

## **Item: 6**

**Policy and Resources Committee: 12 February 2019.**

**Strategic Reserve Fund – Review.**

**Report by Head of Finance.**

### **1. Purpose of Report**

To review the level of disbursements from the Strategic Reserve Fund used to support General Fund Services and other Council priorities for financial year 2019 to 2020 onwards.

### **2. Recommendations**

The Committee is invited to note:

#### **2.1.**

That the Strategic Reserve Fund's investment activities are predicted to underperform the approved budget for financial year 2018 to 2019, as indicated in the probable outturn column of Annex 1 to this report.

#### **2.2.**

That, after allowing for distributions of £5,110,000 during financial year 2018 to 2019, the value of the Strategic Reserve Fund is estimated to decrease by £1,505,000 to £230,412,000 as at 31 March 2019.

#### **2.3.**

That, overall, the value of the Strategic Reserve Fund still compares favourably with the minimum balance or "Floor", calculated at £202,166,000 as at 1 April 2018.

#### **2.4.**

That, by applying inflation based on the Retail Prices Index, the real value of the Floor is estimated as £208,231,000 as at 1 April 2019.

#### **2.5.**

That, based on existing distribution commitments of £10,301,000, £13,181,000 and £8,350,000 for financial years 2019 to 2020, 2020 to 2021 and 2021 to 2022 respectively, the available headroom within the Strategic Reserve Fund relative to the minimum balance or "Floor" is estimated to decline from £19,805,000 to £11,514,000, or from approximately 9% to 5% of usable reserves, over the next three years.

## **2.6.**

That much uncertainty remains within the global economy and therefore considerable volatility can still be anticipated from investment returns over the short to medium term.

## **2.7.**

That a prudent approach is recommended when giving consideration to requests for additional disbursements from the Strategic Reserve Fund over the next three financial years.

**It is recommended:**

## **2.8.**

That the contribution from the Strategic Reserve Fund to the General Fund for financial year 2019 to 2020 be increased by £1,366,000, from £4,684,000 to £6,050,000.

## **2.9.**

That a minimum balance or “Floor”, below which the value of the Strategic Reserve Fund should not fall, be set at £208,231,000 as at 1 April 2019.

## **2.10.**

That the draft Strategic Reserve Fund budget for financial year 2019 to 2020, attached as Annex 1 to this report, be approved.

# **3. Background**

## **3.1.**

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.

## **3.2.**

The Strategic Reserve Fund has been applied to supplement General Fund services on a restricted basis as part of an agreed strategy, whereby the Council has pressed Scottish Government for equality of treatment in the finance settlement across the Island unitary authorities. When the Council set the budget for financial year 2018 to 2019, it was agreed that £4,684,000 of income from the Strategic Reserve Fund be used as a funding source to supplement the General Fund revenue budget.

### **3.3.**

Over-reliance on the Strategic Reserve Fund as a means of balancing the General Fund budget as part of a long term financial strategy would not be considered best practice, particularly given the levels of volatility that continue to impact adversely on investment returns.

### **3.4.**

A strategy review for the Strategic Reserve Fund was completed in February 2016 and presented to the Investments Sub-committee on 15 March 2016. The review concluded that, due to higher levels of volatility and risk which existed in the financial markets, there was a greater probability of an adverse outcome being realised by the Strategic Reserve Fund in terms of investment performance. It was recommended that the Strategic Reserve Fund reliance on equities as a growth asset could be reduced through a process of diversification, as a means of lowering volatility and risk.

### **3.5.**

Revisions to the investment strategy included introducing an allocation to Multi-Asset Credit by reducing exposure to UK equities which would generate an expected return of 5.6% per annum to the Strategic Reserve Fund for a predicted risk volatility of +/- 7.7%.

### **3.6.**

It was further advised that, in order to maintain a real fund value around current levels, regular distributions of only £4,000,000 per annum would be sustainable over the long term from the managed funds investment returns. A higher level of distributions would require to be supported by other income generating activities. By contrast distributions at around £5,000,000 per annum would require the Strategic Reserve Fund to generate investment returns in the region of 6% per annum which was not recommended due to the increased risks that such an approach would bring.

