Annex A

Reserves; Calculation of Optimum Level

1 Background

1.1 There are two approaches for deciding the optimum level of Reserves. Either a percentage of expenditure, which at one stage was defined by the Audit Commission at 5% of net expenditure, or an approach based on a risk assessment of the budget.

1.2 This paper sets out the framework for a risk assessment approach. The issues the framework considers include the following:

- The Council will needs to act as if an ongoing authority.
- Considerable work and effort went into the formation of the 2007/08 budget, on which the 2008/09 budget is based.
- That there are only three material areas of growth as identified in the Corporate Plan, with the exception of correction and re-alignment of budgets as a result of the re-organisation there are no ‘officer’ driven growth areas
- There is always some degree of uncertainty over whether the full effects of any economy measures and/or service reductions will be achieved. Managers have been requested to be prudent in their assumptions and that those assumptions, particularly about demand led budgets, will hold true in changing circumstances.
- The Bellwin Scheme Emergency Financial Assistance to Local Authorities provides assistance in the event of an emergency. The local authority is able to claim assistance with the cost of dealing with an emergency over and above a threshold set by the Government (NWDC’s threshold for 2006-07 has been set at £27,481, 0.2% of budget). The assistance is usually 85% of any eligible costs over the threshold. Any incident for which assistance is sought must involve conditions, which are clearly exceptional by local standards and the damage to local authority infrastructure or communities must be exceptional in relation to normal experience. In the first instance these initial costs will have to be met from reserves.
- The risk of major litigation, both currently and in the future.
- Risk of changes from hypothecated grant to unhypothecated Formula Spending Share.
- The unpredictability of the Formula Grant in the latter two years, which await the Spending Review 2007 announcements.
- The risk of grants being introduced mid-year that require the Council to contribute.
- Unplanned volume increases in major demand led budgets, particularly in the context of high and accelerating growth.
- Potential short term differences between the Council’s Insurance Reserve and outstanding liabilities, although these should be remedied in the following fiscal year.
- The need to retain a general contingency to provide for any unforeseen circumstances, which may arise.
- The need to retain reserves for general day to day cash flow needs.

2 The Framework

2.1 The basis of the Framework is an area of risk, a budget amount, an assessed level of risk (high, medium, low), a percentage factor, which will vary according to the level of risk, which produces a value. The total of the value column, is the level balances required to cover the identified risk. The following example illustrates the text:

Salaries budget: £12.6m Risk: low Factor: 0.50% Value: £63.1k

2.2 In the 2007/08 Budget the Interim S151 Officer outlined ten key areas of risk as set out in the following table, with an explanation of what risk was being covered. This has now been updated to reflect the removal, mitigation or reduction of the risk

Table 1: Ten Areas of risk for NWDC

Note *The updated comments are below each of 2007/8 notes which have been shown but struck through for ease of reference.*

No	Area of risk	Explanation of risk
1	Inflation on expenditure	~~There are two issues. Firstly, there may be some items of expenditure – fuel costs for example - where any estimate of inflation is a 'best guess'. The risk assessment puts a figure to the higher level of inflation that would seem to be unreasonable to include in a budget, but might come to pass.~~ ~~Secondly, information is less accurate for years 2 and 3; the risk assessment covers the higher range.~~
		Inflation has remained controlled for 2007/08 and no call made on the General Fund reserve, the projected underspend in 2007/08 reflects that budget contained adequate inflation. So rolling budgets forward with a moderate inflation factor will be suffice
2	Interest rates on borrowing and investment	~~This is similar to 1 above, but for an specific area.~~
		NWDC has not pursued additional borrowing, the one loan will remain at a fixed rate over 2008/09. There is sufficient liquidity in the investment strategy to ensure no borrowing will be required other than to provide short term liquidity if required. Therefore there is no Interest Rate risk
3	Grants, RSG, LABGI, PDG, Housing Benefits	~~The Government planning system is often short-term and a 'best guess' has to be offered in lieu of hard facts. Currently there are 4 issues:~~ ~~RSG for 2008-10 will firm up when Spending Review 2007 is announced in the summer of 2007.~~ ~~LABGI will always be problematic given that announcements are made after the budget has been set.~~

No	Area of risk	Explanation of risk
		~~PDG is an example of a grant in transition (downward), but who's distribution is a mystery. Housing Benefits – whilst the administration grant is straightforward, the subsidy is subject to audit and, sometimes, abatement.~~
		There are no reductions in grants expected during 2008/09, other than those already known and planned for in the draft budget. LABGI and PDG are no longer applicable.
4	Infant (estimated) budgets, (Inc or Exp) • Job Evaluation • Reorganisation incl redundancies	~~There are some initiatives that are known will happen, but are not sufficiently advanced to accurately cost.~~
		There are no infant budgets for 2008/09, any risk areas such as Unitary or Concessionary fares will be adequately covered through specific Earmarked Reserves.
5	Volume changes - Demand led or volatile budgets (I or E) • S106 • Land sales • Collection Fund • Land Charges • Planning charges	~~Equally, there are long standing areas of risk, that have an exciting existence – we budget for the middle of the range, but might find the actuality is at the higher end.~~
		The areas that have proved volatile during 2007/08, are settling and their volatility expected to settle prior to the start of 2008/09. Allowance has been made in the draft budget for 2008/09 for movements in Income, both favourable and adverse.
6	Efficiency gains incl Gershon savings	~~The budget includes improvement programmes that will deliver savings; the risk is that they may be delivered at a slower rate.~~
		The efficiencies and savings sought for 2007/08 have in the main been achieved. Certain projects and initiatives will not now be commenced in 2008/09 as a result of their not being conducive to the moving to a single authority. As Invest To Save often requires greater investment in the first year than savings achieved, projects not proceeding actually reduce the cost burden in 2008/09, above the savings anticipated.
7	Insurance, funds and excesses	~~Acts of God can result in higher insurance traffic than had been anticipated.~~
		NWDC suffered an uninsured loss in 2007/08 resulting from service with a previous incarnation of the authority during the 1960's. The insurance fund will be

