

- The **strategic case** section. This sets out the strategic context and the case for change, together with the supporting investment objectives for the scheme
- The **economic case** section. This demonstrates that the organisation has selected a preferred way forward, which best meets the existing and future needs of the service and is likely to optimise value for money (VFM)
- The **commercial case** section. This outlines what any potential deal might look like
- The **financial case** section. This highlights likely funding and affordability issues and the potential balance sheet treatment of the scheme
- The **management case** section. This demonstrates that the scheme is achievable and can be delivered successfully in accordance with accepted best practice.

The purpose of this section is to explain and revisit how the scope of the proposed project or scheme fits within the existing business strategies of the organisation and provides a compelling case for change, in terms of the existing and future operational needs of the organisation. This section should clearly demonstrate how the project assists in the progression of Corporate Priorities and Business Transformation.

PART A: THE STRATEGIC CONTEXT

2.1 Organisational overview

The Development Service of Shetland Islands Council is one of the five Council Directorates and the Transport Planning Service, which holds the budget for the funding of the public bus network and school transport services, sits within this area.

The functional responsibility for public bus services lies with ZetTrans, Shetland's Transport Partnership. Under Sections 63 and 64 of the Transport Act 1985 there is a duty placed upon ZetTrans "to secure the provision of such pubic transport services as ZetTrans considers it appropriate to secure to meet any public transport requirements within their area which would not in their view be met apart from any action taken by them for that purpose".

School transport services are the responsibility of Shetland Islands Council as the local Education Authority and must comply with Section 51 of the Education (Scotland) Act 1980, as amended, which requires the Council to make such arrangements as they consider necessary for the provision of school transport and transport facilities on such terms and conditions as may be arranged, and to pay all or part of reasonable travelling expenses for school pupils residing in their area and attending designated schools. Section 42(4) of the 1980 Act defines the statutory walking distance for school pupils as being 2 miles for any pupil under the age of 8 years of age and 3 miles for any other pupil.

The strategic drivers for this review are the above duties, the Council's Medium Term Financial Plan, the Council's values and the Council's Corporate Plan (Our Plan 2016/20).

2.2 Business strategies

The overarching reason behind this business case is the need to re-procure public and school transport services so that services are in place after the current contracts expire on 18 August 2019.

SHETLAND TRANSPORT STRATEGY REFRESH

The Shetland Transport Strategy Refresh contains a specific intervention to review the public bus network in line with ZetTrans' 3 strategic objectives:

- **Strategic Objective 1** - To underpin Shetland's economy by enabling individuals to access employment and training and businesses to access labour markets, customers and suppliers. *This strategic objective broadly aligns with the Money priority of Shetland's Partnership Plan – "All households can afford to have a good standard of living"*

- **Strategic Objective 2** - To support Shetland's communities by enabling individuals, families and localities to thrive socially, physically and economically.
  This strategic objective broadly aligns with the People priority of Shetland's Partnership Plan – "Individuals and families can thrive and reach their full potential"

- **Strategic Objective 3** - To conserve Shetland's environment by enabling the reduction of detrimental transport impacts on Shetland's unique natural resources.
  This strategic objective broadly aligns with the Place priority of Shetland's Partnership Plan – "Shetland is an attractive place to live, work, study and invest"

THE COUNCIL'S MEDIUM TERM FINANCIAL PLAN

The Council's Medium Term Financial Plan outlines the Council's financial position and notes that there is a projected shortfall in funding from 2019/20 and onwards. A report presented to Council on 14 February 2018 said, "The Council must address the underlying challenges that have already been highlighted in the Medium Term Financial Plan, including the anticipation of continued reductions in grant funding, to reduce expenditure and to recognise the need for service redesign that successfully responds to the financial realities that it faces. The report recommends that the Council instruct the Corporate Management Team to develop proposals and options for Service redesign/change in the form of Strategic Outline Cases to address the continuous improvement and financial challenges that lie ahead. This should be done in the context of Council priorities and its contribution to local outcome aspirations, national policy and statutory duties, in a timescale of no more than 3 months."

SIC CORPORATE PLAN

Our Plan 2016/20 states,

- "There will be transport arrangements in place that meet people's needs and that we can afford to maintain in the medium term"
- "Our communities will feel better connected using new community transport solutions developed by communities themselves"
- "We will have a clearer understanding of the options and investments needed to create a sustainable internal transport system over the next 50 years".

These Business Strategies form the main strategic drivers in relation to the need to provide School and Public Bus Services beyond the end of the current contract period (i.e. from 19 August 2019 onwards). They must be viewed in the context of other Organisational Strategies to which the Council and ZetTrans are committed as community planning partners.

2.3. Other organisational strategies

OUR VALUES

The Council's values are excellent services, working well together and taking personal responsibility.

SHETLAND ISLANDS COUNCIL CUSTOMER CHARTER

The Shetland Islands Council Customer Charter states that:

We will:

- Respond promptly when you contact us
- Resolve issues as quickly as possible
- Be polite, helpful and professional at all times
- Treat everyone with equity and fairness
- Communicate clearly, avoiding jargon
- Maintain confidentiality, ensuring only those who need to see your information do so
- Take responsibility and rectify any mistakes we make
- Use your views to help us improve the way we do things

SHETLAND PARTNERSHIP PLAN

Shetland is a place where everyone is able to thrive; living well in strong, resilient communities; and where people and communities are able to help plan and deliver solutions to future challenges

Partner agencies work to align existing plans, strategies and partnerships with priorities to reduce inequality of outcome in Shetland

Priorities and ambitions assessed to identify any potential social, economic, environmental, equality and rural proofing impacts and adapted accordingly

Focuses on where partners' collective efforts can add most value for their local communities, with particular emphasis on reducing inequalities, improving outcomes for most vulnerable and moderating future demand for crisis services.