### **3.7.**

A further review of the investment strategy is currently being progressed in consultation with Hymans Robertson, the Council's investment advisers.

### **3.8.**

This review is considering the plans for future distributions, how these will be financed and how this can have an impact on the attitude to the level of investment risk and return and, therefore, the investment objectives of the Strategic Reserve Fund.

### **3.9.**

A number of strategies have been identified depending on whether the objective or focus of the Strategic Reserve Fund managed fund investments is to achieve growth or income generation going forward.

### **3.10.**

The Head of Finance, in consultation with Hymans Robertson, will develop the findings of the review into a set of specific proposals for a revised investment strategy of the Strategic Reserve Fund managed funds and this will be presented to the Investments Sub-committee in due course.

## **4. Budget Monitoring 2018 to 2019**

### **4.1.**

The Strategic Reserve Fund has performed poorly in financial year 2018 to 2019 with an anticipated loss of £9,204,000 in real terms, which is well behind the budget.

### **4.2.**

This position can be attributed to the poor performance of the Council's managed funds investments offset slightly by an anticipated surplus of £1,458,000 on the Scapa Flow Oil Port, and against the background of planned distributions of £4,684,000 being made from the Strategic Reserve Fund during the financial year.

### **4.3.**

The main factors contributing towards the probable outturn position for 2018 to 2019, as set out in the budget statement, attached as Annex 1 to this report, are as follows:

- Investment activities of £1,445,000, including unrealised gains in the value of investments, which is £10,677,000 behind budget.
- Surplus on the Scapa Flow Oil Port of £1,458,000 which is slightly ahead of budget.
- Contribution to the Community Development Fund of £334,000.

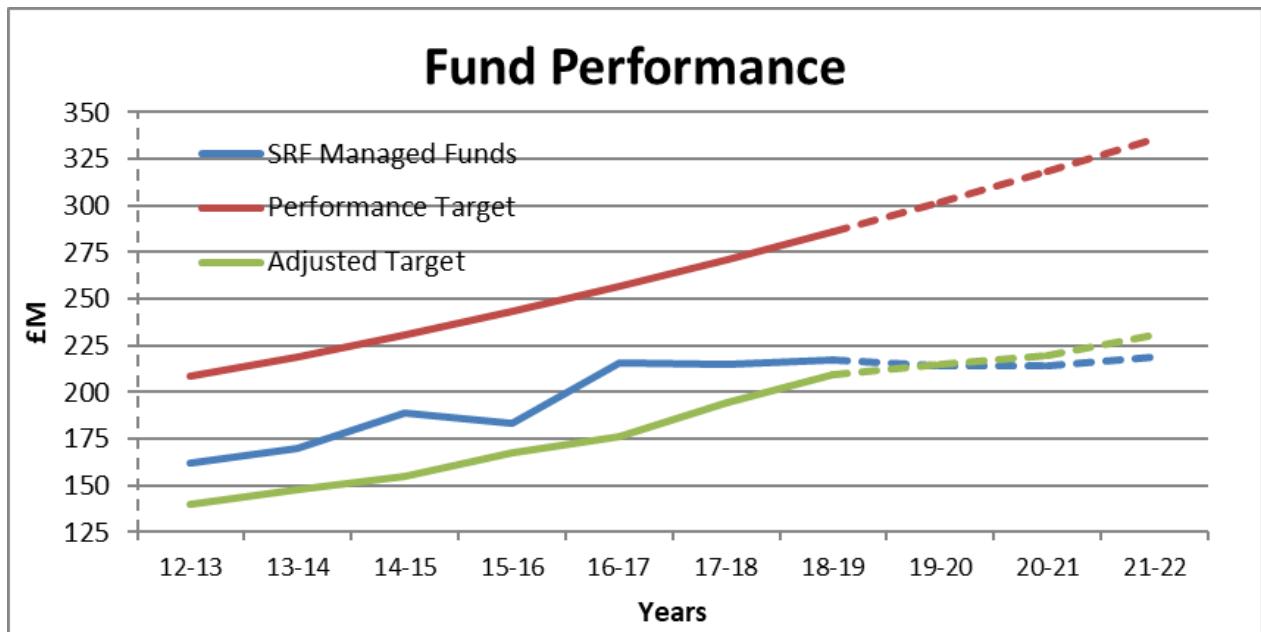
### **4.4.**

With estimated usable reserves reducing by £1,505,000 to £230,412,000 as at 31 March 2019, the value of the Strategic Reserve Fund was not protected in real terms during financial year 2018 to 2019.

