Section 25 Report from Chief Financial Officer

Section 25 of the Local Government Act 2003 requires the Chief Financial Officer (the Director of Corporate Operations) to report to the County Council when setting its council tax on:

- the robustness of the estimates included in the budget, and
- the adequacy of the financial reserves in the budget.

The County Council is required to have regard to this report in approving the budget and council tax. It is appropriate for this report to go first to Cabinet and then be made available to the County Council in making its final decision.

Section 25 concentrates primarily on the risk, uncertainty and robustness of the budget for the next financial year rather than the greater uncertainties in future years. Given the significance of the medium term forecasts outlined in the budget report, this report considers not only the short term position but also the position beyond 2022/23 in the context of Government funding and the service pressures we face.

Robustness of Estimates in the Budget

The budget setting process within the County Council has been operating effectively for many years and is based on setting cash limits for departments each year allowing for pay and price inflation and other marginal base changes in levels of service whether these be the increasing cost of social care or the requirement to make savings to balance the budget.

Individual departments are then required to produce detailed estimates for services that come within the cash limits that have been set. More recently, the requirement to make savings has dominated the budget setting process and major transformation and savings programmes have been put in place to effectively and corporately manage the delivery of savings within the required timescales, or as is more recently the case, to provide cash flow funding to support a longer delivery timescale for the more complex elements of the programmes.

Appropriate provisions for pay and price inflation are assessed centrally with departmental input and are allocated to departmental cash limits. Specific inflationary pressures within the financial year are expected to be managed within a department's bottom line budget but general and specific contingencies are still held centrally in the event that inflationary pressures have a severe impact in any one area (for example, energy costs).

Separate work is also undertaken to assess the demand led areas of service provision, which mainly relate to:

- Adults' Social Care.
- Children's Social Care.
- Waste Disposal.

Any requirement to increase budgets in these areas is considered corporately and may require additional savings to be made across the board to meet the increased demand. This is seen as a more effective way of managing cost pressures and enables strategic decisions to be made about resource allocation and the impact on service provision, rather than these decisions potentially being made in isolation by each department.

Budget management within the County Council remains strong as demonstrated by the outturn position each year since funding reductions began and as reflected in the annual opinion of the External Auditors who have given an unqualified opinion on the annual accounts and in securing value for money / financial resilience.

The Council's financial strength was also evident in its response to the pandemic, enabling it to deal with the financial impact as a one off issue, albeit some of the post pandemic growth we are seeing across social care is not expected to decline at this stage.

There continues to be challenges with the delivery of overlapping savings programmes with around £47m still to be delivered as part of Tt2019 and Tt2021 on top of the £80m planned for SP2023. This is in part due to the impact of the pandemic but cashflow funding is already in place to support this.

Budget 2022/23

The budget for 2022/23 has been produced in line with the process outlined in the section above and therefore I am content that a robust, Council wide process has been properly followed and driven through our Finance Business Partners working with the Operational Finance Team. Further oversight is then provided by the Head of Finance and myself, in presenting the final budget and council tax setting report to Cabinet and County Council.

As part of the budget setting process for 2021/22 a further £80m was removed from detailed budgets and this is reflected in the departmental summaries contained in Appendix 3, albeit the delivery timescales extend beyond this date, supported by cashflow funding.

Despite additional funding being made available through the Spending Review and the provisional local government finance settlement, the County Council faces a range of increased financial pressures due to high inflation, energy costs and most notable the impact significant price increases within the adults' social care market, which have increased expected growth costs from £13.5m to £48.8m for next year alone.

This will necessitate a much larger draw from the Budget Bridging Reserve than originally anticipated and whilst this can be accommodated it does weaken the financial position going forward.

The robustness of the budget is underpinned by the detailed work that is carried out to predict financial pressures in demand led services and to reflect that properly in the budget underpinned by contingencies as well as by the existence of departmental cost of change reserves, which can be used to meet unforeseen costs during the year as well as providing funding for investment to achieve savings.

