



Item: 5

Policy and Resources Committee: 25 February 2025

Strategic Reserve Fund – Budget Review and Long-Term Forecast

Report by Head of Finance

1. Overview

- 1.1. The purpose of the Strategic Reserve Fund is to support projects which provide benefit to the Orkney community as a whole such as the development of industrial estates, harbour infrastructure and recreational projects, while supporting economic development activity in general across the Council area. The Strategic Reserve Fund is also required to support the long-term objective of managing the implications associated with declining oil related revenues on the economy of the islands and to contribute to the decommissioning costs of the Flotta terminal at the end of its life.
- 1.2. The Strategic Reserve Fund has been applied to supplement General Fund services on a restricted basis as part of a strategy, whereby the Council has pressed Scottish Government for equality of treatment in the finance settlement across the Island unitary authorities. More recently, this approach has been extended to support the delivery of income generation and efficiency saving plans.
- 1.3. The current income focused strategy for the Strategic Reserve Fund managed fund investments was adopted on the basis that it offered the prospect of more predictable returns for the Strategic Reserve Fund along with a lower risk profile achieved through improved diversification.
- 1.4. The ongoing reliance on the Strategic Reserve Fund as a means of balancing the General Fund budget as part of a long-term financial strategy, is not best practice, particularly given the levels of volatility that continue to impact on investment returns.
- 1.5. On 27 February 2024, when considering the level of disbursements from the Strategic Reserve Fund used to support General Fund Services and other Council priorities for financial year 2024/25 onwards, the Policy and Resources Committee recommended a contribution of £20,000,000 from the Strategic Reserve Fund to the General Fund for financial year 2024/2,5 with indicative contributions for

2025/26 and 2026/27 of £18,000,000 and £15,000,000 respectively. These values were incorporated into the Investment Strategy review carried out by Hymans Roberston.

- 1.6. In addition, the change in the recording of passenger harbour dues, from Miscellaneous Piers to the County Fund, has diverted approximately £2,000,000 of resources to support corporate objectives.
- 1.7. It was also recommended that the Strategic Reserve Fund allocation to General Fund services be notionally allocated to preventative services, and that a very prudent approach be taken when considering requests for future disbursements from the Strategic Reserve Fund, with the Strategic Reserve Fund being considered as a last resort funding source by Services.
- 1.8. Allowing for distributions of £22,606,000 during financial year 2024/25, the value of the Strategic Reserve Fund is estimated to increase by £6,989,000 to a forecast value of £215,276,000 as at 31 March 2025.
- 1.9. The existing distribution commitments of £52,876,000 for financial years 2025/26 to 2027/28, including the sum of £44,000,000 to support General Fund Services over the same period, are reflected in the 3-year budget and the 10-year forecast, attached as Appendices 1 and 2 respectively to this report. Orkney Community Wind Farm projects are not included.

2. Recommendations

- 2.1. It is recommended that members of the Committee:
 - i. Agree that a financial contribution to General Fund Services of £20,000,000 from the Strategic Reserve Fund be used as a planning assumption as part of the Council's budget setting process for financial year 2025/26.
 - ii. Agree that the Strategic Reserve Fund budget for financial year 2025/26, together with indicative budgets for 2026/27 and 2027/28, attached as Appendix 1 to this report, be approved.
 - iii. Agree that the long-term 10-year budget forecast for the Strategic Reserve Fund, attached as Appendix 2 to this report, be endorsed as a financial planning document.
 - iv. Delegate powers to the Head of Finance, in consultation with the Chief Executive and Corporate Directors, to make any adjustments to the Strategic Reserve Fund contribution to the General Fund, taking account of the 2024/25 year-end position and ongoing budget pressures for 2025/26.

3. Background

- 3.1. Historically the Strategic Reserve Fund had been applied largely for Economic Development purposes with expenditure charged directly to the Strategic Reserve Fund. The direct charging of expenditure to the Strategic Reserve Fund was not particularly transparent.
- 3.2. With pressure on General Fund budgets, there was a change in practice from 2002/03 with a direct contribution from the Strategic Reserve Fund to specific General Fund service areas, together with consolidation of budgets and spending. This contribution from Reserves enabled the Council to move from a budget overspend position to an underspend.
- 3.3. This practice persisted for a few years until a change in accounting requirements led to the Strategic Reserve Fund contribution being applied as a source of funds for the overall budget rather than directly attributed to a specific budget area.
- 3.4. The Strategic Reserve Fund contribution to General Fund services has more recently been “notionally” attached to specific areas of General Fund expenditure in order that the Orkney public can see more readily the benefit of the Strategic Reserve Fund and the additionality of service provision that it allows the Council to deliver.
- 3.5. The following table summarises the use of the reserve fund over the past 5 years:

	2020/21 (Actual)	2021/22 (Actual)	2022/23 (Actual)	2023/24 (Actual)	2024/25 (Prob)
	£'000s	£'000s	£'000s	£'000s	£'000s
General Fund Contributions	6,317	7,470	8,263	6,350	20,000
CDF					333
COVID-19	3,000				
Cost of Living			492	22	
Capital Contributions	320				
Strategic Projects	731	72	305	808	1,260
Island Games	2	6	100	133	747
North Isles Landscape Partnership		38	84	157	
Islands Deal					266
Total	10,370	7,586	9,244	7,470	22,606

- 3.6. The draw on Strategic Reserve Fund balances now far exceeds the cost of the specific budget areas historically identified for “notional” allocations. In effect,

the Council is now protecting some General Fund statutory services not fully funded through the Scottish Government settlement. However, the “notional” budget allocation, totalling £18,000,000 for 2025/26, should continue to support discretionary service areas that fit with the theme of benefiting the quality of life and cultural heritage of Orkney. These functions are considered ‘preventative services’ which are central to encouraging social inclusion, participation and improving health and wellbeing.

- 3.7. The £2,000,000 contribution from the County Fund – passenger harbour dues – will be used to help meet the cost of maintaining General Fund services which support Orkney’s tourism sector.

4. Budget Review

- 4.1. The Strategic Reserve Fund managed funds have performed in line with expectations in financial year 2024/25 and are expected to return a surplus of £13,519,000 on the year, which is £377,000 ahead of the budgeted surplus of £13,142,000. When time value of money is factored in, the overall reported position for the Fund in real terms is that of an anticipated deficit of £15,139,000, which is £11,318,000 better than the overall budgeted position for financial year 2024/25.
- 4.2. The main factors contributing towards the probable outturn position at 31 March 2025, and as set out in the budget statement, attached as Appendix 1 to this report, are as follows:
- Investment activities – timing differences around budget setting and changes in income recognition lines, i.e. the Harbour Dues passenger fees and Scapa Flow Oil Port activities have increased income forecasts by approximately £3,000,000.
 - Projected distributions have fallen by approximately £8,000,000 against budget, due mainly to removal of a previous capital commitment.
 - Consumer Price Index (CPI) Inflation was estimated to reach 3.6% by 31 March 2024, but the actual figure was 3.2% or £449,000 lower than the budget assumption.
- 4.3. The value of the Strategic Reserve Fund usable reserves has been estimated at £215,276,000 as at 31 March 2025.

5. Forecast

- 5.1. The Investment Strategy Review carried out by Hymans Robertson, considered by the Investments Sub-committee on 18 September 2024, provided assurance that the current income focused investment strategy remained appropriate for the Strategic Reserve Fund managed fund investments. The modelling showed that the expected nominal return on investments is 7.7%, which is much higher than the previous projected return in 2021 (5.2%) and is driven by the risk-free rate of return on risk-free assets such as government bonds if held to maturity. However, it is noted that the volatility on the returns has also increased to +/-10% (2021 +/- 7.7%) in any one year.
- 5.2. The Review reflected the indicative future drawdowns of £18,000,000, £15,000,000 and £11,000,000 in financial years 2025/26, 2026/27 and 2027/28 respectively required from the Strategic Reserve Fund to support General Fund services.
- 5.3. The modelling also looked at the length of time required for the Fund to return to its starting position of £240.4 million as at 30 June 2024 (post the £20 million contribution required for 2024/25), dependent on how much is drawdown to support the revenue budgets over the coming years and the rates of return on the investments. The results of this analysis varied considerably but in the worst-case scenarios the value of the Fund never fully recovers and continues to decline.
- 5.4. The conclusions provided by Hymans Robertson were:
 - Assuming the SRF reverted to a lower level of distribution (from the elevated short term funding plans) the current strategy would be expected to generate sufficient returns to rebuild and grow the value of the Fund. However, these are simple deterministic projections that assume a fixed level of return over time.
 - If distributions were kept at higher levels of around £10 million per annum. longer term then it will take the Fund longer to get back on target and any meaningful reduction in the expected levels of return would impact on the sustainability of the Fund value.
 - Simple stress tests carried out show that any short-term negative returns can have a significant impact on outcomes and therefore while the focus of the analysis was primarily on returns, also need to be mindful of the volatility of returns and the potential for them to impact on outcomes and the ability to meet desired cash funding plans.