## 5. Strategic Reserve Fund Performance

### 5.1.

Performance of the Strategic Reserve Fund managed funds is depicted in the following chart and demonstrates that the value of the Council's investments has fallen below target over the last 7 years. While performance was initially ahead of the long term investment target of 5.0% (increased to 5.50% in 2015 to 2016), it is clear that, despite a significant improvement in performance in recent years, the target has not been achieved over the remaining periods.



### 5.2.

The main contributory factors to this apparent level of underperformance are as follows:

- £29,200,000 was brought in-house from Strategic Reserve Fund managed funds in financial year 2011 to 2012 as part of an agreed change in investment strategy to manage cash balances in-house.
- Since 2012, a further £6,900,000 has been brought in-house from Strategic Reserve Fund managed funds, with a further estimated £27,294,000 to be drawn down over the 3 year period 2019 to 2022.

### 5.3.

While bringing Strategic Reserve Fund managed funds in-house for cash flow and investment strategy purposes, as noted in section 5.2 above, would normally mean that these funds are now held in-house by the Council as cash balances, due to the level of disbursements made from the Strategic Reserve Fund over this period, these balances have since been depleted such that the Strategic Reserve Fund is now effectively a borrowing account from the Council's internal loan fund.

#### 5.4.

Adjusting for the capital withdrawals, referred to at section 5.2 above, the underlying performance of the Strategic Reserve Fund managed funds has achieved the long term investment target over the last 7 years, which is equivalent to achieving an average return of approximately 5.5% per annum over this period. This is represented by an adjusted target line in the fund performance chart at section 5.1 above.

#### 5.5.

Over the past 10 years, up to and including 2018 to 2019, the Strategic Reserve Fund has been used to fund the provision of Council services and contribute to various capital projects and other initiatives to the value of £65,551,000, as follows:

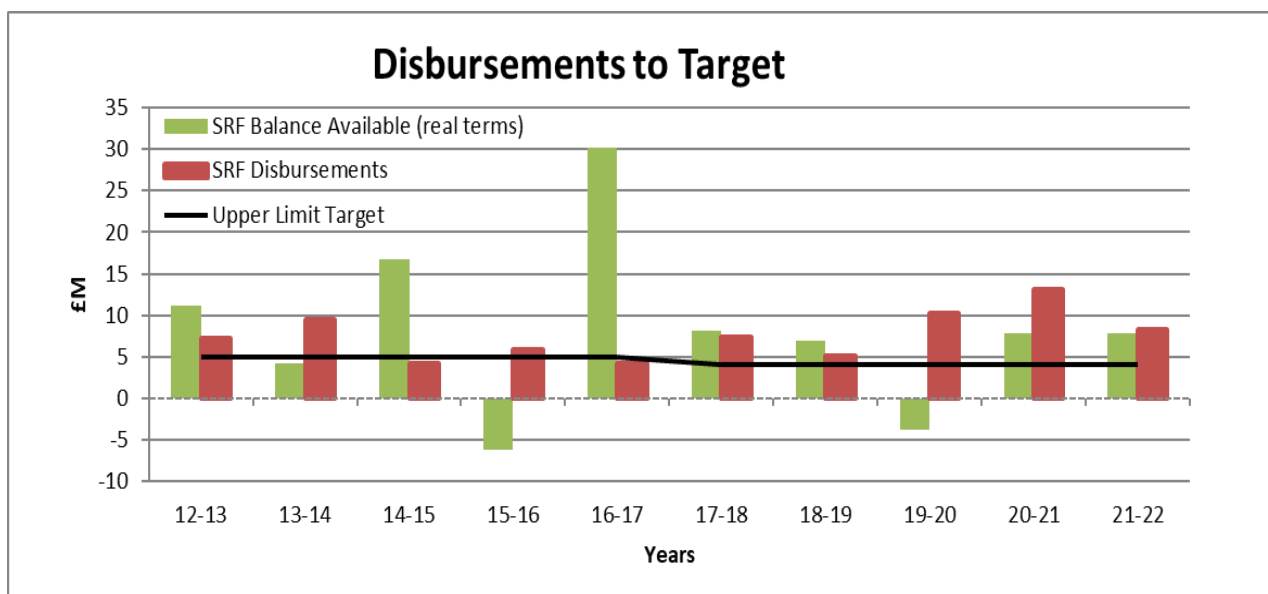
	<b>£'000</b>
Capital Programme Contributions	5,643
Community Development Fund	3,422
General Fund Services	44,840
Scapa Flow Oil Port	6,421
Scapa Flow Landscape Partnership	229
Stromness Townscape Heritage Initiative	638
House Build Programme	4,328
Strategic Projects – Hoy Scale Wind Project	30
Total	65,551