Shared Priorities

- People – individuals and families can thrive and reach their full potential
    - *The number of vulnerable people and households in Shetland will be considerably reduced as a result of people being enabled and empowered to address the issues they face.*
- Participation – people can participate and influence decisions on services and use of resources
    - *Staff from across the Shetland partnership will be actively seeking to involve communities in decision making and service delivery.*
- Place – Shetland is an attractive place to live, work, study and invest
    - *Public Transport is the top priority identified by Shetland Communities*
- Money – all households can afford to have a good standard of living
    - *Households will be supported to minimise their outgoings with low-income households benefitting from reduced bills including food, energy and travel*

TRANSPORT RELATED TARGETS

- 98% of school leavers will be participating in learning, training or work in 2021, rising to 100% in 2028 (currently 97.4%)
- 90% of people will feel that they are part of their community in 2021, rising to 95% by 2028
- 65% of people are satisfied with local services (health care, schools and public transport in 2021, rising to 75% in 2028 (currently 59%)
- The Place Standard Average Score for Public Transport improves from the 3.6 baseline to 5 (NB 7 = less improvement needed, 1 = more improvement needed)
- Carbon emissions are reducing faster than the Scottish average by 2021 and within 20% of the Scottish average by 2028 (carbon emissions currently 73% higher than Scottish average).
- The percentage of households in Shetland who do not earn enough to have an acceptable standard of living will have fallen to 35% in 2021 and 25% in 2028 (currently 49%)
- Locality Planning will be delivering improved outcomes in at least one community by 2021, and inequality of outcome between areas will have reduced by 2028

SHETLAND PLACE STANDARD

939 people provided valid responses and made 4,840 individual comments. Of those who completed the survey, 605 were female (64%) and 334 were male (36%).

- Overall the Shetland community has rated Public Transport as their No.1 priority (14.5%).
- Overall the Shetland community has given Public Transport an average rank of 3.6/6.4.

Highest % response in Lerwick & Bressay (26%). Lowest in Whalsay & Skerries (6%)

- Central, North, South, West, Whalsay and Skerries placed public transport as their No.1 priority.
- North Isles ranked Public Transport their No. 2 priority (behind Work & Local Economy).
- Lerwick and Bressay ranked Public Transport their No. 3 priority (behind Housing & Community, and Work & Local Economy).

Highest % response in 45-54 age group (26.2%). Lowest in 75+ age group (3%)

- For the 25 to 74 age group, Public Transport was chosen as where most improvement is needed,
- For those aged 16 to 24, Public Transport is ranked 2 as the area where most improvement is required
- Those over 75 chose Public Transport as where most improvement is needed

Public Transport Key Issues:

- Frequency of bus and ferry services
- Affordability of transport
- Distance to bus stops and quality of bus shelters.
- Timetables and service information are not easy to understand
- Integration between services – including between bus and ferry and air
- Need for improved access to health facilities

10 YEAR PLAN TO ATTRACT PEOPLE TO LIVE AND WORK IN SHETLAND

What success will look like:

The In 2028 Shetland will:

• Be an island of opportunity for young people, businesses and investors;

• Be a vibrant and positive student destination;

• Have a more balanced demographic profile and a growing population underpinned with more private sector jobs.

How will we measure success?

- Creation of 700 new private sector jobs based in Shetland by 2028. Interim target of 300 by 2022.
- Grow the FTE student population by 20% by 2028 (currently 178 FE and HE students)
- A more balanced demographic profile (in line with the Scottish average) with 20% of the population aged 16-29 years by 2028 (currently at 16%).
- Annual apprenticeship registrations rising to 175 by 2028 (currently at 127)

The plan states that "working in partnership is vital in order to realise the ambitions in this plan, an ambitious growth plan such as this requires support from all community planning partners, the community itself as well as Scottish and UK Governments. Housing and transport are key components of any talent attraction strategy, particularly in an island community such as Shetland. However, refreshed strategies and plans for Transport and Housing...have been refreshed to align themselves to the ambitions in this plan.1

The plan requires Community Partner buy-in - Constituent partner agencies to take a project based approach to this action plan, prioritising and committing resources as required.

"Lack of housing to accommodate incoming workers and families" was identified as a key risk. It also stated that "accommodation is a key concern for young people wishing to return or stay in Shetland." Any housing development would have knock-on effects on the demand for internal transport links.

Targeted support for industry growth sectors should include "infrastructure to support business growth" and a "Tourism Strategy which will aim to increase the number of non-cruise ship tourists to Shetland." Both of these are closely related to internal transport links.

Surveys were undertaken among the general community, the business community and young people. The following key points came out of the consultation in relation to internal transport:

Community - Transport cost and availability (both internally and externally)...if you don't have a car, commuting can be challenging

Business Community - (There are) good internal transport infrastructure – short commuting times... (need to ensure) that internal transport costs were affordable for young people and people on low incomes.

Young People - There should be better transport links at the weekend, but knowing some services are better used than others there could be a pre-booking ticketing scheme either online or by phone. The services should be more consistent based on need across all rural areas. It would also be to have Wifi on the service, particularly on longer routes... A survey should be conducted with young people to find out when and where they require public transport, providing a report to demonstrate the demand. This includes gathering requests from young people including, “second bus time in Yell/Unst at weekend nights" and emergency options if you miss the last bus.

Young people articulated a vision for the future in which: “Improvements have been made to transport, with a new rail link between Unst and Sumburgh. The demand for buses has been recognised and the timetable reflects the needs to the community requirements. Access to technology on transport has also increased particularly on the longer journeys. The faster internet expansion has helped support better communication between communities, however there is awareness that this could further isolate young people.

ON DA LEVEL (Shetland’s Commission on Tackling Inequalities)

Transport Aspirations

- Low income households are supported to reduce their household bills, such as food, energy and travel

It is acknowledged that, even with no public funding constraints, the public transport network will never be comprehensive enough to offer the same level of access and convenience as a private vehicle. In other words, in most areas of Shetland, including the peripheral areas of Lerwick, a car is necessary to ensure access and choice to employment and opportunities. Evidence highlights specific constraints:

- The cost of public transport is high for individuals, if not entitled to concessions: this is preventing people accessing volunteering and work placements that could support them to move into employment
- For those who are unwell and living in remote areas, the challenge (and cost) of public transport can be prohibitive, e.g. accessing Work Capability Assessments (CAB);
- Multi-journey fares ironically means that those more able to afford to buy a book of tickets at a time can get cheaper fares
- Not all households have a driving licence, or the resources to obtain one
- An issue for young people in Shetland is the cost of car insurance, as well as the cost of obtaining a driving licence
- The network and timings remain a challenge for young people, e.g. the lack of a bus from the college to Lerwick at 3.30pm

To date, it had been assumed that the barrier to vulnerable people accessing opportunities was a lack of availability of buses; evidence gathered for this session exposed the lack of affordability as a bigger issue for those on benefits and wishing to move into employment.

