East Lothian Council

REPORT TO:	East Lothian Council
MEETING DATE:	22 November 2022
BY:	Executive Director for Council Resources
SUBJECT:	Finance Update

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1 PURPOSE

1.1 To provide Council with an urgent update on the in-year financial position, which now presents a critical risk due to the escalating financial challenges facing the Council, and to set out a series of enhanced mitigation measures.

2 RECOMMENDATIONS

2.1 The Council is recommended to:

a. Note the deteriorating financial position facing the Council during this year, and the wider impact on future budgets.

b. Approve the increased cost control measures proposed by Council officers set out in paragraph 3.13; noting any changes to policies will need to be brought back to members for further consideration.

c. Note the update on the wider financial environment and current risks.

d. Agree that the Council Leader write to the UK Government and Scottish Government setting out the scale of financial challenges facing East Lothian and calling for an urgent review on how local government is funded.

e. Approve that Council officers continue to explore all practical options on wider flexibilities aligned to mitigating the recurring impact of the unfunded element of the national pay negotiations, and that further updates on proposed options and proposals be brought forward to a future Council meeting.

3 BACKGROUND

3.1 The Council has in place robust financial management arrangements to ensure services fully understand and deliver their service commitments within their allocated budgets, and robust monitoring arrangements to support this process remain in place. This is evidenced in findings summarised in the recent Audit reports presented to Audit & Governance Committee including the Internal Audit report on Budget Monitoring, and Audit Scotland Annual Audit report for 2021/22.

3.2 Since the commencement of this financial year, the external financial operating environment has remained very challenging, and there remains a growing range of financial risks and challenges, all of which are placing significant pressures on current resources. These wider pressures have already been set out in recent financial reviews presented to both Council and Cabinet, and a range of management mitigation measures aimed at controlling escalating costs is already in place, alongside enhanced scrutiny measures whereby Council, rather that Cabinet, receives in-year financial review reports until the wider financial position improves.

3.3 The most recent report presented to Council on 25 October 2022 set out the broad range of financial risks and challenges. Since that meeting, Finance Officers have concluded the detailed Quarter 2 financial review and details of this are set out in **Appendix 1** of this report. It is now clear that the scale of the financial risks and pressures has further escalated and has now reached an enhanced level. As such, there is an urgent need to consider further mitigation measures with more detail set out in the paragraphs below.

Scale of un-budgeted pressure

3.4 There has been a significant increase in the projected overspend facing the Council, with current forecasts now projecting an un-budgeted overspend in excess of £5 million in addition to a planned draw down of reserves of just under £13 million. If the scale of this materialises at the year-end, this overspend would be met from the Council's uncommitted reserve, which reported a balance of just over £6.9 million as at 31 March 2022. The requirement to hold a minimum level of reserves remains an essential part of the Council's financial strategy to ensure that Council has the ability to meet any unforeseen/unplanned commitments during any year. Given the wide range of financial risks, sitting alongside a very challenging external public sector funding outlook, the ability to respond to unplanned external factors remains even more critical than ever, and significantly exposes the Council to risk that it may not be able to support its financial obligations and commitments.

External Factors

3.5 Similar to most households and wider businesses, the Council is facing very significant external pressures, with most of the un-budgeted overspend caused by external factors that remain outwith the Council's direct control. These risks are varied and wide and include: very significant utility and energy pressures; rising inflationary and indexation costs with many contracts linked to inflation indices; significantly higher costs relating to interest rate rises and cost of borrowing; as well as a very significant unfunded burden relating to national pay negotiations.

3.6 These risks remain very significant and live, but since the previous Financial Update report, there is now a change in assumption around whether the full cost of the national pay award will be mitigated. The impact of this, alongside updated wider forecasts largely driven by increasing cumulative pressure from inflationary demand, are collectively placing further significant financial pressures for the Council to manage, and have forced the urgency and escalation of the financial situation now facing the Council. These areas are summarised in the section below.

National Pay Negotiations (Status)

3.7 National pay negotiations remain on-going for 2022/23 with only one of the four negotiations affecting local government staff now resolved and set out in the table below. Whilst noting a large proportion of the local government workforce will be covered by the agreed SJC pay offer, this remains subject to risk given all other negotiations remain on-going and the potential to re-open further negotiations should any group receive a higher offer than others.