#### 5.6.

The impact that these distributions were having on the long term sustainability of the Strategic Reserve Fund was formally recognised, when the Council established a policy to review the impact on the sustainability of the Strategic Reserve Fund when giving consideration to any future request for financial assistance. At that time, in reviewing the investment strategy for the Strategic Reserve Fund managed funds, it was recognised that the income would not be sufficient to maintain a distribution level of £5,000,000 per annum from the Strategic Reserve Fund and maintain the real value of the Fund over time.

#### 5.7.

The following chart shows the impact that introduction of an affordability criteria has had on disbursements from the Strategic Reserve Fund since 2012, and against the target upper limit of £5,000,000 per annum and reducing to £4,000,000 with effect from 2017:



## 5.8.

This position is also compared against the performance of the Strategic Reserve Fund as a whole, including local investments and the Scapa Flow Oil Port, to give an actual Strategic Reserve Fund balance available for disbursement (in real terms) as set out in Annex 1 to this report. From this it can be seen that the level of disbursements were brought into line with the upper limit target in financial year 2014 to 2015, before the current budget strategy was adopted in financial year 2017 to 2018 onwards.

## 5.9.

Against the background of a recurring commitment to support General Fund Services by increasing the baseline contribution of £4,350,000 to £6,050,000 for financial year 2018 to 2019 and then increasing it further to £7,350,000 in financial years 2019 to 2020 and 2020 to 2021, it is considered that it should be possible to maintain distributions from the Strategic Reserve Fund at this level over the next 3 financial years and still maintain the value of the fund above the minimum balance or “Floor”.

## 5.10.

There are however other commitments on the Strategic Reserve Fund that are expected to be drawn down over the next 3 years, including:

- £320,000 contribution towards the House Build Programme originally planned for 2015 to 2016.
- £9,100,000 contribution towards the replacement facility for St Rognvald House.
- £1,000,000 contribution towards the Island Games 2023.
- £276,000 contribution towards North Isles Landscape Partnership Scheme.
- £356,000 contribution towards Strategic Projects (Scale Wind, Staff Resources, Grid Connection, Private Wire and Lyness Decommissioning).

## 5.11.

While the existing level of net distribution commitments on the Strategic Reserve Fund, estimated at £10,301,000, £13,181,000 and £8,350,000 for financial years 2019 to 2020, 2020 to 2021 and 2021 to 2022 respectively, are regarded as being sustainable over the medium term, it should be noted that any disbursements will have an adverse impact on the capacity of the Strategic Reserve Fund to generate income in the future. In simple terms, the disbursement of £31,832,000 of funds over the 3 year period translates into a loss of income generating capacity within the SRF of approximately £1,751,000 per annum, based on a long term investment target return of 5.50%.