The cost and availability of transport influence individuals' ability to gain access to employment, services and social opportunities. Travel concessions are available for external and internal travel; some are provided at a national level and others are local. At the individual and household level, travel is prohibitive for those on lower incomes, particularly those not entitled to concessions. This can lead to debt to meet costs if people are forced to travel (e.g. family bereavement, hospital visits and family crisis).

The 2006 research highlighted that, in most areas of Shetland, including the peripheral areas of Lerwick, a car is necessary to ensure access to and choice of employment and opportunities. It had been assumed that the barrier to vulnerable people accessing opportunities was a lack of availability of buses; however, evidence has demonstrated that inability to afford fares, for example for those on benefits who wish to move into employment, is also an issue. Those groups that benefit from discounted or free travel are not necessarily those that, financially, need it most.

NATIONAL TRANSPORT STRATEGY

High Level Objectives

- Promote economic growth by building, enhancing, managing and maintaining transport services, infrastructure and networks to maximise their efficiency;
- Promote social inclusion by connecting remote and disadvantaged communities and increasing the accessibility of the transport network;
- Protect our environment and improve health by building and investing in public transport and other types of efficient and sustainable transport which minimise emissions and consumption of resources and energy;
- Improve safety of journeys by reducing accidents and enhancing the personal safety of pedestrians, drivers, passengers and staff; and
- Improve integration by making journey planning and ticketing easier and working to ensure smooth connection between different forms of transport.

Key Strategic Outcomes

- Improved journey times and connections, to tackle congestion and lack of integration and connections in transport
- Reduced emissions, to tackle climate change, air quality, health improvement
- Improved quality, accessibility and affordability, to give choice of public transport, better quality services and value for money, or alternative to car.

PART B: THE CASE FOR CHANGE

2.4 Investment Objectives

The investment objectives for this project are as follows:

- Investment Objective 1: Ensuring that ZetTrans meets its statutory duty to secure a fit for purpose network of public and school bus transport services.
- Investment Objective 2: Ensuring continuity of public transport services from 19 August 2019 for a minimum period of five years.
- Investment Objective 3: Ensuring that the public and school transport bus network contributes to the Shetland Partnership Plan target to increase the Place Standard score on Transport from 3.6 to 5 by 2028.
- Investment Objective 4: Reducing unit costs through the procurement process.
- Investment Objective 5: Meeting Investment Objective 1 in line with the financial objectives of Shetland Islands Council described in the prevailing version of the Medium Term Financial Plan, (currently reducing the cost of school and public bus contracts by £500,000 a year).

2.5 Existing Arrangements

The existing arrangements are as follows: -

The current public bus services network is made up of mainline and feeder services, with dial-a-ride services providing demand responsive provision. School Transport is provided by a mix of dedicated services and use of public services where compatible.

Lerwick is the main service centre in Shetland and it is possible to commute to Lerwick by bus for a 9-5 work-day, and at lunch times, 6 days a week from most parts of Shetland, including the Northern Isles. Outwith Lerwick, the main service centres are Brae, Scalloway and Sandwick and it is possible to commute locally to these centres by bus for a 9-5 work-day, and at lunch times, 6 days a week. Most outlying rural areas have a local, sometimes demand-responsive, shopping service 1 or 2 days a week. In addition, there is a regular bus service linking Lerwick to the airport at Sumburgh.

This network of public and school transport services comprises 174 contracts covering 63 public services and 111 dedicated school services. The public network covers a range of travel needs related to the following hierarchy of travel needs factors, which were established from engagement with users and communities:-

- Journey to work
- Access to training and further/higher education
- Access to Healthcare
- Access to shops (rural and Lerwick)
- Access to social and leisure opportunities
- Access to external transport link
- Access to tourist attractions/destinations

The existing public bus service network in Shetland has a gross budget of £2.5M and the existing cost of school transport services has a gross budget of £2.2M.

These figures all relate to contract costs and are revenue budgets.

There are currently no capital budgets related to bus services in Shetland.

All current contracts covering public bus services and school transport services expire on 18 August 2019.

Table 1: Existing Costs

Existing costs (£m)	**Public Transport**	**School Transport**	**Staff/ Office Costs**	**Total**
Current	2.5	2.2	0.3	5.0
Capital	0	0	0	0
Duration of contract	5 years	5 years	N/A	5.0

2.6 Business Needs

Under Sections 63 and 64 of the Transport Act 1985 there is a duty on ZetTrans *"to secure the provision of such public transport services as ZetTrans considers it appropriate to secure to meet any public transport requirements within their area which would not in their view be met apart from any action taken by them for that purpose"*.

This means that there isn't a scenario where no public transport is provided in Shetland.

In terms of school transport, section 2.1 describes the business need in terms of the statutory requirement to provide school transport.

The fundamental requirement to provide these services arises from these statutory duties. The detail of the current network was derived from an extensive engagement exercise with the users of services, public of Shetland, service providers and a range of agencies.
The network was carefully configured from this information to optimise routes and services as well as integrating public and school services.

Since the implementation of the current contracts there has been a range of research to inform strategy and policy development (ref LOIP, On Da Level (Commission on Tackling Inequalities), Place Standard, Transport Strategy Refresh, Local Development Plan, Masterplans, Island Development Plans, Locality Planning, Islands With Small Populations, etc.)

This research and engagement has established that there are some areas that communities feel should be addressed. Examples are frequency, network coverage, the length of day and days of the week, coverage outwith the conventional working day, some areas feel poorly served. The TAS report suggests increasing headway (i.e. frequency) on some services

With reference to all of this it is clear that from a service perspective the current network is the minimum requirement on the basis that it meets many of the travel needs of the Shetland public and should form the basis for the next generation of public and school bus services.

Provision of public transport services is reliant on having access to enough qualified drivers. There are not currently young drivers coming through to replace those who have, or are coming up for retirement. It is clear that action will need to be taken to address this within the lifespan of the next 5-year contract, bearing in mind that Shetland has very low levels of unemployment and potential drivers can find more lucrative work.

An overarching business need is to deliver services within a sustainable financial model. This will be defined within the Financial Case.