Risks in the Budget 2022/23

Since the period of austerity began from 2010, the biggest financial risks related purely to reductions in government funding, and social care demand and cost pressures. Since 2019/20 the County Council has not received any Revenue

Support Grant so the risks have shifted towards the extent to which increasing cost pressures outstrip available funding, particularly given the Government control over council tax rises. These items together with other traditional risks are outlined below:

a) **Government Funding and Policy** – The Comprehensive Spending Review announced last year did provide for some additional resources to the County Council, but these are flat at a national level until 2024/25 and only a single year local government finance settlement was announced.

   Whilst we therefore have certainty of funding for 2022/23 we are once again placed in the difficult position of having no visibility of future funding despite the mounting pressures we face across social care services in particular. More worrying is that resources that have been allocated for the next three years do not increase and do not therefore provide any increased year on year funding to mitigate the predicted growth that we have.

   Whilst the Government has promised some sort of Fair Funding Review to come in from 2023/24 this represents a further risk to the County Council and even if resources are directed to upper tier authorities, it is likely that damping arrangements will be put in place to limit large swings in funding. In any event the current total quantum of funding is simply not sufficient to address the pressures faced by the sector.

b) **Social Care Demand Pressures** – This is by far the biggest financial risk that the County Council faces. Following a long period of ‘stable’ growth in adults’ social services, the annual growth was increased by £3.5m to £13.5m just before the pandemic hit.

   Although activity was reduced during the pandemic, this is now returning at much higher levels than normal, but more worryingly we are seeing price increases in the residential and nursing sector by 16% to 18% and this is expected to flow through to additional full year costs of £35.3m in 2022/23 on top of the £13.5m already set aside, albeit some of this can be met from Covid funding provided for next year on a one off basis.

   The County Council cannot ignore this potential increase and must budget accordingly, which it has done and can then monitor actual costs against this position.

   Children’s social care continues to experience high levels of ‘front door’ activity post pandemic and this is increasing costs in a range of areas albeit it is not showing significant numbers of new looked after children. Costs for social workers and agency staff remain high and have been factored in for 2022/23 along with increased allowances for children looked after in line with previous forecasts. This is obviously a risk if the increased activity starts to flow through into additional looked after children, but there are central contingencies to mitigate this.

   I am therefore content that the budget for 2022/23 contains a realistic assessment of the likely growth we will face in the year, backed up by further contingency amounts and reserves if growth should be higher than forecast.

c) **Council Tax** – The Government has assumed that local authorities will increase council tax by the maximum permitted by the referendum thresholds and on this basis the recommended increase is 2.99%, of which 1% relates to adults' social care, in line with the thresholds included in the provisional local government finance settlement released in December last year.

   This has added to the gap for 2022/23 as our forecasts had assumed a 2% adults' social care precept. Whilst additional government funding helps to make up some of this loss for 2022/23, the County Council was already relying on additional Government funding as part of its SP2023 Programme and this does not therefore assist in the medium term, particularly as the loss of 1% will also impact in 2023/24 and 2024/25.

d) **Pay Inflation** – This ceases to be a major issue within the budget especially as wage rates within Council's have aligned to the National Living Wage over time. The 2021/22 pay award is yet to be agreed but has been allowed for at the current employers offer rate and provision of 2.5% has been made in 2022/23 and 2% beyond this date.

   It is worth re-iterating that a 1% change in pay equates to around £3m extra costs for the County Council, which is minimal compared to the forecasts for social care costs. Any deviations from the budgeted position will be managed in year and reflected in future forecasts.

e) **Pension Costs** - Following the 2019 Pension Fund valuation, Hampshire County Council's employer's contributions rates increased from 16.1% to 18.4%, which is reflected in the budget but has been fully funded from the eradication of the deficit contribution that we were previously paying.

   The next triennial valuation is due in 2022, but current indications are that there will be no upward pressure on rates for the majority of employers and any changes would not impact on the 2022/23 financial year in any event.

   The saving in the deficit contribution of £15m has been used to contribute additional funding to the Budget Bridging Reserve for three years but will be released to help balance the budget in future years given the pressures faced by the County Council.

f) **Price Inflation** – This is usually an area of low risk outside the potential increases within social care. However, there are significant inflation pressures at the present time that are expected to continue into next financial year.