## 5.12.

The budget estimates have been prepared using a number of assumptions, not least of which is that the level of investment returns generated from the Strategic Reserve Fund managed funds can be maintained at 5.50%, but also that the activities of the Scapa Flow Oil Port are such that some assurances can be given as to the level of surpluses to be expected over the next 3 years.

## 5.13.

The minimum balance or “floor” for the Strategic Reserve Fund was established at £175,000,000, as at 1 April 2012, and has been recalculated using the Retail Prices Index to maintain its capital value in real terms. The calculation is based on the official figures available from the Office for National Statistics, together with estimates from the UK Government Autumn Budget Statement and spending review, and as such are updated annually as follows:

<b>Year.</b>	<b>Retail Price Index Estimate.</b>	<b>Retail Price Index Actual.</b>	<b>Original.</b>	<b>Update.</b>	
1 April 2012			£175,000,000	£175,000,000	
1 April 2013	2.50%	3.28%	£179,400,000	£180,741,000	Actual
1 April 2014	2.10%	2.45%	£183,100,000	£185,174,000	Actual
1 April 2015	2.90%	0.90%	£188,500,000	£186,846,000	Actual
1 April 2016	2.20%	1.56%	£188,200,000	£189,753,000	Actual
1 April 2017	3.40%	3.14%	£196,200,000	£195,707,000	Actual
1 April 2018	3.40%	3.30%	£202,361,000	£202,166,000	Actual
1 April 2019	3.00%	n/a	£208,231,000	n/a	Probable outturn
1 April 2020	3.00%	n/a	£214,478,000	n/a	Estimate
1 April 2021	3.10%	n/a	£221,126,000	n/a	Estimate

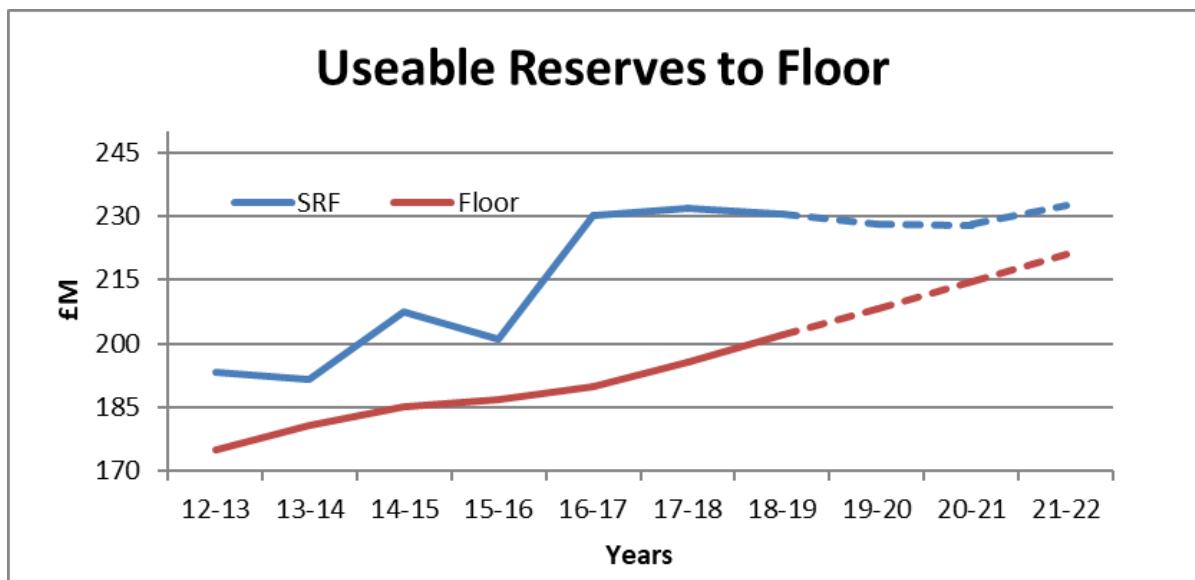


### 5.14.

By way of comparison, the value of the Strategic Reserve Fund usable reserves has been estimated at £230,412,000 as at 31 March 2019. This compares favourably with the minimum balance or “floor” of £202,166,000 as at 1 April 2018 and represents probable headroom of £28,246,000 for financial year 2018 to 2019. Thereafter, the headroom is forecast to decline to £11,514,000 over the 3 years to 31 March 2022, as the level of disbursements on the Strategic Reserve Fund exceeds the amount of income generated.