2.7 Potential Business Scope and Key Service Requirements

Table 2: Business Scope and Key Service Requirements

	Minimum	**Intermediate**	**Maximum**
Potential business scope	Continue with the current network of integrated public and school services and dedicated school transport services where required. For School Transport services provide transport to all entitled pupils as per national policy	Continue with the current network of integrated public and school services and dedicated school transport services where required. For School Transport services provide transport to all entitled pupils as per current Council policy. Work on the gaps over a medium term approach to developing complementary measures with communities, community agencies and third sector.	Immediately address the gaps in the network through a dedicated public transport network alongside a dedicated school transport network where entitled pupils get transport in line with current SIC policy.
Key service requirements	• Journey to work across Shetland • Access to training and further/higher	• Journey to work across Shetland • Access to training and further/higher	• Journey to work across Shetland • Access to training and further/higher education

	Minimum	Intermediate	Maximum
	education from across Shetland • Access to Healthcare across Shetland • Access to shops (rural and Lerwick) • Access to social and leisure opportunities	education from across Shetland • Access to Healthcare across Shetland • Access to shops (rural and Lerwick) • Access to social and leisure opportunities • Access to external transport links • Access to tourist attractions/destinations	from across Shetland • Access to Healthcare across Shetland • Access to shops (rural and Lerwick) • Access to social and leisure opportunities • Access to external transport link • Access to tourist attractions/destinations • Higher levels of intra and inter community transport • Lower or free fares • Long operating days • Highest standards of environmental performance of vehicles

2.8 Main Benefits Criteria

The potential benefits that will be realised in relation to the Investment Objectives will be identified through stakeholder consultation before the completion of the Outline Business Case. This exercise will highlight the benefits delivered through implementation of the minimum, intermediate and maximum scope that have been defined to meet the business needs.

The benefits will be listed in relation to the following beneficiaries:

- Shetland Islands Council
- ZetTrans
- Other Agencies

- Service Users
- Wider Community

They benefits will be defined under the following headings:

- Cash Releasing Benefits (CRB)
- Financial but non-Cash Releasing Benefits
- Quantifiable (or quantitative) benefits
- Non-quantifiable (or qualitative) benefits

2.9 Main risks

Business and service risks associated with the design of this project are shown below, together with their counter measures. Further risks related to development will be identified through stakeholder engagement before completion of the Outline Business Case.

Main Risk	Counter Measures
Lack of Stakeholder Engagement	Ensure adequate time to engage stakeholders in setting and/or validating: • Investment Objectives • Business Scope and Key Service Requirements • Benefits criteria • Development risks • Critical Success Factors Extend current contracts to accommodate this if required.
Clarity on Political view on cuts if necessary	Provide Members with a menu of costed options along with their implications in relation to organisational finance, and in relation to meeting the aspirations of related strategies and plans.
Lack of organisational experience in Business Case of this nature – wide reaching	Identify knowledge gaps and agree how they will be addressed
Internal resources • Transport Planning • Legal • Procurement • Senior management time to be involved	Ensure project is carefully planned out and engage with senior managers to agree and secure the necessary resources
• Supplier – Are suppliers in a position be more competitive through efficiency? • Specification – there is a tension between the expressed needs from users, policy, other agencies and financial constraints • Timescale – sufficient lead in time is required to allow operators to secure the required vehicles • change management and project management - Community Planning and Locality Planning in	To be identified through stakeholder engagement

transition and not yet mature	

2.10 Constraints

The two main constraints for this project are the identified investment objective of reducing costs by £500,000 per annum and the timescale for the completion of the preferred option in order to ensure continuity of services from August 2019.

There may also be a constraint on resources in the bus industry in Shetland, for example drivers.

2.11 Dependencies

This project is dependent on the appropriate levels of staffing and resources within Transport Planning, Finance Services and Legal Services being available. These will be carefully monitored and managed through the lifespan of the project.

3. The Economic Case

3.1 Introduction

In accordance with the Capital Investment Manual and requirements of HM Treasury's Green Book (A Guide to Investment Appraisal in the Public Sector), this section of the SOC documents the wide range of options that have been considered in response to the potential scope identified within the strategic case.

3.2 Critical Success Factors (CSFs)

The proposed Critical Success Factors for this project are as follows:

CSF1: A fit for purpose public and school transport service can be tendered in time to be operational by 19th August 2019, or the nearest suitable date with a corresponding extension of current contracts.

CSF2: The project stimulates competition in the market to try to achieve cost reductions through the procurement process.

CSF3: The school and public transport service meets Shetland Transport Strategy Objectives 1 and 2, and contributes to Objective 3.

CSF4: The school and public transport service fits with a stakeholder approved hierarchy of transport need and contributes to raising the Transport Place Standard Score.

CSF5: The school and public transport network provides best Value for Money in relation to public spend and avoids incurring any unnecessary expenditure.

CSF6: The project can be delivery by existing Shetland Islands staff and resources within Transport Planning, Financial, and Legal services.

CSF7: The levels of transport service proposed are deliverable within the scale/capabilities of local service providers, particularly in relation to driver availability, bearing in mind the capacity of Shetland Islands Council to operate services in-house.

CSF8: The project creates the ability to generate a list of costed network options to ensure decision makers can make informed choices in relation to available funding.

Stakeholder engagement is essential to consult on the Critical Success Factors noted above. This engagement exercise will be undertaken during the construction of the Outline Business Case, which will form the subject of a report to Shetland Islands Council and ZetTrans in October 2018.

3.3 The Long-Listed Options

The long list of options have been derived from the scope, service solution, service delivery and implementation options available. The verification of this long list will form part of the stakeholder engagement exercise which will be undertaken to inform the Outline Business Case for report to Shetland Islands Council and ZetTrans in October 2018.

The evaluation was undertaken in accordance with how well each option met the investment objectives and CSFs.

3.4 Scoping options

3.4.1 Introduction

This range of options considers coverage of the Shetland public and school transport network. In accordance with the Treasury Green Book and Capital Investment Manual, the status quo/do minimum has been considered as a benchmark for potential VFM. An infinite number of options and permutations are possible; however, within the broad scope outlined in the strategic case, the following main options have been considered:

Option 1.1: Do Nothing
Description – Allow current contracts to run out and see if the market meets the service gap.
Advantages – This option would save the Shetland Islands Council money.
Disadvantages – This option does not meet the inverse meant objectives, most importantly it fails to meet ZetTrans' statutory duties.

Conclusion – Discounted.

