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Adrian Waite (Independent Consultancy Services) Limited

8th January 2019

Ms. Rose Rouse,
Chief Executive,
Eden District Council,
Town Hall,
Penrith,
Cumbria.
CA11 7QF.

Sent by e-mail to: chief.exec@eden.gov.uk

Dear Ms. Rouse,

Budget Consultation

I write in response to your budget consultation in my capacity as a resident of the Eden District and as Managing Director of 'AWICS Limited' a management consultancy company that is based in the district.

My observations on your budget and financial management are as follows:

Revenue Reserves

I have always been surprised at the high level of general fund reserves that are maintained by the Council. I obviously understand that it is prudent to maintain an adequate level of reserves but there is a difference between an adequate and prudent level and an excessive level. The annual accounts show that reserves were £8.2million at 31st March 2016, £8.6million at 31st March 2017 and £8.3million at 31st March 2018. This represents 21 months of Council Tax revenue. In effect, every penny of Council Tax that residents have paid from July 2016 to March 2018 remained unspent in the bank at March 2018!

The Council is budgeting to reduce reserves to £7.6million by 31st March 2020. However, the Council is more likely to see a further increase in reserves due to 'over budgeting' (see below).

The usual reason for a Council to hold reserves is to guard against unforeseen overspending. However, I would hope that the Council's budget monitoring processes would be sufficiently good to avoid an overspend of up to £7.6million on a £8.5million budget! Another reason would be to ensure that the Council has sufficient cash, but cash balances appear to be more than sufficient at £4.6million backed by other current assets of £9.7million (see below).

PO Box 17, Appleby in Westmorland, Cumbria. CA16 6YL. Telephone: 017683-51498. Mobile: 07502-142658.
E-Mail: Adrian.waite@awics.co.uk. Website: www.awics.co.uk
Managing Director: Adrian Waite MA CPFA CIHM FInstLM.
Registered Address: c/o Butterworths Solicitors, 3 Walker Terrace, Gateshead, Tyne & Wear. NE8 1EB.
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Furthermore, the Council also held a further £3.8million in useable earmarked reserves at 31st March 2016 that increased to £5.8million at 31st March 2017 and £5.7million at 31st March 2018. Total reserves increased from £12.0miilion in March 2016 to £14.4million in March 2017 and were £14.0million in March 2018 (representing more than three years' Council Tax revenue).

The earmarked reserves include:

- Affordable Housing Fund - £1.7million in 2016, £1.8million in 2017, £2.0million in 2018.
- Renewals Fund - £0.9million in 2016, £1.1million in 2017, £0.9million in 2018.
- Community Housing Fund – nil in 2016, £0.9million in 2017, £0.9million in 2018.
- BRRS Reserve – nil in 2016, £0.8million in 2017, £0.8million in 2018.
- Homelessness Reserve - £0.5million in 2016, £0.4million in 2017, £0.1million in 2018.
- Capital Funding Reserve - £0.4million in 2016, £0.4million in 2017, £0.4million in 2018.
- Other Reserves - £0.3million in 2016, £0.4million in 2017, £0.6million in 2018.

The amounts set aside in these reserves are more often increasing than being spent. It also appears to me that these reserves may be general reserves rather than sums set aside to meet specific liabilities.

It appears to me that the Council may have a policy of managing risk by having large reserves. Accumulating reserves on this scale by failing to use the resources that are available to the Council may be a sign of poor financial management rather than a sign of good financial management.

The view was expressed in the budget reports for 2015/16 and 2017/18 that reserves should be maintained at between £1.5million and £2.0million – equivalent to about a quarter of the annual spend. In the 2018/19 budget papers there is a reference to 'a normal minimum of £1.5million'. I would suggest that the Council budget to reduce its reserves to that level.

The 2019/20 budget and the medium-term financial plan for 2018 to 2022 both show the Council reducing the level of its balances to £2.2million in 2022 and then as low as £0.7million in 2023. This level would appear to be too low. However, in view of the Council's history of over-budgeting and under-spending I am not sure how much confidence can be placed in these projections.

It appears to me that an opportunity exists to bring forward capital or non-recurring schemes to improve the infrastructure of the district and / or to 'invest to save' that may be being missed in the draft budget as it is currently constructed.