- 5.5. The Review recommended that the current expected return of 7.7% per annum can support the current short term spending plans and longer-term distributions of £6.35 million per annum.
- 5.6. The market may perform better or worse than forecast, and while less extreme market volatility is being experienced currently, uncertainty remains within the global political and economic outlook and therefore instability can be anticipated from investment returns over the short to medium term.
- 5.7. The forecast cashflow requirements, as detailed in Appendix 1 to this report, indicates a requirement to draw down £44,000,000 over the 3-year period 2025 to 2028 to support General Fund services. In simple terms, this level of disbursement of funds over the three-year period translates into a loss of income generating capacity within the Fund of approximately £3,388,000 per annum, based on a long-term investment target return of 7.7%.
- 5.8. In addition to the General Fund contribution there are several other commitments on the Strategic Reserve Fund that are also expected to be drawn down over the next three years, including the following contributions totalling £8,876,000:
- £6,000,000 from the County Fund – passenger harbour dues – to support Orkney’s tourism industry.
 - £392,000 towards the Island Games 2025.
 - £1,351,000 towards Strategic Projects.
 - £466,000 towards Islands Growth Deal projects.
 - £667,000 towards Community Development Fund projects.
- 5.9. This list of commitments/disbursements only reflect current decisions and exclude any potential additional requests. The Strategic Reserve Fund is likely to be considered as a funding source for other decisions, further reducing the balance of useable reserves.
- 5.10. In assessing the sustainability of the Strategic Reserve Fund, it is considered good practice to review the impact of the current financial arrangements over the longer term. Appendix 2 to this report provides a 10-year projection or forecast for the Fund.
- 5.11. In assessing any financial projection or forecast over the longer term, it is helpful to remember that the information is only ever as good as the underlying assumptions behind the figures. Also, the longer-term financial forecast should be considered in the context that much uncertainty remains within both the UK and global economies over the short term such that the level of underlying risk of error

is likely to increase significantly as the timeline of any forecast is extended out beyond the short-term.

5.12. The long-term forecast is based on the following assumptions using both local experience, government forecasts and investment advisor modelling:

- Investment income – managed funds – 7.7%.
- SRF contribution to General Fund Services reverting to £6.35m from 2028/29, plus the Harbour Dues passenger fees estimated at £2 million.
- Investment income – local investments – 0.0% to 5.5%.
- Inflation – Consumer Price Index – 2.0%.

5.13. The success or failure of the Strategic Reserve Fund, in terms of financial performance, comes from investment activities, primarily through externally managed fund investments but also to a lesser extent through local investments. In order to balance the investment returns and the associated risks, the strategies for local investments and externally managed fund investments are reviewed regularly. For example, the recent review in September 2024 agreed an increase in high quality investment Corporate Bonds as liquid assets and a potential income source to meet the cash flow needs of the Council. More liquid investments are likely to have a lower return.

5.14. In terms of local investments, a potential significant local investment is the Orkney Community Wind projects. These are anticipated to start generating revenues in 2028/29, provided governance is obtained to progress the projects. The three projects themselves having different risk/return profiles, and subject to individual decisions based on their unique business cases.

5.15. At present the implications of the Orkney Community Wind projects are excluded from this review and forecast.

For Further Information please contact:

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Implications of Report

1. Financial

Detailed throughout the report.

2. Legal

Section 69 (3)(e) of the Orkney County Council Act 1974 permits the Council to apply any reserves established thereunder for any purpose which in the opinion of the Council is solely in the interests of the County or its inhabitants.