Option 1.2: Do Minimum A (status quo public / legal minimum schools)
Description – Provision of the current network of public service provision and the legal minimum of school transport service provision.
Advantages – This option would meet all of the investment objectives and most of the critical success factors whilst saving money.
Disadvantages – Service provision would be less than it currently is with potential knock on effects – most significantly it may not contribute positively to objectives set in the Shetland Transport Strategy and Shetland Partnership Plan.
Conclusion – Possible.

Option 1.3: Do Minimum B (status quo)
Description – Provision of the current network of public and school transport service provision.
Advantages – This option would meet most of the investment objectives and critical success factors, providing the current level of service.
Disadvantages – This option does not save money directly, although it could through the procurement process.
Conclusion – Preferred.

Option 1.4: Intermediate
Description - The current network of services provision with gaps in service being filled in the longer term.
Advantages – This would meet the investment objectives and critical success factors in terms of service provision.
Disadvantages – Adding in new services during the contracts might not provide best value for money as the chances for packaging would have been missed. Overall this approach would cost SIC more.
Conclusion – Possible.

Option 1.5: Maximum
Description – Immediately address gaps in current service provision and run a dedicated public transport service alongside a dedicated school transport service.
Advantages – This would address all service needs comprehensively.
Disadvantages – It would not be value for money or avoid unnecessary expenditure and it may be beyond the capacity of local service providers to deliver.
Conclusion – Discounted.

3.4.2 Overall conclusion: scoping options

The table below summarises the assessment of each option against the investment objectives and CSFs.

Table 5: summary assessment of scoping options

Reference to:	Option 1.1	Option 1.2	Option 1.3	Option 1.4	Option 1.5
Description of option:	**Do nothing**	**Minimum A**	**Minimum B**	**Intermediate**	**Maximum**
Investment objectives					
OI1		Yes	Yes	Yes	Yes
OI2		Yes	Yes	Yes	Yes
OI3			Yes	Yes	Yes
OI4		Yes	Yes	Yes	
OI5		Yes	Yes		
Critical success factors					
CF1		Yes	Yes	Yes	Yes
CF2	Yes	Yes	Yes	Yes	
CF3			Yes	Yes	Yes
CF4		Yes	Yes	Yes	Yes
CF5					
CF6	Yes	Yes	Yes	Yes	
CF7	Yes	Yes	Yes		
CF8		Yes	Yes	Yes	
Summary	**Discounted 3/13**	**Possible 10/13**	**Preferred 12/13**	**Possible 10/13**	**Discounted 6/13**

3.5 Service solution options

3.5.1 Introduction

This range of options considers potential solutions in relation to the preferred scope.

Option 2.1: Only Tendered Services

Description – All services provided through a tender process with SIC as the operator of last resort.
Advantages – This would meet all the investment objectives and critical success factors.
Disadvantages – None
Conclusion – Preferred

Option 2.2: Only Directly Provided Services

Description – All services are provided by SIC/ZetTrans
Advantages – None
Disadvantages – This would not meet most of the investment objective and critical success factors, most notably it would not be do-able within the preferred timeframe and within existing staff resources.
Conclusion – Discounted

Option 2.3: Combination of Tendered and Directly Provided

Description – Some services are provided through a tender process, and some by SIC/ZetTrans
Advantages – This would meet about half of the investment objectives and critical success factors.
Disadvantages – The main disadvantage would be that it would be unlikely to provide best value for money, and would probably end up costing SIC more.
Conclusion – Possible

Option 2.4: Combination of Tendered and Community

Description – Some services are provided through a tender process and some by community organisations that wish to do so.
Advantages – This would meet about half the investment objectives and critical success factors.
Disadvantages – The main disadvantage would be that it would be unlikely to provide best value for money, and would probably end up costing SIC more. There is also a lack of clarity about the legality of awarding community contracts at the expense of private operators.
Conclusion – Possible

Option 2.5: Combination of Direct and Community

Description – Services are provided by SIC/ZetTrans and some community organisations that wish to do so.
Advantages – This may be positive in terms of community empowerment
Disadvantages – This would fail to meet most of the investment objectives and critical success factors and would damage local service providers.
Conclusion – Discounted.

Option 2.6: Community Transport Alone

Description – All services are provided by community organisations that wish to do so.
Advantages – None
Disadvantages – It is unlikely this would be within the capacity of community organisations in Shetland, it would not meet any investment objectives/critical success factors and would not provide value for money. It would probably prove significantly more expensive than the current contracts
Conclusion – Discounted

Option 2.7: Combination of Direct, Tendered and Community

Description – Some services are provided through a tender process, some by SIC/ZetTrans and some by community organisations that wish to do so.
Advantages – This would meet about half of the investment objectives and critical success factors and may have benefits in terms of community empowerment.
Disadvantages – This may not be deliverable within the current staff resources of SIC and is unlikely to provide best value for money.
Conclusion – Possible.

Option 2.8: De-regulation of Some Transport Services

Description – SIC can decide not to regulate taxi drivers/vehicles.
Advantages – This could stimulate competition in the market, bringing down costs dramatically in some areas.
Disadvantages – There would be no guarantee of quality or safety of service provision.
Conclusion – Discounted.

Option 2.9: Private Sector Car Club

Description – Have a pool of cars available to community members that opt in.

Advantages – This would fit with most of the investment objectives and some of the critical success factors.
Disadvantages – It is unlikely to be of great benefit to the network as a whole, particularly in relation to value for money.
Conclusion – Possible.

Option 2.10: Personal subsidy to travel

Description – Every individual in Shetland is given an annual budget to arrange their own travel
Advantages – This would reduce workload and hence costs within SIC
Disadvantages – Unless people clubbed together to best effect they would not obtain best value for only and may find the subsidy wouldn't come close to covering their needs.
Conclusion – Discounted

3.5.2 Overall conclusion: service solutions options

The table and narrative below summarises the assessment of each option against the investment objectives and CSFs.