No	Area of risk	Explanation of risk
		refreshed directly and maintained as an Earmarked Reserve
8	Emergency planning – Bellwin, disaster recovery, snow days	~~Were a disaster to occur, we have to have a reserve in place to pick up costs that will fall to the Council.~~
		There is always a risk and a level sufficient to meet the Bellwin trigger needs to be maintained
9	Change (I or E) • Financial systems • Instalment date • NWLL • Parking charges • White Paper • Lyons report • Local Land Tax	~~Change necessarily means doing things in a way for which we have no evidence. Our assumptions may be wrong.~~ ~~Also, the areas of change will alter over the years.~~
		Whilst change will always occur, the changes underway within NWDC are very tightly controlled and specific budgets allocated. The main change ahead is the transition to Unitary, this will be covered through the creation of a specific Earmarked Reserve
10	Financial guarantees /legal exposure • PFI • WCC over NWLL	~~The contract for the Council's offices would contain obligations that if not fulfilled, would attract a penalty.~~
		These risks are known, mitigated and managed, the cessation of NWLL has had an impact and may have ongoing financial consequences as a result of liquidation proceedings etc, however they are now more quantifiable and being actively managed. The subsequent contract with DC Leisure contains an element of risk for NWDC, however this has been assessed and included in the core budget.
11	Unknown unknowns	~~A specific item for anything not covered above~~
		There are now few opportunities during 2008/09 for material unknown unknowns to arise.

2.3 Risks can change over time. The three year budget approach last year stated that it would identify these risks and the Reserves requirement for each year would be adjusted. What might be an adequate level of Reserves in Year One, might be excessive or inadequate for Years Two or Three. Reserves would ordinarily be looked at over a three year period, in this budget exercise the horizon has been adjusted to a two year period.

2.4 The issue of "unknown, unknowns" was raised at the January 18 2007 Budget & Strategy Working Party. This is a difficult concept - for example, hard to quantify - that has to some extent been covered by the inclusion within the calculation of £500k for "other Disaster Recovery" and throughout the calculation, preferring to shade the risk at the higher end for reasons of prudence. However a sum of £200k was proposed, to recognise the concept and, review at a later date when there is evidence of performance against the risks. The consequence of this review is that as a result of Unitary, few new initiatives can be commenced, considerable officer resource will be re-directed toward its achievement and therefore there will be little opportunity to commence new and unplanned initiatives during 2008/09

2.5 This approach has be extended to the capital programme, leading to a re-profiling of planned capital expenditure.

3 Outcomes

3.1 As a consequence, it is recommended that the minimum prudent level of general fund reserves is £2.4m for 2008-09 on the basis of reduced risk and greater fiscal control. The summary of the calculation is set out below. This is still a very prudent 12% of the net costs, against the central Government recommended minimum of 5%.

Risk calculation for the level of General Fund Reserves

		2006/07	2007/08	2008/09	**2008/09**	2009/10
		Actual	Forecast	MTFP Estimate	**Revised Estimate**	Revised Estimate
1	**Inflation**	348,372	362,306	376,799	**200,000**	200,000
2	**Interest Rates**	50,000	50,000	50,000	**0**	0
3	**Grants**	574,308	648,432	409,415	**200,000**	250,000
4	**Infant budgets**	0	297,500	155,000	**0**	0
5	**Demand led or volatile**	165,875	165,875	165,875	**150,000**	150,000
6	**Efficiency Gains incl Gershon**	231,211	240,459	250,078	**250,000**	250,000
7	**Insurance**	36,563	36,891	49,735	**100,000**	100,000
8	**Emergency Planning**	1,038,493	1,039,647	1,040,837	**1,100,000**	1,100,000
9	**Change**	111,800	414,500	589,500	**200,000**	100,000
10	**Financial guarantees/legal exposure**	12,500	32,500	32,500	**100,000**	100,000
11	**Unknown unknowns**		200,000	200,000	**100,000**	0
	Total	2,569,120	3,488,110	3,319,739	**2,400,000**	2,250,00
	Movement	260,555	918,990	(168,372)	**(1,088,110)**	(150,000)
	Balance March 2007 Actual	4,240,000				
	Balance March 2008 predicted at Dec 2007		4,990,000			
	Excess (projected) 1 Apr 2008	1,634,880	2,590,000			