3. **Corporate Governance** – None.
4. **Human Resources** - None
5. **Equalities** – N/A
6. **Island Communities Impact** – N/A
7. **Links to Council Plan:** The proposals in this report support and contribute to improved outcomes for communities as outlined in the following Council Plan strategic priorities:
 - Growing our economy.
 - Strengthening our Communities.
 - Developing our Infrastructure.
 - Transforming our Council.
8. **Links to Local Outcomes Improvement Plan:** The proposals in this report support and contribute to improved outcomes for communities as outlined in the following Local Outcomes Improvement Plan priorities:
 - Cost of Living.
 - Sustainable Development.
 - Local Equality.
9. **Environmental and Climate Risk** – N/A
10. **Risk**

The risk for future budget efficiency exercises of not notionally attaching the Strategic Reserve Fund contribution to specific General Fund service areas is that those areas which are likely to be non-statutory or discretionary areas of spend are likely to be the natural choice of proposed efficiencies as the Council continues to face significant budget constraints.
11. **Procurement** – N/A
12. **Health and Safety** – N/A
13. **Property and Assets** – N/A
14. **Information Technology** – N/A
15. **Cost of Living** – N/A

List of Background Papers

Policy and Resources Committee, 27 February 2024, Strategic Reserve Fund Budget Review and Forecast

Appendices

Appendix 1: Strategic Reserve Fund – Draft 3 Year Budget for financial years 2025/26, 2026/27 and 2027/28.

Appendix 2: Strategic Reserve Fund – 10 Year Long Term Budget Forecast.

SRF Draft 3 year budget - 2025/28	2024/25 Budget Estimate £000's	2024/25 Budget Outturn £000's	2025/26 Budget Estimate £000's	2026/27 Budget Estimate £000's	2027/28 Budget Estimate £000's
Investment Activities - local investments	(162)	(400)	(350)	(300)	(300)
- managed funds	(13,142)	(13,519)	(19,480)	(18,024)	(18,230)
- loans fund	789	832	686	520	493
- other, including strategic projects	1,591	1,279	953	932	885
Property Investments	(841)	(934)	(934)	(934)	(934)
Renewable Energy	(276)	0	(138)	(138)	(138)
Scapa Flow Oil Port	0	(700)	(200)	(200)	(200)
County Fund	0	(2,400)	(2,400)	(2,400)	(2,400)
Loan Charges - interest and debt management	(46)	(52)	(52)	(52)	(52)
Loan Charges - CFCR	119	268	119	119	119
Other	10	9	9	9	9
Net budget surplus	(11,958)	(15,617)	(21,787)	(20,468)	(20,748)
	3.6%	3.2%	2.3%	2.0%	1.9%
less allocation to protect value of fund @ CPI	7,999	7,550	4,709	4,137	3,884
Balance available for disbursement	(3,959)	(8,067)	(17,078)	(16,331)	(16,864)
Disbursements:					
General Fund Services	20,000	20,000	18,000	15,000	11,000
County Fund - passenger harbour dues	0	0	2,000	2,000	2,000
Community Development Fund (CDF)	333	333	333	334	0
Contribution to capital projects - General Fund	8,070	0	0	0	0
Contribution to the Island Games	747	747	392	0	0
North Isles Landscape Partnership Scheme	0	0	0	0	0
Islands Deal	266	266	266	100	100
Contribution to other projects, incl. revenue strategic projects	1,000	1,260	1,000	351	0
	30,416	22,606	21,991	17,785	13,100
Deficit/(Surplus) on SRF (in real terms)	26,457	14,539	4,913	1,454	(3,764)
Deficit/(Surplus) on SRF (actual)	18,458	6,989	204	(2,683)	(7,648)
Cashflow - Opening Balance	(17,530)	(18,485)	(15,964)	(17,331)	(16,425)
Surplus/(Deficit) on year	(18,458)	(6,989)	(204)	2,683	7,648
Less: Non-cash - Managed Funds Income	(13,142)	(13,519)	(19,480)	(18,024)	(18,230)
Fund Transfers - Inflow/(Outflow)	31,600	20,508	19,684	15,341	10,582
Other Movements	1,566	1,328	(1,367)	906	859
Cashflow - Closing Balance	(15,964)	(17,157)	(17,331)	(16,425)	(15,566)
	2024/25 Budget Estimate £000's	2024/5 Budget Outturn £000's	2025/26 Budget Estimate £000's	2026/27 Budget Estimate £000's	2027/28 Budget Estimate £000's
SRF Balance Sheet					
Investment Properties	19,346	22,241	19,465	19,584	19,703
Local Investments	8,862	9,784	8,822	8,782	8,742
Managed Funds Investments	234,277	252,990	234,073	236,756	244,404
OIC Loans Fund Deposit/(Advance)	(15,964)	(17,157)	(17,331)	(16,425)	(15,566)
Provisions	(43,625)	(41,256)	(42,209)	(43,066)	(43,876)
Net Accruals	966	2,613	966	966	966
Net Assets	203,862	229,215	203,786	206,597	214,373
Less: Unusable Reserves	9,755	13,939	9,883	10,011	10,139
	194,107	215,276	193,903	196,586	204,234
Represented by: Useable Reserves					
Strategic Reserve Fund	175,699	197,719	172,786	175,150	182,489
Flotta Terminal Decline Fund	6,359	5,754	8,930	9,111	9,282
Conservation Fund	198	208	198	198	198
Travel Fund	107	112	107	107	107
Talented Performers Fund	63	65	63	63	63
Orkney Memorial Fund	434	449	434	434	434
Talented Young Persons Fund	9	7	9	9	9
Renewable Energy Fund	10,073	9,797	10,211	10,349	10,487
Capital Receipts Reserve	1,165	1,165	1,165	1,165	1,165
	194,107	215,276	193,903	196,586	204,234
Target Minimum Balance or "Floor" for SRF	263,439	262,422	269,524	274,995	280,165
Useable Headroom	(69,332)	(47,146)	(75,621)	(78,409)	(75,931)
	-35.7%	-21.9%	-39.0%	-39.9%	-37.2%