<u>Over-Budgeting</u>

The proposed budget for 2019/20 and budgets for all recent years have included provision of £150,000 a year for 'over-budgeting'. This is explained as follows:

"There is a tendency for a degree of underspend. This is a function of having a large number of budgets, some of which are not always fully used."

If I understand what is meant by 'over-budgeting' correctly I find this rather disturbing. My understanding of the situation is that, because some of the Council's budgets are excessive, they are likely to be underspent (accountants sometimes call this 'budget slack') and so the Council has decided to count on an underspending of £150,000 occurring each year.

In 2015/16 the Council underspent on its budget by £1.5million on a net expenditure of £7.5million – a 20% under-spend. In 2016/17 the Council underspent on its budget again, this time by £2.2million on a net expenditure of £8.8million – a 25% under-spend. In 2017/18 the Council also underspent its budget but only by £0.4million – a 5% under-spend. It is generally considered to be evidence of good financial management if there is an under-spend of less than 2%.

As Eden District Council usually reports a significant under-spend on its revenue budget, this leads me to suspect that the Council may be over-cautious in the preparation of its estimates with the result that its budgets contain significant 'budget slack'. The budget report for 2017/18 seemed to admit that this was the case and states (for example) that:

"Based on previous years, there is a tendency for a degree of underspend. This is a function of having a large number of budgets, some of which are not always fully used due to circumstances. Such a provision has been included in the last few years. The proposed level of £150,000 was used for 2015-2016."

This does not appear to me to represent good practice. There are two reasons for this: Firstly, if managers have budgets that are excessive there is little incentive for them to exercise effective budgetary control; and secondly, if the estimated 'underspend' does not materialise the Council will 'overspend'. Most accountants would say that it would be good practice to identify the excessive budgets and reduce them to a reasonable level rather than indulging in 'over budgeting'. I wonder if this approach to budgeting is linked with the apparent policy of managing risk by having high levels of reserves!

The Chartered Institute of Public Finance & Accountancy, in its workbook for students of Management accounting considers 'budget slack' as a problem and defines it as follows:

"Carrying forward past inefficiencies to future periods within the budget is one reason for the existence of budgetary slack. Budgetary slack refers to areas of the budget where the value of the budget is more than is really required for delivery of the budget."

I am led to speculate whether the Council may have been unprepared for the relatively low level of under-spend in 2017/18. One of the reasons why this occurred is that expenditure increased by £0.9million (12%) between 2016/17 and 2017/18 especially in the Resources and Housing & Health Directorates as shown below. Expenditure in the Resources Directorate was significantly higher than in the original or revised estimates. It would be interesting to ascertain why some of these increases in expenditure occurred!

	2016/17 £,000	2017/18 £,000	Variation £,000	Variation %
Commercial Services	642	750	108	+16.8%
Communities	1,055	930	125 -	- 11.8%
Eden Development	688	334	354 -	- 51.5%
Housing & Health	125	639	514	+411%
Leader	122	116	6 -	- 4.9%
Resources	2,614	3,223	609	+23.3%
Services	2,310	2,491	181	+ 7.8%
Total	7,556	8,483	927	+12.3%

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I note that the Council is forecasting an under-spend in 2018/19 based on budget monitoring for the first half of the year.

I would suggest that the Council consider changing its approach to budgeting. There appears to be a significant disconnect between the figures in the budgets and the figures in the accounts. I would recommend establishing firmer budgets based either on past performance or on a zero-based approach.

Council Tax

In view of the need for the Council to maintain important services in the district I am surprised that the Council is proposing to freeze Council Tax in 2018/19. Inflation is currently running at just over 2% and in the local government finance settlement for 2019/20, announced in December 2018, government announced for the second year that local authorities could increase Council Tax by up to 3% without having to hold a local referendum (in the case of Eden District Council this could be even more because of the 5% flexibility).

The government currently controls the level of Council Tax that councils can charge by limiting annual increases rather than by setting any sort of cap. This means that a decision not to increase Council Tax in one year depresses the capacity of the Council to raise Council Tax permanently. For this reason, it is often considered unwise for Councils not to increase Council Tax by the maximum permitted by government.

I would therefore suggest that the Council should increase Council Tax by at least 3% in 2018/19; but only if the Council can demonstrate that it has a robust plan to spend these resources in a way that would benefit the people of the district.

