KCC Budget – Updated Financial Risks

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The national fiscal and economic context is an important consideration for the Council in setting and managing its revenue and capital budgets. The budget report to County Council on 10th February referred to the extraordinary and unexpected challenge to the UK economy and economies across the world arising from the Covid-19 pandemic. The combination of additional public spending both on dealing with the pandemic and the economic fallout from the subsequent recession, and reduced tax yields, has resulted in an unprecedented peacetime national budget deficit.

The budget report noted that the pace of economic recovery had slowed in recent months and that of more significant economic concern was the rise in inflation over the second half of 2021 which has seen rates of inflation more than double since July 2021 (CPI increased from 2% in July to 5.4% in December) with further increases forecast early in 2022 (Bank of England forecast 7.25% by April 2022). Inflation has a significant impact on the Council's budget especially through commissioned services, which total £1.3bn.

The forecasts for public spending, tax receipts, budget deficit and accumulated public debt set out in the Chancellor's Autumn Budget were included in the report to Cabinet on the provisional local government finance settlement on 6th January. That report also included the latest economic indicators for growth, inflation, unemployment and earnings. The Spring Budget is due to be presented on 23rd March 2022. The revised fiscal and economic forecasts from the Spring Budget will be provided verbally for Cabinet as the announcement will be too late for the publication deadline for this report.

This report provides further detail on the inflation assumptions included in the budget and the risks accepted at the time, with a high level analysis of the increased risks posed by the further economic uncertainty following the Russian invasion of Ukraine. This includes the impact of potential inflationary increases (especially for energy and fuel) on council spending and potential impacts on supply chains. The report also sets out in summary the potential impact on Treasury and Pension Fund investment returns.

The likely impact of inflation arising from the increased economic uncertainty has significantly increased the risks facing the council in terms of delivering the budget for 2022-23 as well as containing increased costs in future forecasts.

2.1 The latest Bank of England Monetary Policy Committee (MPC) quarterly report was released on 3rd February 2022. This was not available in time for the County Council budget report published on 2nd February 2022. The MPC report noted that inflation (the pace of price rises) has risen above the 2% target and prices rose by 5.4% last year. The report identified that higher energy prices were one of the main reasons for this. It also identified that higher prices for goods bought from abroad have also played a big role. As economies reopened around the world and people started to buy more goods, some businesses struggled to meet this extra demand, held back by, for example, shortages of materials and workers. That pushed up their costs and led to higher prices for consumers.

2.2 The MPC concluded that these effects are likely to continue pushing inflation up in the coming months. It expected inflation to rise to around 7.25% in the spring. Thereafter the report concluded that the MPC expected inflation to fall back from the middle of the year as they did not expect that energy prices will continue to rise as fast, and the shortages that are currently making it difficult for businesses to make their products should ease. They expected inflation to be close to the 2% target in around two years' time.

2.3 The Bank of England has used fan graphs in their inflation and other economic forecasts for many years. These fan graphs represent a range of probability distributions in bands representing 30% likelihood with the darkest area deemed the most likely range of predictions. Inflation is expected to lie somewhere within the entire fan chart on 9 out of 10 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes.

2.4 One of the reasons the rate of inflation has been rising is due to suppressed prices in one year ago comparisons due to a range of Covid-19 measures such as reductions in VAT. These base effects should drop out in time leading to the lower rates of increase later in 2022. However, the recent sharp rises in energy prices are likely to lead the Bank of England to increase the inflation forecasts for the coming months. Gas prices are only one source of higher energy prices, and the recent spike will feed into a higher headline inflation rate in months to come. UK gas tariffs are recalculated bi-annually and will add inflationary pressure when prices are recalculated in April 2022.

2.5 the latest inflation indices for the year to February were released by the Office for National Statistics on 23rd March. The headline rate of inflation for CPI has increased to 6.2% (up from 5.5% in January). The rate for RPI has increased to 8.2% (from 7.8% in January).