	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32	2032/33	2033/34
	Budget	Budget	Budget	Budget	Budget	Budget	Budget	Budget	Budget	Budget
	Estimate	Estimate	Estimate	Estimate	Estimate	Estimate	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's	£000's	£000's	£000's	£000's	£000's
SRF Balance Sheet										
Investment Properties	19,465	19,584	19,703	19,822	19,941	20,060	20,179	20,298	20,298	20,417
Local Investments	8,822	8,782	8,742	8,102	7,462	7,462	7,462	7,462	7,462	7,462
Managed Funds Investments	234,073	236,756	244,404	255,487	267,456	280,381	294,324	309,363	309,343	325,663
OIC Loans Fund Deposit/(Advance)	(17,331)	(16,425)	(15,566)	(14,048)	(12,513)	(11,600)	(10,669)	(9,719)	(9,719)	(8,750)
Provisions	(42,209)	(43,066)	(43,876)	(44,754)	(45,649)	(46,562)	(47,493)	(48,443)	(48,443)	(49,412)
Net Accruals	966	966	966	966	966	966	966	966	966	966
Net Assets	203,786	206,597	214,373	225,575	237,663	250,707	264,769	279,927	279,907	296,346
Less: Unusable Reserves	9,883	10,011	10,139	10,258	10,377	10,496	10,615	10,734	10,734	10,853
	193,903	196,586	204,234	215,317	227,286	240,211	254,154	269,193	269,173	285,493
Represented by: Useable Reserves										
Strategic Reserve Fund	172,786	175,150	182,489	193,246	204,882	217,467	231,064	245,749	245,729	261,689
Flotta Terminal Decline Fund	8,930	9,111	9,282	9,468	9,657	9,850	10,047	10,248	10,248	10,453
Conservation Fund	198	198	198	198	198	198	198	198	198	198
Travel Fund	107	107	107	107	107	107	107	107	107	107
Talented Performers Fund	63	63	63	63	63	63	63	63	63	63
Orkney Memorial Fund	434	434	434	434	434	434	434	434	434	434
Talented Young Persons Fund	9	9	9	9	9	9	9	9	9	9
Renewable Energy Fund	10,211	10,349	10,487	10,628	10,771	10,918	11,067	11,220	11,220	11,375
Capital Receipts Reserve	1,165	1,165	1,165	1,165	1,165	1,165	1,165	1,165	1,165	1,165
	193,903	196,586	204,234	215,317	227,286	240,211	254,154	269,193	269,173	285,493
Target Minimum Balance or "Floor" for SRF	269,524	274,995	280,165	285,768	291,483	297,313	303,259	309,324	309,324	315,510
Useable Headroom	(75,621)	(78,409)	(75,931)	(70,451)	(64,197)	(57,102)	(49,105)	(40,131)	(40,151)	(30,017)
	-39.0%	-35.7%	-37.2%	-32.7%	-28.2%	-23.8%	-19.3%	-14.9%	-14.9%	-10.5%