Capital Programme and Prudential Borrowing

The summary capital programme shows the Council's investment in the district declining from £3.2million in 2018/19 and £4.5million in 2019/20 to £1.8million in 2020/21, £1.1million in 2021/22 and £0.7million in 2022/23. Included within this are mandatory renovation grants of £751,000 in 2018/19 and £440,000 a year in subsequent years that (apart from £300,000 in 2018/19) are funded by the Better Care Fund and not by the Council.

The Council has identified its corporate priorities as:

- Decent Homes for All
- Strong Economy, Rich Environment
- Thriving Communities
- Quality Council.

This year's capital programme is more supportive of these objectives than programmes that have been agreed in previous years and this is to be welcomed. The programme is supported by a combination of prudential borrowing (£4.5million), capital reserves (£2.7million), grants (£2.6million), capital receipts (£1.2million) and other sources (£0.2million).

The major schemes are for single site accommodation (£2.3million scheduled for 2019/20) and funding for Heart of Cumbria (£3.2million). The Council appears to be relying almost totally on Heart of Cumbria to deliver its strategic objectives especially around housing and economic development (see below).

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As the capital programme is expected to 'tail off', I would suggest that the Council should consider what options exist for sustaining a larger capital programme into the future. When I was Finance Director at Copeland Council, we resourced a capital programme that peaked at £19.6million a year.

The Council's balance sheet shows total assets of £62.0million and reserves of £48.8million as at March 2018. This compares with £57.2million and £42.5million respectively as at March 2017. This is a considerable sum and I am not convinced that the Council is making best use of its resources and assets to invest for the benefit the community. For example:

- £10.6million is held as cash and short-term investments. This is £1.9million more than at the end of the previous year and is a significant amount. Is this a good use of resources?
- £22.5million is held as investment property and long-term investments – an increase of £0.7million on the previous year. Is this a good use of resources? This may also represent a risk (see below).
- Only £23.5million is held in Property, Plant, Equipment and Heritage Assets. Should the Council be investing more in infrastructure for the benefit of the community rather than in cash investments?

If the Council was a housing association, it would be required to 'sweat its assets'. Perhaps the Council should act more like a housing association and use its considerable assets to improve the infrastructure of the district including for housing and economic development.

In 2015/16 the Council's revised capital programme was £1,593,000 while actual expenditure was only £778,000 (only 49% of budget). This was due to significant 'slippage' in budgets including housing renovation grants and the affordable housing innovation fund both of which have been identified as being of strategic importance.

In 2016/17 the Council's revised capital programme was £1,150,000 while actual expenditure was only £717,000 (only 62% of budget). This 'slippage' occurred in budgets again including the affordable housing innovation fund.

In 2017/18 the Council's revised capital programme was £4,585,000 while actual expenditure was only £2,401,000 (only 52% of budget). This 'slippage' occurred in budgets including housing and health and the Leader's programme.

In 2018/19 the Council's capital programme is for £6.9million but at the end of the second quarter of the year only £1.2million had been spent. Excluding support for Heart of Cumbria, only £0.2million had been spent out of a capital programme of £5.3million.

I would like to refer to two of the Council's capital schemes; one large scheme of strategic importance and one scheme that would appear to be relatively small and straightforward.

First, the single site accommodation scheme. It has been the intention of the Council to centralise its office staff at a single site for at least five years. It has been said that this is the Council's main corporate priority. Much money and officer time has been spent on the scheme and a further £2.3million is earmarked in the capital programme. However, the staff are still based where they were originally and there is doubt that the scheme will ever be completed. The Council's resources plan notes (in what may be considered an under-statement) that:

"The main risks in this project are project overspend and overrun."

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Second, the railings between the churchyard and riverside path in Appleby. In December 2015 there was a flood that knocked down a 75metre stretch of railings. It has taken the Council three years to appoint a contractor. It has been reported that the cost of the scheme will exceed £100,000 – about £1,300 a metre. It is not clear where the original railings have gone.

Both these examples, and the significant 'slippage' in the capital programme in all recent years, suggest that there is potential for the Council to improve its project management in terms of both effectiveness and value for money.

There may therefore be a need to consider how the Council can improve its project management arrangements.