### 5.15.

A notable inclusion is the assumption that investment performance will not be consistently maintained at the long term target level over the next 3 years, in particular following on from the average level of performance experienced in financial year 2017 to 2018, compounded by the very poor levels of estimated performance compared to budget for financial year 2018 to 2019.



### 5.16.

While budget projections assume that the available headroom within the Strategic Reserve Fund will decline from £19,805,000 to £11,514,000, or by approximately 9% to 5% of usable reserves, over the 3 financial years from 2019 to 2022, these estimates need to be considered in the context of the uncertainty that remains within the global economy.

### 5.17.

As such, it is considered that much volatility can still be anticipated from the Council's investment returns over the short to medium term, and therefore a prudent approach is recommended when giving consideration to requests for any additional disbursements over this period.

## **5.18.**

In setting a budget for financial year 2019 to 2020, a minimum balance or “floor” for the Strategic Reserve Fund of £208,231,000 should be applied as at 1 April 2019.

## **6. Corporate Governance**

### **6.1.**

This report relates to the Council complying with its financial processes and procedures and therefore does not directly support and contribute to improved outcomes for communities as outlined in the Council Plan and the Local Outcomes Improvement Plan.

### **6.2.**

However, operation of a sustainable Strategic Reserve Fund contributes indirectly to the provision of Council services and therefore will assist in delivering the Council’s priorities, as detailed in the Council Plan 2018 to 2023, by allocating resources to those areas of activity which have been highlighted as priorities as a result of public and staff engagement exercises

## **7. Financial Implications**

### **7.1.**

It is recognised that a clear link needs to be maintained between the level of distributions being made by the Strategic Reserve Fund and the actual level of investment income being generated if the value of the Strategic Reserve Fund is to be maintained in real terms.

### **7.2.**

Accordingly, the established practice that requests for disbursements from the Strategic Reserve Fund are supported by a full business case appraisal and are accompanied by an impact assessment prepared by the Head of Finance should continue. This should ensure that due regard is given to the associated financial implications, and in particular that the full impact that any such proposals have are quantified in terms of the sustainability of the Strategic Reserve Fund as a whole and the level of funds available for distribution in future years.

## **8. Legal Aspects**

### **8.1.**

Section 95 of the Local Government (Scotland) Act 1973, as amended, obliges the Council to make arrangements for the proper administration of its financial affairs.

## **8.2.**

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

## **8.3.**

The Council must make arrangements which secure best value. An authority securing best value will be able to show that it is making effective and efficient use of its financial resources.

## **9. Contact Officers**

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## **10. Annex**

Annex 1: Strategic Reserve Fund – Draft Budget for financial year 2019 to 2020.