Table 6: summary assessment of service solutions options

Reference to:	Option 2.1	Option 2.2	Option 2.3	Option 2.4	Option 2.5	Option 2.6	Option 2.7	Option 2.8	Option 2.9	Option 2.10
Description of option:										
Investment objectives										
OI1	Yes	Yes	Yes	Yes	Yes		Yes		Yes	
OI2	Yes		Yes	Yes			Yes		Yes	
OI3	Yes	Yes	Yes	Yes	Yes		Yes		Yes	
OI4	Yes							Yes		
OI5	Yes							Yes	Yes	
Critical success factors										
CF1	Yes		Yes	Yes			Yes		Yes	
CF2	Yes							Yes		
CF3	Yes	Yes	Yes	Yes	Yes		Yes		Yes	
CF4	Yes	Yes	Yes	Yes	Yes		Yes		Yes	
CF5	Yes									
CF6	Yes									
CF7	Yes		Yes	Yes			Yes	Yes		
CF8	Yes	Yes	Yes	Yes	Yes		Yes			
Summary	**Preferred 13/13**	**Discount 5/13**	**Possible 8/13**	**Possible 8/13**	**Discount 5/13**	**Discount 0/13**	**Possible 8/13**	**Discount 4/13**	**Possible 7/13**	**Discount 0/13**

3.6 Service delivery options

3.6.2 Introduction

This range of options considers the options for service delivery in relation to the preferred scope and potential solution.

Option 3.1: Shetland Islands Council
Description – All services are provided by Shetland Islands Council
Advantages – None
Disadvantages –This would not meet most of the investment objective and critical success factors, most notably it would not be do-able within the preferred timeframe and within existing staff resources.
Conclusion – Discounted

Option 3.2: ZetTrans
Description - All services are. Provided by ZetTrans
Advantages – None
Disadvantages –This would not meet most of the investment objective and critical success factors, most notably it would not be do-able within the preferred timeframe and within existing staff resources, particularly as ZetTrans does not currently hold an Operator's License.
Conclusion – Discounted

Option 3.3: Private Sector
Description – All services provided by the private sector with SIC as the operator of last resort.
Advantages – This would meet all the investment objectives and critical success factors.
Disadvantages – None
Conclusion – Preferred

Option 3.4: Community Enterprise
Description – All services provided by Community organisations
Advantages – This would embed transport provision within the community and could contribute to community empowerment
Disadvantages – It would prove complex and is unlikely to provide value for money. It is also not within the existing capacity of community organisations in Shetland
Conclusion – Discounted

Option 3.5: Voluntary Sector
Description – All services provided by voluntary organisations

Advantages – This would be inexpensive and could contribute to community empowerment
Disadvantages – It would prove complex and is way beyond the existing capacity of voluntary organisations in Shetland
Conclusion – Discounted

Option 3.6: Public/Private Partnership

Description – Some services are provided by the private sector, and some by SIC
Advantages – This would meet about half of the investment objectives and critical success factors.
Disadvantages – The main disadvantage would be that it would be unlikely to provide best value for money, and would probably end up costing SIC more.
Conclusion – Possible

3.6.2 Overall conclusion: service delivery options

The table below summarises the assessment of each option against the investment objectives and CSFs.

Table 7: summary assessment of service delivery options

Reference to:	Option 3.1	Option 3.2	Option 3.3	Option 3.4	Option 3.5	Option 3.6
Description of option:	**SIC**	**ZetTrans**	**Private Sector**	**Community Enterprise**	**Voluntary Sector**	**Public/Private Partnership**
Investment objectives						
OI1	Yes	Yes	Yes			Yes
OI2			Yes			Yes
OI3	Yes	Yes	Yes			Yes
OI4			Yes			
OI5			Yes			
Critical success factors						
CF1			Yes			Yes
CF2			Yes			

CF3	Yes	Yes	Yes			Yes
CF4	Yes	Yes	Yes	Yes	Yes	Yes
CF5			Yes			
CF6			Yes			
CF7			Yes			Yes
CF8	Yes	Yes	Yes	Yes	Yes	Yes
Summary	**5/13 Discounted**	**5/13 Discounted**	**13/13 Preferred**	**2/13 Discounted**	**2/13 Discounted**	**8/13 Possible**

3.7 Implementation options

3.7.1 Introduction

This range of options considers the choices for implementation in relation to the preferred scope, solution and method of service delivery.

Option 4.1: Immediate
Description – Implement new services from 19th August 2019
Advantages – This would meet all investment objectives and critical success factors.
Disadvantages – None
Conclusion – Preferred

Option 4.2: Short delay

Description - Extend current contracts for an agreed period based on the next suitable date to introduce new service after 19th August 2019

Advantages – This would meet all investment objectives and critical success factors.
Disadvantages – It would require an extension of existing contracts and services would not begin in-line with the school year.
Conclusion – Possible

Option 4.3: Delay 1 year

Description - Extend current contracts and aim to introduce new service in August 2020

Advantages – This would meet most investment objectives and about half of the critical success factors.

Disadvantages – It would significantly delay implementation of the service that will best meet the strategic aspirations set out in the Shetland Transport Strategy and Shetland Partnership Plan.
Conclusion – Possible

Option 4.4: Delay 2 – 5 years

Description – Extend current contracts and aim to introduce new service in August of 2021, 2022, 2023 or 2024
Advantages – This would give plenty of time to analyse service provision to secure the best possible service/value for money in the long term.
Disadvantages – It would very significantly delay implementation of the service that will best meet the strategic aspirations set out in the Shetland Transport Strategy and Shetland Partnership Plan, since the new services would not be in place until more than half way through the lifecycle of the SPP.
Conclusion – Discounted

Option 4.5: Phased

Description – Extend some contracts and introduce new service by stages
Advantages – This would meet about half the investment objectives and some critical success factor.
Disadvantages – A phased approach would reduce the opportunities for cost-saving through packaging.
Conclusion – Discounted.

3.7.2 Overall conclusion: implementation options

The table below summarises the assessment of each option against the investment objectives and critical success factors.

Table 8: summary assessment of implementation options

Reference to:	Option 4.1	Option 4.2	Option 4.3	Option 4.4	Option 4.5
Description of option:	**Immediate**	**Short delay**	**Delay 1 yr**	**Delay 2-5 yrs**	**Phased**
Investment objectives					
OI1	Yes	Yes	Yes	Yes	Yes
OI2	Yes	Yes	Yes	Yes	Yes
OI3	Yes	Yes			Yes
OI4	Yes	Yes	Yes	Yes	

OI5	Yes	Yes	Yes	Yes	
Critical success factors					
CF1	Yes	Yes			Yes
CF2	Yes	Yes	Yes	Yes	
CF3	Yes	Yes			Yes
CF4	Yes	Yes			Yes
CF5	Yes	Yes			
CF6	Yes	Yes	Yes	Yes	
CF7	Yes	Yes	Yes	Yes	
CF8	Yes	Yes	Yes	Yes	
Summary	**Preferred 13/13**	**Possible 13/13**	**Possible 8/13**	**Possible 8/13**	**Discount 6/13**

3.8 Funding options (For Finance Use Only)

It is agreed that the scheme will be funded by Shetland Islands Council. No alternative methods of finance have been explored.