<u>Risk Management</u>

Any budget or financial plan represents merely one possible financial outcome for the year or financial period under consideration – even though it is the outcome that is considered most likely and for which plans are made. However, the budget and financial plan are underpinned by data and assumptions and there is a risk that in practice events may differ from those that have been assumed. The Council's budget papers identify several uncertainties that affect the budget. There is therefore a need to identify key variables and to subject them to rigorous sensitivity analysis and 'stress testing'.

'Stress testing' involves considering what combination of risks would 'break' the budget or financial plan if they were to occur and considering how to manage the possibility of such a combination of risks occurring.

The Council has identified significant risks including:

- Whether Eden's share of the Council Tax bill is increased or not.
- The level of income from the retained business rates scheme.
- A new system of funding councils.
- Inflation
- Office Accommodation
- Recycling Credits
- Planning fee income
- Pension contributions
- Significant capital schemes are susceptible to slippage and overspend
- If schemes are not undertaken, grants provided by third parties may be recovered
- There is a risk that anticipated capital receipts may not arise as forecast
- There is a risk that the Council may lose its current level and previously unused funding for Disabled Facilities Grants.
- Digital Innovation
- Heart of Cumbria
- Britain leaving the European Union

There is increasing concern nationally about how local authorities are investing in property, seeking a financial return and the risks to which they are exposed especially if there is a downturn in property values. Don Peebles, Head of Policy at the Chartered Institute of Public Finance & Accountancy told the Local Government Chronicle that:

"There are public services… which are dependent on how well rental income in the property market is doing. This is a risk that local authorities have never been exposed to before and you have to ask whether they are equipped to handle that risk."

Of the Council's total long-term assets of £47.7million, £17.2million is held in investment property so this represents a significant exposure.

I would suggest that 'stress testing' be carried out around these risks.

<u>Economic Development</u>

I think that the Council has correctly identified economic development as a major priority. While the district enjoys low levels of unemployment, much of the employment that is available is part-time, seasonal, low wage and / or insecure. There is a need to build an environment in which more secure high-value businesses will develop. The Council's chosen vehicle for this is Heart of Cumbria (see below).

<u>Housing</u>

I think that the Council has correctly identified affordable housing as a major priority.

The Council's proposals to support housing are to be welcomed, especially the:

- Commitment to provide loans to a Registered Social Landlord through the Affordable Housing Innovation Fund (although I understand that of the £1million that was budgeted for 2017/18 only £650,000 was spent).
- Proposal to establish a £6million fund for new affordable homes, to support community-led housing projects and housing provided through the Heart of Cumbria Limited. This could be financed by existing Council resources, as the investment will provide higher income returns than is currently available through banks. Income generated will be used to support housing services (see below).

I would suggest that the Council should support this priority with significant budgets for new affordable housing, disabled facilities grants and discretionary housing payments.

<u>Heart of Cumbria</u>

The creation of the 'Heart of Cumbia' as a commercial arms-length vehicle that is designed to use the Council's resources to achieve the Council's objectives is to be welcomed. I also note that the Council's capital programme for 2017/18 includes provision for a loan of £1million to the Heart of Cumbria that I understand has already been made to the company.

My understanding is that a £1million loan was approved by full Council in January 2017 on the basis that £500,000 would be available to fund affordable homes and £500,000 would be available to fund commercial investments and that the Council would expect a return on its investment of 3%. It was also agreed that the Council would not expect to receive a return if the company failed to make a profit.

However, the evidence from reports in the media is that there appears to be some confusion regarding the purpose and priorities of ‘Heart of Cumbria’. As shareholder, the Council has instructed the directors to:

- Provide affordable housing
- Seek economic growth and higher paid jobs
- Seek a 3% return on any Council investment

I understand it has also been agreed that ‘Heart of Cumbria’ should consider:

- Buying and managing housing for people in need, for people who are key workers and market housing
- Buying and managing commercial and / or residential property generating an income above the threshold of 3%
- Development schemes involving non-Council owned land
- Development schemes involving the Council land
- Renewable energy schemes

I understand that it has been agreed that the work to be undertaken by ‘Heart of Cumbria’ will include:

- Purchase and management of affordable and key worker housing
- Purchase and management of commercial and residential property investment
- Advice and consultancy from initial feasibility, guidance on planning applications and regulations, legal guidance to a full project management of the total build
- Representation and securing planning permissions
- Total site/project management from tendering through build to final ‘sign off’, this service will also ensure appropriate contracting, on-going liaison and project management according to the agreed build schedule

One of the aims of the Council’s Company, Heart of Cumbria Limited, is to provide the Council with increased revenue income. In February 2018, the Council approved a business case for the Company to purchase and let 86 affordable dwellings. The financial projections included in the business case showed interest income realised of £50,000 and increasing from 2019/20. It must be noted realisation of this income is dependent on the draw-down of loan funding by the Company.

However, there is a potential conflict between these objectives. For example, if resources are allocated to economic development they cannot be allocated to housing; while investment in market housing is likely to achieve a higher rate of return than investment in social housing. It is not clear to me what conditions the Council has attached to the loan that it has provided to ‘Heart of Cumbria’ that will govern how the company should invest the money.

The overall targets of ‘Heart of Cumbria’ appear to me to be rather vague. They are to achieve:

- Additional income from cash investments for the Council of up to £200,000 a year within five years as a minimum assuming the Council’s financial support is forthcoming.
- To facilitate additional new higher paid jobs and employment development.
- To own at least 50 affordable dwellings.

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The ‘Heart of Cumbria’ business plan states that the company intends to:

“Invest in affordable dwellings and also to work with the Council through use of Section 106 monies or other funds with the Council and developers to own the dwellings which would then be managed and rented out by it.”

My understanding is that ‘Heart of Cumbria’ would have to register with the Homes & Communities Agency as a registered provider if it wished to own and manage social housing. However, I am not aware that the Council has considered the implications of this for ‘Heart of Cumbria’ (for example a registered provider must be a not-for-profit company) or for the Council.

I would have thought that the Council would have prepared a business case for the establishment of ‘Heart of Cumbria’ before establishing the company and certainly before providing the company with any public funds. This would have identified the objectives that the Council is trying to achieve and demonstrated that creating ‘Heart of Cumbria’ would not only be able to achieve those objectives but would be the best way to achieve those objectives. However, I have not been able to identify the existence of such a report.

It appears to me that the arrangements with ‘Heart of Cumbria’ probably present financial risks to the Council, but it is not clear to me from the budget papers whether these risks have been assessed and how they have been accounted for in the risk strategy (for example the risk that ‘Heart of Cumbria’ may not achieve a rate of return of 3% on its investments) or the finances (for example in the provision for doubtful debts - what is the probability that the loans to ‘Heart of Cumbria’ will not be repaid?).

Since January 2017, Heart of Cumbria has received a significant amount of public money as equity and loans. However, there appears to be a lack of transparency, a lack of accountability, a lack of clarity about objectives and a lack of performance monitoring. Despite the significant investment, very little appears to have been achieved in the two years since Heart of Cumbria first received funding.

I would suggest that the Council should consider introducing greater clarity and transparency regarding the role of ‘Heart of Cumbria’ and its financial arrangements; and should consider any implications for the Council’s approach to risk management.

<u>Fair Funding Review</u>

The Council has received favourable local government finance settlements in recent years, but it is important that the Council engages fully with the Fair Funding Review (that the government is conducting of local government finance in England) when appropriate.

<u>Conclusion</u>

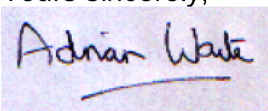
I think that the Council is being insufficiently ambitious in this budget and that there may be an opportunity to improve financial management. I would suggest that the Council consider:

- A more significant capital programme to address especially the economic development and housing objectives that it has identified, funded through surplus reserves, prudential borrowing and more effective asset management.
- Providing greater clarity and transparency about the objectives and activities of ‘Heart of Cumbria’.
- Improvements to the project management of the capital programme.

- Approving revenue budgets that do not contain 'budget slack', that aim to reduce reserves to an appropriate level and that focus resources on direct services.
- Adopting a more robust approach to risk management and stress testing.
- Increasing Council Tax by 3% in 2019/20.

I hope that you find these observations useful. If you have any questions about any of the issues that I have raised I would be pleased to hear from you.

Yours sincerely,



Adrian Waite
Managing Director

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