2.6 Inflation indices are compiled comparing the price of a basket of goods and services with the price of the same goods and services 12 months previously. Indices are published on a monthly basis. Chart 5 shows the path of monthly CPI indices since January 1989 as published by the Office for National Statistics (ONS). Chart 6 shows the path of Retail Price Index (RPI) over a longer period since World War II. RPI lost its status as a National Statistic in 2013 and is now treated as a 'legacy measure' by the statistical authorities. The UK Statistics Authority has continued to urge the Government and others to cease to use RPI as it is statistically flawed (as the methodology used in its calculation can over/underestimate inflation). However, RPI remains the only measure with data available over a longer period of time as CPI is not available over the same period. Spikes in inflation are usually followed by lower rates of year on year increases in prices in the succeeding periods to the volatile prices in the one year ago comparison.

Chart 5 – CPI Inflation

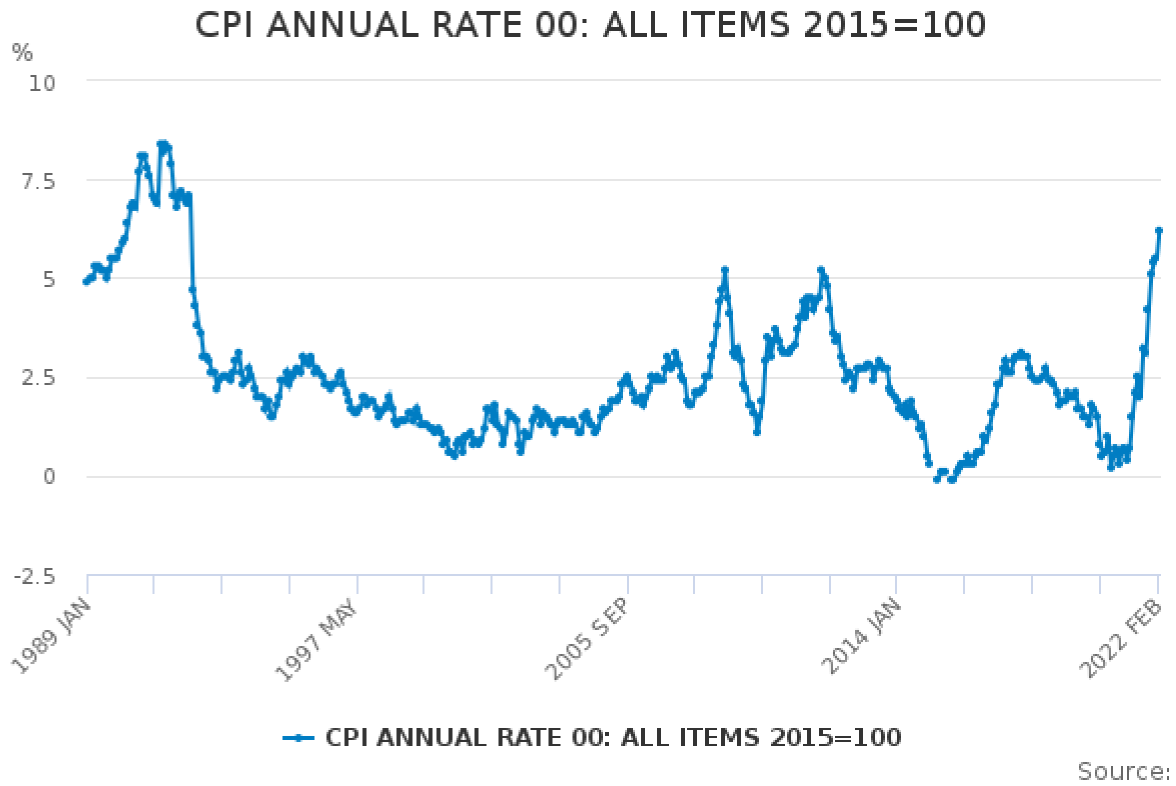
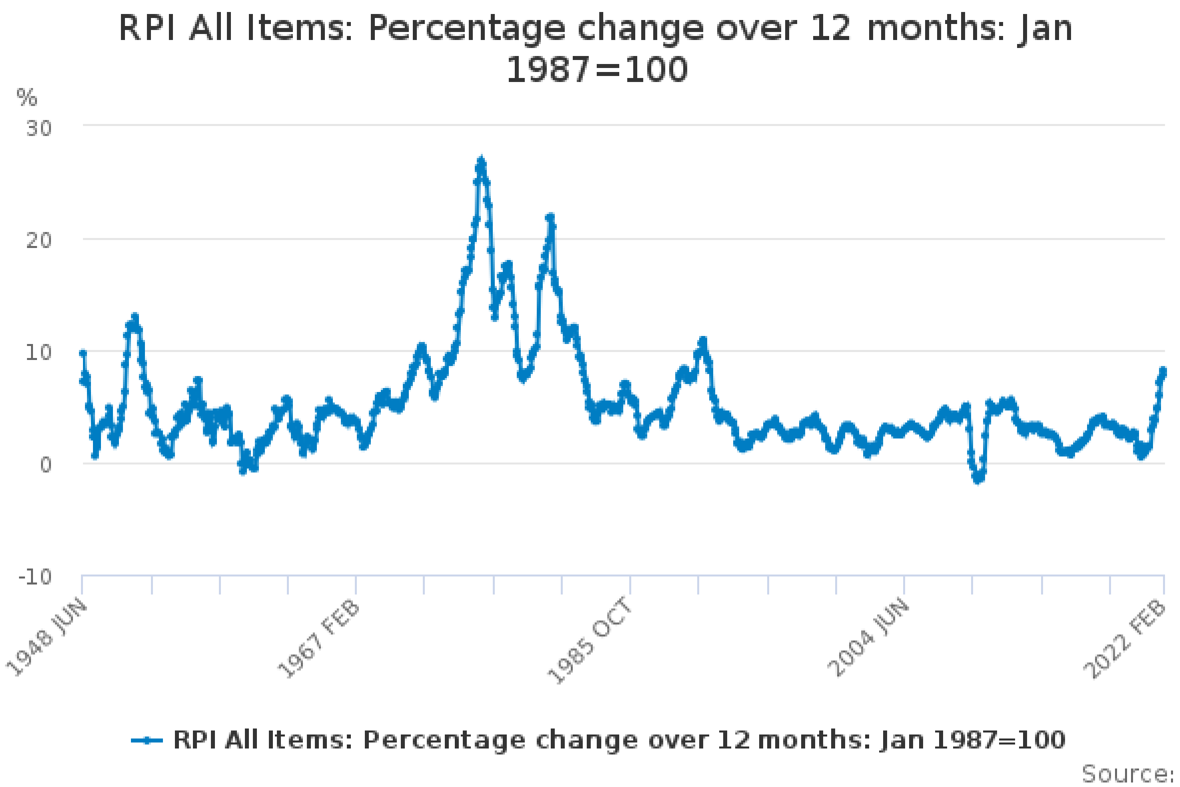
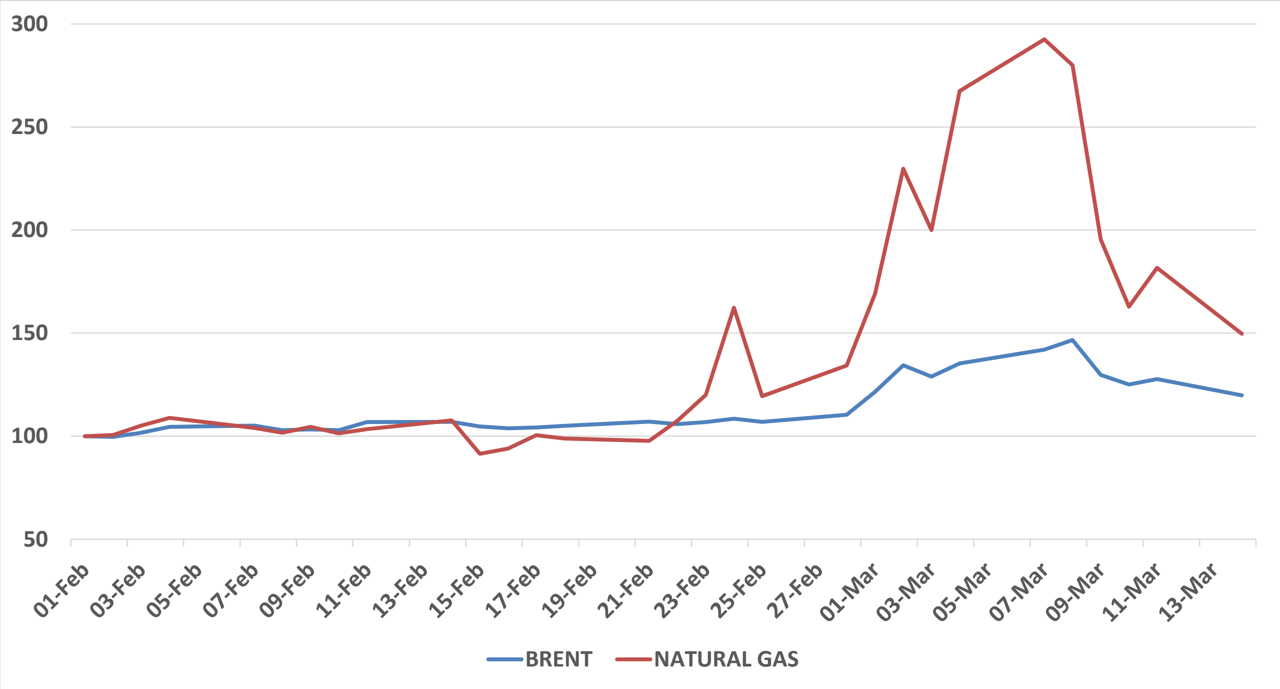


