Appendix 5

Assessment of the Authority's financial risk and the levels of reserves and balances needed (2011/12)

1 Introduction

1.1 The Local Government Act 2003 requires that the Treasurer should assess the financial risks faced by the Authority and make recommendations to mitigate the risks appropriate levels of resources involved.

1.2 In considering financial risks, a distinction must be made between:

- A ***provision***, which is made for known liabilities. For example, the Authority currently has a provision for uninsured losses.

- A ***reserve***, which is set up to protect against the possibility of future costs that not yet liable and/or capable of being quantified. Reserves can include, a 'general balance' – which not earmarked for a specific purpose; or an 'earmarked reserve' set up for specific purpose (e.g. a reserve to meet future capital payments).

2 Assessing the level of general balance required

2.1 This involves assessing the risk – both the impact and likelihood – of the Authority having to deal with significant unplanned increases in expenditure. To help determine the overall level of reserve needed, some adjustment is made for:

- the unlikely event that all identified risks will occur in the same year;

- the potential to use savings and/or transfers from underspent budgets (the Authority has a good recent record in achieving these); and

- the potential use of capital funding.

3 Pensions fluctuations

3.1 The financial framework for pensions was established on 1 April 2006. This transferred the main financial risk associated with pensions expenditure from fire and rescue authorities to the Government. But there are still some risks that authorities face. One is the cost of dealing with any ill-health retirements and, based on the Authority's past experience a sum of £50,000 is considered sufficient.

3.2 At some point there will be an increase in the employers' pension contribution rates for firefighters. It is recommended that a sum equivalent to approximately 1% (part year effect) is included in

the calculation – this is £300,000 bringing the total provision for pension related issues to £350,000.

4 Inflation risk: pay

4.1 The Government's announcement of a two-year public sector pay freeze gives some confidence in setting the base budget for pay for 2011/12 & 2012/13. However, there is always the possibility that we might experience a pay v prices inflationary spiral following the freeze. This could have a significant impact on budgets in 2013/14 and 2014/15 (for which the draft budget assumes only a 1% increase to pay budgets in each year). It would be prudent to anticipate the potential for this risk and increase this element of reserves by 0.5% for 2011/12, i.e. an increase of £200,000.

5 Uninsured risks

5.1 Although the Authority has comprehensive insurance covers in place, there are always some associated risks. For example, the Authority incurred significant costs in 1997-2001 because it had to obtain retrospective cover when its primary insurer went into liquidation. There are also some uninsured risks: e.g. for employment practice claims and the potential that we might need to deal with any emerging health and safety issues. This is one of the harder areas to assess, but there is no reason to increase the current figure of £600,000.

6 Extremes of weather

6.1 Unusually hot dry summers, wet winters and storms can all lead to additional operational costs. These are primarily associated with increased activity by retained firefighters and vehicle running expenses including fuel. The current provision of £250,000 would seem appropriate and no change is proposed to this figure.

7 Other inflation

7.1 There is some risk attached to non-pay inflation. In particular, energy and fuel costs are expected to increase and this has been anticipated in the draft budget. But if the increases are significantly higher than anticipated it would be sensible to continue to allow for an additional 5% increase - about £40,000.

8 Capital programme issues

8.1 The Authority has a significant capital programme in place. The details of the capital settlement for fire and rescue authorities has not yet been announced. It seems likely that supported borrowing will no longer be available. Instead, funding will be through capital grant and prudential borrowing. This causes problems for planning and funding the capital programme - especially given uncertainty over timing and value of capital receipts.

8.2 The recent increase of 1% on Public Works Loan Board (PWLB) borrowing rates, and the expectation that interest rates will start to increase given current inflation levels, compound the risks in making capital funding decisions. It is appropriate, therefore, to continue to take the capital programme into account when considering the level of general balance to hold. It is difficult to rationalise a formula-based approach to this, but a sum of £1,100,000 would appear reasonable. This is an increase of £500,000 on the 2010/11 assumption.

9 Uncertainties in 2011/12 and beyond

9.1 The change of Government has resulted in some new uncertainties. Of note are: the cancellation of the Regional Control Centre project, changes to the Firelink arrangements, and changes to revenue and specific capital funding. Of particular concern is uncertainty about the basis of the new formula-based grant (from 2013/14). This makes medium-term financial planning extremely difficult – particularly for the last two years of the four-year grant settlement period. Previously we have made assumptions for such uncertainties of: £800,000 in 2007/08, £400,000 in 2008/09 and £200,000 in 2009/10 - with £250,000 now built into the base budget. For 2010/11 it was agreed that reserves should allow for the potential of a formula grant reduction of 3% and thus a sum of £600,000 was allowed for giving an overall giving a total figure for uncertainty of £800,000. In addition, a grant reduction reserve was established to help ease pressures anticipated through Government grant reductions in future years. The balance on this reserve is expected to be £607,000 at the end of the current financial year. Although the formula grant hasn't reduced to the extent expected for 2011/12, the potential for up to 25% reductions in 2013/14 and 2014/15 would justify the retention of this level of reserve for uncertainty.

10 Conclusion: level of reserves

10.1 Bringing all these factors together leads to a 'maximum exposure' of £3,340,000 as set out in Table 1. However, as mentioned above, other funding sources may be available, and it is not likely that all these potential risks will occur in the same year. Experience bears this out. The Authority's outturn position has very rarely resulted in an overspend. In recent years there have underspends have been achieved. There are two other mitigating factors:

- The extent to which earmarked reserves could be diverted, at least on a temporary basis, to deal with changes in funding priorities or levels of perceived risk during the year. These earmarked reserves are expected to total about £3.5m (before any of the additions proposed within this report are made) at the end of 2010/11.

- The inclusion of a £250,000 contingency in the base budget

from 2010/11 to cover the risks of possible, but as yet hard to assess, pressures on the revenue budget.

10.2 In theory it would be reasonable to discount the level of reserves required by up to 50% on the basis of these mitigating factors and the improbability of simultaneous reoccurrence. However, given the level of uncertainty on future funding, it is considered sensible to take a more cautious position. So, a reduction of only 25% is proposed. This would suggest general reserve of £2.5m would be appropriate. This will be kept under review.

10.3 This puts reserves at approximately 3.7% of the Authority's annual spend. While this may be an interesting comparative indicator, it should not be regarded a determinant of good practice when setting reserves. It does not take account of how much risk is being carried in the base revenue budget. The Authority's budget is built on a realistic basis with a prudent provision for future inflation.

Table 1: Summary of Factors

Factor	**Assessed impact 2010/11 £000**	**Assessed impact 2011/12 £000**
Pensions: payments	250	350
Inflation: pay	100	200
Uninsured risks	600	600
Extremes of weather	250	250
Inflation: other	40	40
Capital factors	600	1,100
Future years' uncertainties	800	800
	2,640	**3,340**
x 75%	1,980	2,505
Rounded £100,000	**2,000**	**2,500**

10.4 It is therefore proposed the budget for 2011/12 should be built on the basis of providing for a £2.5m level of general balance.