3.9 The long list: inclusions and exclusions

The long list has appraised a wide range of possible options.

Tables 10a and b: summary of inclusions, exclusions and possible options

Option	1	2	3	4	5	6	7	8	9	10
Scope	**Discount**	**Possible**	**Preferred**	**Possible**	**Discount**					
Service Solution	**Preferred**	**Discount**	**Possible**	**Possible**	**Discount**	**Discount**	**Possible**	**Discount**	**Possible**	**Discount**
Service Delivery	**Discount**	**Discount**	**Preferred**	**Discount**	**Discount**	**Possible**				
Implementation	**Preferred**	**Possible**	**Possible**	**Possible**	**Discount**					

Table 10b

	Preferred	Possible
Scope	Do Minimum B	Do Minimum A Intermediate
Service Solution	Only Tendered	Tenders & Direct Tendered & Communi-ty Tendered, Direct & Community Private Sector Car Blub
Service Delivery	Private Operators	Public/Private Partner-ship
Implementation	Immediate	Short Delay 1 Year Delay

3.10 Short-listed options

3.10.1 Overview

The 'preferred' and 'possible' options identified in table 6 above have been carried forward into the short list for further appraisal and evaluation. All the options that were discounted as impracticable have been excluded at this stage.

On the basis of this analysis, the recommended short list for further appraisal within the OBC is as follows:

- Option 1 – Do nothing – extend current contracts for 5 years
- Option 2 – Implement the 'Do Minimum B' scope (i.e. the current network of public and school service provision). Tender all services to private operators (with SIC as the operator of last resort), trying to obtain savings through the procurement process, with contracts beginning on 19th August 2019
- Option 3 – Implement the 'Intermediate scope (i.e. the current network of service provision with gaps in service being addressed in the longer term). Tender all services to a combination of private and community operators, trying to obtain savings through the procurement

process, with contracts beginning on 19th August 2020 (to allow time for engagement with potential community operators).

- Option 4 – Implement the 'Do Minimum A' scope (i.e. the current network of public service provision with the legal minimum of school service provision). Tender all contracts to private operators, trying to obtain savings through the procurement process, with contracts beginning as soon as possible after 19th August 2019 (to allow time to revise the school service requirements in-line with the legal minimum).

4. The Commercial Case

4.1 Introduction

This section covers the proposed procurement exercise in relation to the preferred option of tendering public bus services at the current level of provision and school transport services in line with the current SIC School Transport Policy, in a joint tendering exercise between ZetTrans and the Shetland Islands Council, for implementation on 19 August 2019.

4.2 Required services

The level of public bus services to be tendered matches the level of public bus services currently in operation across Shetland and the level of school transport services to be tendered is in line with provision under the current SIC School Transport Policy.

4.3 Potential for risk transfer

The potential for risk transfer was fully explored when the initial procurement strategy was established for the procurement of passenger transport. This strategy has subsequently been reviewed in preparation for this exercise and no alterations are proposed. The strategy transfers the risks as follows:

See Next Page

Table 11: risk transfer matrix

Risk Category	Potential allocation		
	Client	Contractor	Shared
1. Design risk	Y		
2. Construction and development risk	Y		
3. Transition and implementation risk			Y
4. Availability and performance risk			Y
5. Operating risk		Y	
6. Variability of revenue risks	Y		
7. Termination risks	Y		
8. Technology and obsolescence risks	Y		
9. Control risks	Y		
10. Residual value risks	Y		
11. Financing risks	Y		
12. Legislative risks			Y
13. Other project risks	Y		

4.4 Proposed charging mechanisms

ZetTrans and Shetland Islands Council will make payments for the contracts awarded in line with the Conditions of Contract as established under the Framework Agreement currently in place.

Where the contract is for the provision of a public bus service, this contract will be established on a minimum cost basis and in line with section 10.3 of the Conditions of Contract, the invoice presented "shall show the total revenue taken during the performance of the Service as a net reduction in the total payment due to the Contractor".

The specific section (10.6) of the Conditions of Contracts states, "The Client will endeavour to pay to the Contractor the due amount within 30 days of receipt of a correctly completed invoice. A separate invoice must be issued by the Contractor for each calendar month (or other period specified by the Client."

In cases where, under section 10.5, the Client provides "more than 48 hours notice of the fact that the Contractor shall not be required to provide transport on any day, then the Contractor shall not be entitled to any payment whatsoever".

4.5 Proposed contract lengths

The proposed contract lengths for inclusion in the tendering exercise will be five and seven years. Bidders will have the opportunity to put forward tenders for both contract lengths.

4.6 Proposed key contractual clauses

Tenders shall be sought from Operators on the current Passenger Transport Framework.

This Framework Agreement has a suite of established documents which would apply to all contracts tendered under it. These documents include:

- Passenger Transport Conditions of Contract
- Passenger Transport Service Performance Specification

The documents cover all contractual clauses applicable to this exercise.

4.7 Personnel implications (including TUPE)

It is anticipated that the TUPE – Transfer of Undertakings (Protection of Employment) Regulations 1981 – will not apply to this investment as outlined above.

Section 18 of the Passenger Transport Conditions of Contract notes that Contractors recognise "his/her responsibilities under the Transfer of Undertakings (Protection of Employment) Regulations 2006 as amended and will provide relevant information on staff employed on the Contract as may be required". It also notes that "at no time shall the Contractor's employees be or become employees of the Client either in terms of any Contract or the Framework Agreement or otherwise".

4.8 Procurement strategy and implementation timescales

It is anticipated that the procurement strategy will match that which was successfully utilised when tendering the existing services.

It is anticipated that, subject to the approval of the SOC, the implementation be conducted to the following timescale:

September 2018 – Tender Documents Drafted

October 2018 – Tender Documents Finalised (following completion and approval of the OBC)

22 October 2018 – Issued Tender Documents

19 November 2018 – Tender Submission Deadline

November – December 2018 – Analysis of Submissions

January 2019 – Report to ZetTrans and Shetland Islands Council

February 2019 – Award Contracts

19 August 2019 – New Contracts Begin

4.9 FRS 5 accountancy treatment *(Finance Use Only)*

It is envisaged that the assets underpinning the delivery of service will/will not be on the balance sheet of the organisation…..