Chart 6 – Retail Price Inflation



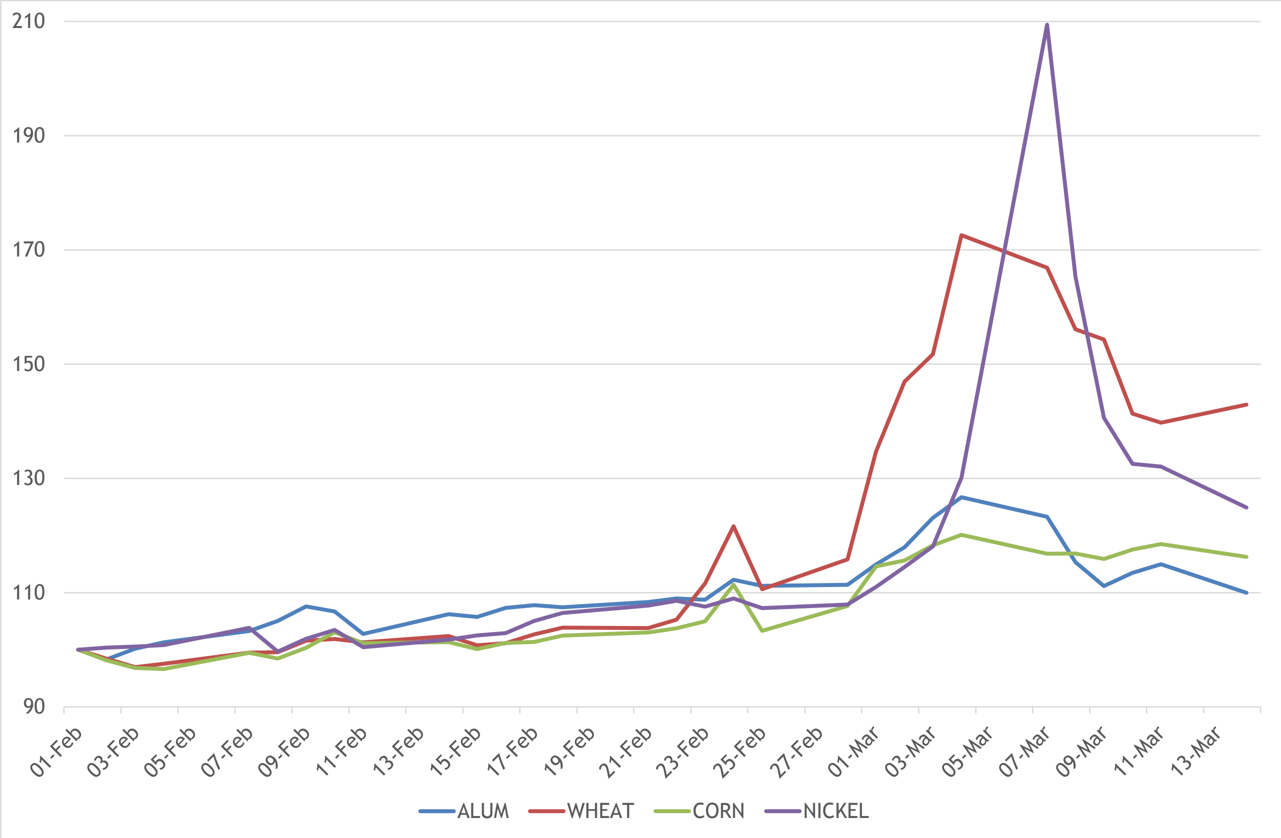
3.1 The Russian invasion of Ukraine has made an already uncertain economic situation even more uncertain. In the immediate aftermath there have been significant increases in commodities prices. Unsurprisingly given Russia's position as a leading global producer of oil and gas, energy prices have been volatile. Despite the lack of direct sanctions on energy up to now, the ramping up of financial sanctions on the Russian economy is likely to disrupt supply as will the suspension of cargo bookings to and from Russia by the large shipping giants who will only transport medical supplies and humanitarian goods. There are also concerns and some evidence that Russia will and has retaliated by slowing/stopping the supply of oil and gas to Europe. International buyers are also refusing to purchase Russian oil and seeking alternatives from other parts of the world, putting pressure on prices. Brent crude oil price briefly peaked at $139 a barrel on 8th March before settling back to around $130, over 30% higher than the London closing price the day before the invasion. There have been further falls in the week commencing 14th March with prices falling back to around $100 a barrel. UK wholesale gas prices peaked around 85% higher at one stage before falling back to around 12% higher than 23rd February.