Pay Group	**Status**
SJC (Non-Teaching Staff)	- National agreement now reached
Teachers Pay	- No national agreement reached with discussions on-going - Current notice for industrial action planned 24 November 2022
Craft	- National agreement now reached
Chief Officers	- No national agreement reached with discussions on-going

National Pay Negotiations (Funding)

3.8 Scottish Government has made some national funding available to support national pay awards in this year aligned to specific conditions, with details set out in the previous Financial Update report. Nevertheless, there remains a very significant un-funded pay gap of around 1.5% or circa £2 million, as highlighted further in **Appendix 1** of this report. This represents a recurring pressure which will increase the already significant budget gap for future years as well as contributing to the overspend in the current year.

3.9 The current offers have been made on the understanding that no further national funding is now available, and as such, COSLA would pursue discussions with Scottish Government on flexibilities to existing national funding streams where funding has been made available through the national settlement to support the delivery of new or existing policy initiatives. The Deputy First Minister has since written to COSLA on 1 November 2022, and did recognise that councils will be required to make some very difficult decisions locally in order to balance their budgets and meet the costs of the pay award offer. The letter reaffirmed that it is for councils to meet their obligations within the resource envelope available, taking into consideration the legal and shared priorities set out in National Performance Framework. In addition, the letter sets out that councils should engage with relevant Scottish Government directorates where flexibility is considered appropriate within ring-fenced funding areas.

3.10 Given the pay commitments arise from 1 April 2022, and most existing funding streams are already committed and remain aligned to delivering national policy commitments, in reality, it may be very difficult to realise any recurring benefit to meet these un-funded costs without any impact on national policy commitments. As such, the financial projections currently presented assume the full impact of this remains an un-funded burden. Officers remain committed to fully exploring all options available with a view to realising further opportunities within existing funding streams and an update on progress will be presented to future Council meetings.

Inflationary Pressures / Increased Demand

3.11 Previous reports have indicated that wider inflationary pressures are placing increased costs on the delivery of council commitments, and further details are set out in **Appendix 1**. Many of the council's contracts remain linked to inflation indices and the scale of these pressures alongside increased demand for services aligned to population growth and cost of living has now reached a significant level. Whilst services are doing all that they can to mitigate the impact, the pressures are largely driven by external challenges and the scale of these collectively means that the cost of delivering services cannot now be delivered within the funding made available.

Cost of Borrowing

3.12 Previous financial update reports have indicated that the on-going impact of current interest rate rises is now presenting a significant financial challenge for the council's wider budgets (General Services and HRA) and more details are set out in **Appendix 1**. The scale and impact on current and projected cost of borrowing, alongside wider construction and inflationary pressures is creating significant affordability challenges aligned to current capital budgets, and more widely placing a further challenge on limited revenue borrowing costs which is likely to have a significant impact on future financial strategies and plans.

Mitigation / Enhanced Cost Control Measures

3.13 The magnitude and range of the combined financial pressures facing the council is now at a level that we have not experienced in recent years, with no significant prospect that the external financial environment will improve in the foreseeable future, and many of these pressures likely to be recurring in nature. There now remains an urgent need to explore further mitigating actions with a view to containing the scale of current overspend caused largely by these external factors. As such, aligned to discussions with the wider Council Management Team, further additional and enhanced mitigation actions have been developed, in addition to those previously approved, and are set out below for urgent implementation and approval.

a. All Council Managers must do all that they can to ensure that they deliver their service commitments within their approved budget levels, including preserving existing underspends, and support cost recovery actions;

b. In addition to existing and targeted controls in place to review and control vacancies, introduce further vacancy controls to prioritise recruitment targeted at business critical risk areas linked to Business Continuity status, statutory functions, supporting trading activities delivering a surplus return or supporting the delivery of wider transformation projects.

c. Enhanced review of all council's reserves and carry forward commitments (including earmarked reserves), and considering any opportunities to apply flexibility to mitigate existing pressures, or redirect to support future commitments.

d. Explore all opportunities to apply 'flexibilities' within existing national funding streams where funding has been made available through the national settlement to support new/existing policy initiatives in line with recent letter from Deputy First Minister, in discussion with political group leaders.

e. Enhanced controls relating to carry forward funding requests, where these will only be permissible in very limited circumstances (e.g. aligned to national grant conditions).

f. Enhanced review of all capital projects including options for further value engineering possibilities, exploring opportunities to pause non committed spend projects with a view to reprofiling projects in the future aligned to market conditions and wider affordability.

g. Enhanced review of council operational assets, to optimise usage in cost terms including minimising energy and maintenance costs and where possible bring forward capital receipts to offset net borrowing requirements. This will also include options to temporarily mothball buildings.

h. Maintain the temperature in all public buildings at 18 degrees max where possible.

i. Introduce energy champions in all public buildings and explore the option of community champions.

