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 need to budget for provision for the cost of any redundancies necessary to achieve any budget savings and restructuring to the extent they are not contained in the budget proposals. The Council's policy is that redundancy costs are contained in the budget proposals.
- There is always some degree of uncertainty over whether the full effects of any economy measures and/or service reductions will be achieved. Strategic 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 losing subsidy arising from outstanding Housing Benefit and Council Tax Benefit Subsidy claims
- 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 The ten areas of risk are set out in the following table, with an explanation of what risk is being covered.

Table 1: Ten Areas of risk for NWDC

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.
2	Interest rates on borrowing and investment	This is similar to 1 above, but for an specific area.
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. • 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.
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.
5	Volume changes -	Equally, there are long standing areas of risk, that

No	Area of risk	Explanation of risk
	Demand led or volatile budgets (I or E) • S106 • Land sales • Collection Fund • Land Charges • Planning charges	have an exciting existence – we budget for the middle of the range, but might find the actuality is at the higher end.
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.
7	Insurance, funds and excesses	Acts of God can result in higher insurance traffic than had been anticipated.
8	Emergency planning – Belwin, 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.
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.
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.

2.3 Risks can change over time. The three year budget approach will identify this, and produce a different Reserves requirement for each year. What might be an excessive level of Reserves in Year One, might be inadequate for Years Two or Three. Reserves have to be looked at over a three year period.

2.4 The issue of "unknown, unknowns" was raised at the January 18 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 is proposed, to recognise the concept and, review at a later date when there is evidence of performance against the risks.

2.5 This approach will be extended to the capital programme.

3 Outcomes

3.1 As a consequence, it is recommended that the minimum prudent level of general fund reserves is £3.5m for 2007-08 and, an optimal level of the same, over the medium term. The summary of the calculation is set out on the next page. The detailed calculation will be circulated separately.

Risk calculation for the level of Reserves

		2005/06 Actual	2006/07 Actual	2007/08 Estimate	2008/09 Estimate	2009/10 Estimate
1	**Inflation**	320,269	348,372	362,306	376,799	391,871
2	**Interest Rates**	50,000	50,000	50,000	50,000	50,000
3	**Grants**	476,834	574,308	648,432	409,415	266,232
4	**Infant budgets**	0	0	297,500	155,000	0
5	**Demand led or volatile**	165,875	165,875	165,875	165,875	165,875
6	**Efficiency Gains incl Gershon**	211,782	231,211	240,459	250,078	260,081
7	**Insurance**	36,250	36,563	36,891	49,735	62,597
8	**Emergency Planning**	1,035,054	1,038,493	1,039,647	1,040,837	1,042,062
9	**Change**	0	111,800	414,500	589,500	414,500
10	**Financial guarantees/legal exposure**	12,500	12,500	32,500	32,500	22,500
11	**Unknown unknowns**			200,000	200,000	200,000
	Total	2,308,565	2,569,120	3,488,110	3,319,739	2,875,717
	Movement		260,555	918,990	(168,372)	(444,021)
	Balance March 2007 (anticipates Exec Feb 8 decision on NWLL)			4,045,000		
	Excess			556,890		