   By far the biggest risk is the current spike in energy costs due to global issues with supply, which is seeing prices in the market increase by around 65% for 2022/23, which equates to nearly £7m additional costs for the County Council, which has been allowed for within central contingencies and will be distributed during the year based on actual costs.

   It is anticipated that this is a temporary spike and that future prices will stabilise at lower levels, so much of the impact will be felt mainly within 2022/23, but this remains an area for ongoing review to ensure that the right procurement decisions are made for future supplies.

g) **Treasury Risk** – The County Council has limited exposure to interest rate risk as most long term borrowing is undertaken on a fixed rate. At the present time we are not undertaking any new or replacement long term borrowing due to the significant ‘cost of carry’ involved and our ability to internally borrow given our high level of reserves and cash balances. However, we do need to be mindful of the fact that we do not want to store up a large value of external borrowing that needs to be taken out in less favourable circumstances as our reserves reduce. Given current predictions on base rate levels and the fact that long term borrowing rates are based on the price of gilts rather than the underlying base rate, this is still considered low risk at this stage.

On the investments side, the absolute value of estimated income for 2022/23 is around £13.5m per annum, which is minimal against the County Council’s overall budget, however, the change in investment strategy which moved part of the portfolio to medium term investments has increased the risk in the portfolio overall. This has been mitigated by the creation of an Investment Risk Reserve which will deal with any changes in valuations of investment and provide a buffer against any significant drop in returns. Contributions to this reserve were increased to match 2.5% of the higher yielding investment portfolio, which is considered sufficient mitigation at this stage.

The Adequacy of Reserves

The County Council’s policy on general balances is to hold a minimum prudent level which based on the previous risk assessment is around 2.5% of net expenditure. The projected level of general fund balances will be 2.6% of net expenditure at the beginning of 2022/23.

Overall the level of earmarked reserves and balances that the County Council holds stood at £754.8m (including schools and the Enterprise M3 LEP reserve) at the end of March 2021 and these reserves, the majority of which are held for specific purposes as set out in the Reserves Strategy in Appendix 5, underpin the overall MTFS and the Capital Programme.

Those reserves that are available to support the revenue position are used sensibly to manage change and provide the time and capacity to properly implement savings plans that seek to minimise the impact on service users. Cash flow funding to support the Transformation to 2019 and Transformation to 2021 Programmes has already been included in our financial plans along with funding to bridge the original £40m budget deficit in 2022/23, which is an ‘interim year’ in the savings cycle.

However, the increased pressures outlined in the report mean that there is an additional draw from the BBR in 2022/23, together with an increased deficit of £48m by 2023/24 over and above the £80m that had been predicted. The Medium Term Financial Strategy outlined in the main report makes provision to meet these additional draws from the BBR thereby stabilising the position to 2023/24 in order to give the time to draw up further plans for bridging the significant deficits from 2024/25 onwards.

Whilst the majority of reserves are allocated for a specific purpose, as outlined in the Reserves Strategy, this does still provide flexibility in being able to manage the finances of the County Council going forward, compared to some County Councils whose total reserves stand at less than the BBR which we currently hold. I am therefore satisfied that the level of reserves is adequate to support the agreed financial strategy over the next two financial years.

CIPFA Financial Resilience Index

Following the heightened national focus on the finances of local government due to a number of local authorities experiencing severe financial difficulties and requiring Government support, the Chartered Institute of Public Finance and Accountancy (CIPFA) produced a Financial Resilience Index (FRI) which uses a range of financial information and other factors to generate a series of measures against which all authorities are 'stress tested'.

The Index for 2020/21 has been issued to Chief Financial Officers for review but has not yet been formally published. Our low and high risk areas have not changed significantly, but there are some strange results due to the way in which certain indices are calculated. These are set out below with a commentary:

Lower Risk Areas:

- The County Council scored well on most indicators relating to reserves, in fact Hampshire has one of the highest level of reserves of any County Council.
- Interest payable as a proportion of net revenue expenditure is low compared to most authorities, possibly as a result of strong reserves position but also reflecting that we have not taken out borrowing to buy commercial property as others have done.
- The council tax requirement as a proportion of total funding was also positive meaning that a high proportion of resources was generated locally and was therefore low risk as a continued income source.
- Hampshire has an outstanding children's social care Ofsted judgement and an unqualified External Auditors value for money assessment.