3.14 Where mitigation options are likely to impact on the wider delivery of council policies and wider plans, these will remain subject to political consideration at the earliest opportunity, and an update on progress provided at the next Council meeting in December.

3.15 In addition to the above, officers are recommending the approval of further mitigation options relating to the suspension of policies, which automatically allow flexibility in carry forward funding requests, specifically this will include the current DSM policy. Any request for carry forward will only be considered in limited circumstances aligned to specific business need.

3.16 An update on the Corporate Risk Register will be presented to Council in December, where *Maintaining the Financial Environment* is currently assessed as the highest scoring risk that we have ever reported, and will now be the Council's key priority risk.

Financial Sustainability

3.17 The scale of the challenges faced by the council is now raised to a level that we have not experienced in recent years, and 'doing nothing' is not an option given the need to protect vital services and ensure on-going financial sustainability. The council has clear priorities aligned to protecting the most vulnerable in our communities and has a good record of accomplishment in supporting and delivering commitments and priorities within available resources. Nevertheless, the scale of the external pressures are now at a level that it seems inevitable that outwith significant additional national funding, the council will simply not be able to continue to meet all existing commitments within available resources.

3.18 In recent years, a significantly enhanced proportion of the council's national settlement remains aligned to the delivery of wider policy commitments, and as such, in reality there remains limited options available to redirect funding streams without an impact on the specific policy delivery.

3.19 Furthermore, alongside these very difficult external pressures which are facing all public authorities, businesses and individuals, East Lothian remains one of the fastest growing authorities in Scotland, with population growth continuing to increase year on year. The on-going costs and demands associated with meeting this growth alongside these wider challenges remains hugely significant, and a more holistic approach to supporting and sustaining both revenue and wider infrastructure funding is now urgently needed.

3.20 Current forecasts suggest further pressures will remain on national public funding, and the impact of this may become clearer in the weeks and months ahead with the Chancellor expected to make a budget statement on 17 November 2022, and the Scottish Government expected to publish draft budget plans for the year ahead on 15 December 2022. If no additional funding is made available to support local services and communities, an urgent and honest conversation is now needed as to how local government and East Lothian Council is currently funded, and what policy commitments can be prioritised. This is vital to ensure the wider on-going financial sustainability of local services.

3.21 Given this escalating position, it is recommended that the Council Leader write to both the UK Government and Scottish Government setting out the scale of financial challenges facing East Lothian and calling for an urgent review on how local government is funded. In addition, officers will continue to support national discussions aligned to escalating the risks, and levers in order to support future financial sustainability.

Conclusion

3.22 Inevitably, the scale of challenge has now reached at a level we have not experienced in recent years. The proposed measures set out in 3.12 remain essential to actively mitigate where possible within the context of current wider pressures, but this alone will not ensure on-going financial sustainability. Going forward this will require a more fundamental review of the council's financial strategy and priorities alongside wider review of local government funding and distribution of resources to ensure we can continue to operate on a sustainable financial platform.

4 POLICY IMPLICATIONS

4.1 There are no direct policy implications associated with this report, although, ongoing monitoring and reporting of the Councils financial performance is a key part of the approved Financial Strategy.

5 INTEGRATED IMPACT ASSESSMENT

5.1 The subject of this report has been considered and given there is no change in policy direction, there is no requirement to undertake any further impact assessment.

6 RESOURCE IMPLICATIONS

6.1 Financial – as described above and in the supporting appendices.

6.2 Personnel – none.

6.3 Other – none.

7 BACKGROUND PAPERS

7.1 Council – 1 March 2022 – Item 1 – Budget Development including setting of Council Tax and Council Rent for 2022/23

7.2 Council – 1 March 2022 – Item 2 – Budget Proposals on General Service – Amendment Submitted by the Labour Administration

7.3 Cabinet – 13 September 2022 (Meeting delayed until 27 September 2022) – Item 1 – Quarter 1 Financial Review 2022/23

7.4 Council – 25 October 2022 – Item 4 – Finance Update

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Appendix 1
East Lothian Council
Finance Update – Period 6

Introduction

The period 3 finance update noted a number of emerging budget pressures across the council. This included a continuing overspend in Children's Services, unprecedented pressure in utilities, inflation of over 9% which was impacting annual price rises in multiple contracts and uncertainty over pay. From a capital point of view the report noted significant increase in tender price costs, material costs and labour availability. The report went to Cabinet where it was agreed that a supplementary report be taken to Council at Period 5 with all subsequent quarterly reports to be taken to Council until the financial position improves.