SRF Draft budget 2019/20 and 2021/22	2018/19 Budget Estimate £000's	2018/19 Probable Outturn £000's	2019/20 Budget Estimate £000's	2020/21 Budget Estimate £000's	2021/22 Budget Estimate £000's
Investment Activities - local investments	( 210)	( 210)	( 210)	( 210)	( 210)
- managed funds	( 12,201)	( 1,487)	( 5,929)	( 11,798)	( 11,796)
- loans fund	212	120	246	328	328
- other, including strategic projects	77	132	71	70	70
Property Investments	( 490)	( 611)	( 611)	( 611)	( 611)
Renewable Energy	( 309)	( 210)	( 300)	( 300)	( 300)
Scapa Flow Oil Port	( 1,258)	( 1,458)	( 1,311)	( 740)	( 594)
Loan Charges	119	119	119	119	119
<b>Net budget surplus</b>	<b>( 14,060)</b>	<b>( 3,605)</b>	<b>( 7,925)</b>	<b>( 13,142)</b>	<b>( 12,994)</b>
	3.4%	3.3%	3.0%	3.0%	3.1%
<b>less</b> allocation to protect value of fund @ RPI	8,132	7,699	6,957	6,890	7,122
<b>Balance available for disbursement</b>	<b>( 5,928)</b>	4,094	( 967)	( 6,252)	( 5,872)
<b>Disbursements:</b>					
General Fund Services	4,350	4,350	6,050	7,350	7,350
Community Development Fund	334	334	0	0	0
Contribution to capital projects - HRA	320	0	320	0	0
Contribution to capital projects - Care Home	1,200	0	3,513	5,617	0
Contribution to the Island Games	0	0	0	0	1,000
Contribution to other projects, incl. revenue strategic project	1,006	426	418	214	0
	7,210	5,110	10,301	13,181	8,350
<b>Deficit/(Surplus) on SRF (in real terms)</b>	<b>1,282</b>	<b>9,204</b>	<b>9,334</b>	<b>6,929</b>	<b>2,478</b>
<b>Deficit/(Surplus) on SRF (actual)</b>	<b>( 6,850)</b>	1,505	2,376	39	( 4,644)
<b>Cashflow - Opening Balance</b>	<b>( 14,148)</b>	<b>( 11,920)</b>	<b>( 16,412)</b>	<b>( 16,412)</b>	<b>( 16,412)</b>
Surplus/(Deficit) on year	6,850	( 1,505)	( 2,376)	( 39)	4,644
Less: Non-cash - Managed Funds Income	( 12,201)	( 1,487)	( 5,929)	( 11,798)	( 11,796)
Fund Transfers - Inflow/(Outflow)	4,143	0	8,305	11,837	7,152
Other Movements	0	( 1,500)	0	0	0
<b>Cashflow - Closing Balance</b>	<b>( 15,356)</b>	<b>( 16,412)</b>	<b>( 16,412)</b>	<b>( 16,412)</b>	<b>( 16,412)</b>
	<b>2018/19 Budget Estimate £000's</b>	<b>2018/19 Probable Outturn £000's</b>	<b>2019/20 Budget Estimate £000's</b>	<b>2020/21 Budget Estimate £000's</b>	<b>2021/22 Budget Estimate £000's</b>
<b>SRF Balance Sheet</b>					
Investment Properties	21,368	21,676	21,795	21,914	22,033
Local Investments	10,099	10,222	10,222	10,222	10,222
Managed Funds Investments	229,887	216,890	214,514	214,475	219,119
OIC Loans Fund Deposit/(Advance)	( 15,356)	( 16,412)	( 16,412)	( 16,412)	( 16,412)
Net Accruals	145	( 465)	( 465)	( 465)	( 465)
Net Assets	246,143	231,911	229,654	229,734	234,497
Less: Unusable Reserves	1,281	1,499	1,618	1,737	1,856
	<b>244,862</b>	<b>230,412</b>	<b>228,036</b>	<b>227,997</b>	<b>232,641</b>
<b>Represented by: Useable Reserves</b>					
Strategic Reserve Fund	198,448	180,830	177,005	175,482	178,566
Flotta Terminal Decommissioning Fund	36,948	38,283	39,431	40,614	41,873
Conservation Fund	188	189	189	189	189
Travel Fund	102	103	103	103	103
Talented Performers Fund	61	61	61	61	61
Orkney Memorial Fund	559	510	510	510	510
Talented Young Persons Fund	16	16	16	16	16
Renewable Energy Fund	8,231	8,750	8,750	8,750	8,750
Capital Receipts Reserve	309	1,670	1,970	2,270	2,570
	<b>244,862</b>	<b>230,412</b>	<b>228,036</b>	<b>227,997</b>	<b>232,641</b>
<b>Target Minimum Balance or "Floor" for SRF</b>	<b>202,361</b>	<b>202,166</b>	<b>208,231</b>	<b>214,478</b>	<b>221,126</b>
Useable Headroom	42,501 17.4%	28,246 12.3%	19,805 8.7%	13,519 5.9%	11,514 4.9%