Higher Risk Areas:

- The level of unallocated reserves was flagged as high risk, which reflects the commentary in the Reserves Strategy in Appendix 5 that the majority of our reserves are set aside for a specific purpose. We are fully aware of this fact and the MTFS provides for specific future funding that is essential to maintain our financial sustainability over the next two years.
- Both the change in earmarked reserves and the change in the overall level of reserves were flagged as very high risk for Hampshire. However, this is because the index is measured in purely percentage terms. Our level of reserves only went up by 12.5% over the last three years but that is on a value of reserves of over £600m. In relative terms, this therefore compares unfavourably to Northamptonshire whose reserves increased by 2,229%, but who only had a total of £3.2m in reserves on 1 April 2018. This highlights that the headline indices require careful treatment as the underlying information may present a much clearer picture.

I am content that the results of the FRI, reflect what we already know about the financial sustainability of the County Council and is supported by the fact that there are only three areas flagged as high risk, but two of these are not at all representative of the level of risk we actually face for the reason highlighted in the bullet point above.

CIPFA Financial Management Code

In addition to the FRI outlined above, CIPFA have also published, during 2019, a Financial Management Code, designed to aid local authorities in assessing and developing their financial management activities across all areas of governance and management.

Full compliance with the code is required from the current financial year and the County council has already taken steps to make a number of improvements and changes to ensure compliance.

There remains one standard where our practices are not in strict alignment with the exact wording of the code, which is :

The leadership team monitors the elements of its balance sheet which pose a significant risk to its financial sustainability.

The draft guidance quoted various specific areas covered by this Standard including:

- Capital investment and the maintenance of assets
- *Long and short term investments*
- *Debt collection*
- *Cash flow management*
- *Borrowing*
- Reserves

Whilst we do not present these items in the context of a balance sheet, all of them are covered through specific or general financial reporting to the Corporate Management Team (CMT), albeit that the items highlighted in italics are delegated to the Chief Financial Officer to deal with on a day to day basis. Having said that they do of course form part of the medium term financial planning carried out through CMT.

I therefore believe that the County Council is still compliant with this item.

Budget 2022/23 – Conclusion

Given the details outlined above, provided that the County Council considers the above factors and accepts the budget recommendations, including the level of earmarked reserves and balances, a positive opinion can be given under Section 25 on the robustness of the estimates and level of reserves for 2022/23.

The Position Beyond 2022/23

Although we have only received one year's worth of grant figures, the funding allocated to local government for the next three years was announced in the Comprehensive Spending Review and in effect is flat for the whole period.

If we therefore prudently assume that we receive the same level of funding in 2023/24 and 2024/25 as we will for 2022/23, that gives us a basis on which to predict the future budget position for the County Council.

The main budget report outlines that we will face a predicted cumulative deficit by 2025/26 of £157m after we have implemented £80m of savings by 2023/24 and after a 2.99% council tax increase each year. The plan is to stabilise the budget position through the use of reserves up to and including the 2023/24 financial year in order to give the time to consider options for balancing the budget in future years.

The County Council has consistently stated that unless something is done to address the annual growth in social care costs, that we are not financially sustainable in the medium term. Faced with the size of the deficit to 2025/26 together with the fact that we will have removed £640m from budgets by this time, it would appear that we are at the point where it is not possible to close the predicted deficit without decimating services over this period.

The size of the deficit in 2024/25 and the use of the BBR to bridge the next two financial years deficits also means that we will need to re-think our normal two year savings cycle in addressing the deficits.

Even if the County Council were able to balance the budget by 2025/26 if the underlying causes of the deficits are not addressed by the Government during this period, this would almost certainly mean we would not be financially sustainable beyond this date.

Rob Carr

Director of Corporate Operations

27 January 2022