General Services

At Period 6, before applying planned reserves there is a forecast overspend for the year of £18 million. The planned use of reserve is £12.895 million, made up of:

- Planned use of General Reserves - £8.690 million
- Cost Reduction Fund - £829,000
- Resilience & Recovery Fund - £1.696 million
- Other Planned Reserves - £1.680 million (includes Employability, Business Recovery & Rapid Rehousing Transition Plans)

This leaves an unplanned forecast overspend of just over £5 million. The main reasons for this are:

- Unfunded pay pressure - £1.882 million
- Utilities pressure - £1.218 million
- Children's overspend - £919,000
- H&SC Non IJB overspend - £313,000
- IJB overspend - £332,000 (mainly unfunded pay element, and the current assumption is this will be met from IJB reserve)

Please note, the position above is the full year forecast, the Period 6 overspend is showing £2.6 million and reflects the unplanned overspend.

General Services Capital

There is a continuing risk of delays in delivery of individual projects and achieving the planned budget spend. There are also costs risks around tender prices and contractor claims on projects in construction. Where project costs increase there is a risk that projects funded from external resources may have a funding shortfall which will increase the borrowing requirement.

The forecast spend for the year is £91 million against a budget of £111 million with £38 million spent to date. The borrowing requirement is £54 million against a budget of £68 million.

HRA – Revenue & Capital

At this stage HRA revenue is forecast to be around about breakeven at year end, there has been a slight improvement in rental income projections due to some earlier than anticipated new build completions. Voids remain high and work is ongoing to remedy. Rent arrears at September was £1.2m (£1.3 million the year before), at this stage the Bad Debt Provision is assessed as being adequate.

Capital spend at period 6 was just over £10 million with over £40 million forecast at year-end. New Build Council Houses is expected to overspend due to Newcraighall Phase 2 starting earlier than planned. This also means that grant income will be higher than budget with £11.3 million now expected. The modernisation programme has seen a small amount of slippage and is expected to underspend.

Impact of 2023/24 to 2027/28 Budget Strategy

Pay
The Finance team is currently updating the budget model to reflect the agreed pay rise for non-teaching staff (excluding senior officers and craft). Despite assurances that the pay award was being fully funded at this stage there will likely be a budget gap of over £2 million which will need to be added to current budget scenario planning. In addition, Teachers pay negotiations are still to be settled and anything over 5% is not funded. Each 1% for Teachers is around £700,000.

Utilities
There is now more clarity on the contract for utilities in the latter part of 2023/24. This will add a further £1.1 million to the pressure which will need to be added to the current budget scenario planning. Whilst this year the bigger pressure has been gas, the 2023/24 pressure is being driven by electricity. It is also worth noting that the prices paid by the council remain below the price energy gap introduced by the UK Government. At this stage further significant increases in 2024/25 cannot be ruled out.

Inflation
Inflation is back over 10% with forecasts suggesting that the end of the electricity price freeze in April 2023 will have an inflationary impact of 5%. This is impacting contract renewals and annual price rises on contracts linked to inflation. Waste have recently highlighted contract increases that are unavoidable. In addition, Transport have been able to extend home to school contracts for 12 months limiting price rises to inflation, however intelligence is showing some routes in other councils increasing by 125% and therefore there are risks going forward as to what that will mean for East Lothian.

Interest Rates
Interest rates have been rising in recent months with the most recent increase the single largest increase this century. This is having a significant impact on our borrowing with projections showing a £2.5 million increase in debt charges next year for HRA (equal to an 8% rent rise). This is putting a strain on the council's ability to meet the £1 million surplus and 40% debt to income ratio in the HRA revenue budget per the approved Financial Strategy.

From a General Service perspective, the impact is also significant and aligned to the scale set out for HRA above. The wider borrowing impact on General Services has in in part been mitigated in recent years due to the application of the previously agreed Loans Fund Review, with current interest rate challenges now likely to remove significant opportunity to explore future benefit and overall is likely to further place pressure on the affordability of available resources to fund the capital programme.

Capital Plans

The affordability of capital projects is now in doubt. Increased borrowing costs impact revenue but contract and material price rises and availability of labour is having a significant impact. In addition the revenue consequences of these projects is becoming more unaffordable without a change in the funding mechanism from COSLA.