5.0 The Financial Case (to be completed in conjunction with Finance Services)

The Financial Case will be completed with colleagues in Finance Services following the procurement exercise as will be set out in the Outline Business Case and presented to Shetland Islands Council and ZetTrans in October 2018.

The procurement exercise will provide accurate financial information with which to cost each option.

Due to the changing landscape of passenger transport service provision in Shetland over the past few years, it is not possible to provide costed options ahead of the tender exercise as all contract information held is four years out of date. The necessary detailed knowledge of the specific circumstances, strategies and financial models of each member of the Framework Agreement that would be required to produce accurately costed models of each option are not held by the Council.

6. The Management Case

6.1 Introduction

This section of the SOC addresses the 'achievability' of the scheme. Its purpose is to set out the actions that will be required to ensure the successful delivery of the scheme in accordance with best practice.

6.2 Programme management arrangements

The project is an integral part of the portfolio of projects currently being undertaken to ensure a sustainable network of public transport services within Shetland and to/from Shetland.

The project is overseen by the Shetland Transport Programme Board.

The programme management arrangements are consistent with the Managing Successful Programmes methodology.

6.3 Project management arrangements

The project will be managed in accordance with PRINCE 2 methodology.

6.3.1 Outline project reporting structure

The project is overseen by the Shetland Transport Programme Board

The project sits within a programme of transport projects and initiatives and the Programme Manager is the Executive

6.3.2 Outline project roles and responsibilities

The Shetland Transport Programme Board comprises: -

Chief Executive Shetland Islands Council
Director Infrastructure Services Shetland Islands Council (Senior Responsible Owner and Chair)
Director Development Services Shetland Islands Council (Senior Executive)
Executive Manager Finance Shetland Islands Council (Senior Business Owner)
Executive Manager Community Planning and Development Shetland Islands Council (Senior Adviser)

Programme Manager – Executive Manager Transport Planning/ Lead Officer ZetTrans

6.3.3 Outline project plan

Table 12: milestones

Date	Activity	Who
By 13th Aug 2018	Prepare SOC	Michael/Elaine/Robina
22nd Aug 2018	Present SOC and timeline to Council and ZetTrans for approval	Michael
23rd Aug 2018 – 8th Oct 2018	Develop OBC	Michael/Robina/Elaine
September 2018	Consultation: • Verification/ refinement of Investment Objectives and Critical Success Factors • Verification/ refinement of Benefits and Risks • Verification/ refinement of methodology to obtain shortlist • Verification/ refinement of Hier-	Michael/Robina/Elaine

	archy of Transport Need and priorities	
1st Oct 2018 – 8th Oct 2018	Finalise preferred option based on consultation feedback and each of the five components of the business case	Michael/ Elaine
15th Oct 2018 (Special Meeting)	Present OBC (which will include procurement strategy) to Council and ZetTrans for approval to go to Final Business Case	Michael
16th Oct 2018 - 31st Dec 2018	Complete FBC: • Stakeholder Engagement • Procurement or VFM solution • Recommended service provider and solution • Finalise methodology for awarding contracts	Michael/Elaine/Robina
22nd Oct	Issue tender docs	Elaine
16th Nov	Tender submission deadline	
19th Nov – 5th Dec (or 10th Dec if necessary – depends on availability of finance/legal staff)	Assess tender docs	Elaine/Michael
First half of Jan 2019	Report FBC to Council and ZetTrans for decision on final set of contracts to be awarded	Michael/Elaine
Feb 2019	Award contracts with 6 month lead in time	Elaine

6.4 Use of special advisers

Special advisers have been used in a timely and cost-effective manner.

Details are set out in the table below:

Table 13: special advisers

Specialist Area	Adviser
Financial	N/A to date
Technical	TAS Partnership
Procurement and legal	N/A to date
Business assurance	N/A to date
Other	N/A to date

6.5 Gateway review arrangements

The impacts/risks associated with the project will be developed in full detail in the preparation of the OBC.

The presentation to Shetland Islands Council and ZetTrans on 22 August will confirm that the project fits with the strategic aims of the two organisations which is consistent with Gate 0 of the assurance process.

Further reviews will be developed as part of the OBC process and reported the Programme Board, Shetland Islands Council and ZetTrans as required.

Date	Activity	Who
By 13 August 2018	Prepare SOC	Executive Manager Transport Planning Transport Contracts and Operations Officer Transport Policy and Projects Officer
22 August 2018	Present SOC and timeline to Council and ZetTrans for approval	Executive Manager Transport Planning
23 August 2018 – 8 October 2018	Develop OBC	Executive Manager Transport Planning Transport Policy and Projects Officer Transport Contracts and Operations Officer
27 August 2018 – 30 September 2018	Consultation: • Verification/ refinement of Investment Objectives and Critical Success Factors • Verification/ refinement of Benefits and Risks • Verification/ refinement of methodology to obtain shortlist • Verification/ refinement of Hierarchy of Transport Need and priorities	Executive Manager Transport Planning Transport Policy and Projects Officer Transport Contracts and Operations Officer
1 October 2018 – 8 October 2018	Finalise preferred option based on consultation feedback and each of the five components of the business case	Executive Manager Transport Planning Transport Contracts and Operations Officer
15 October 2018 (Special Meeting)	Present OBC (which will include procurement strategy) to Council and ZetTrans for approval to go to Final Business Case	Executive Manager Transport Planning
16 October 2018 – 31 December 2018	Complete FBC: • Stakeholder Engagement • Procurement or VFM solution • Recommended service provider and solution • Finalise methodology for awarding call off contracts under the Framework Agreement	Executive Manager Transport Planning Transport Contracts and Operations Officer Transport Policy and Projects Officer
22 October 2018	Issue tender documents in accordance with Framework Agreement	Transport Contracts and Operations Officer
16 November 2018	Tender submission deadline	
19 November – 5 December 2018	Assess tender documents	Transport Contracts and Operations Officer Executive Manager Transport Planning
21 January 2019	Report FBC to Council and ZetTrans for decision on final set of contracts to be awarded	Executive Manager Transport Planning Transport Contracts and Operations Officer
15 February 2019	Award contracts with 6 month lead in time	Transport Contracts and Operations Officer