Graph 1 – Gas and Oil Price Volatility



3.2 Oil and gas are not the only commodity stories. Ukraine and Russia are significant producers of cereals (corn and wheat) and sunflower oil; the wholesale price of wheat has rocketed upwards, but prices have been on a rising trend since the start of February. Russia is also a large exporter of fertiliser. Other commodity prices have risen, with Russia being a significant producer of Aluminium, Nickel, Iron and Copper. Finished goods relying on these raw materials faced inflationary pressure over the same period, although again have subsequently fallen back from the peak.

Graph 2 – Other Selected Commodity Prices



3.3 The economic impacts of the invasion are fast moving and constantly changing. We will need to closely monitor the situation and implications for 2022-23 spending and medium-term consequences. This is likely to require some urgent decisions.

Conclusions on Potential Economic Impact

3.4 It is more than likely that the increased economic uncertainty following the Russian invasion of Ukraine will result in higher levels of UK inflation in the coming months. At this stage it is too early to predict the extent of how much this will increase prices, or how long the higher rates of increases in prices will endure before the rate of inflation starts to decline on the back of the one year ago comparison. This will put further pressure on both the Council's revenue and capital spending if the Council is unable to procure goods and services within the price assumptions built into the 2022-23 budget, which was already very challenging. We will need to monitor closely the impact on inflation indices and Council spending and take action as necessary to ensure increased costs are offset. As an illustration of the potential impact on the Council's budget, if inflation increases to 8% and remains at this level throughout 2022-23 this would equate to a net pressure of around £40m excluding grant funded spending. The impact on capital spending could amount to more than £20m.

3.5 It is also likely there could be an impact on economic growth with the spectre of a further recession. A recession is likely to add demand for council services (and spending) and impact on income receipts/local taxation. We will need to continue to monitor the impact of any reduced economic growth on spending and income levels.

4.1 The 2022-23 final draft budget and 2022-25 medium term financial plan (MTFP) for County Council approval was published on 2nd February 2022 and approved on 10th February. The report and the accompanying Section 25 assurance statement highlighted the already uncertain and volatile background impacting on financial planning. The budget report highlighted the rising rate of inflation over the second half of 2021 with CPI inflation rising from 2% in July 2021 to 5.4% by December 2021.

4.2 The 2022-23 budget included provision for those contracts which include indexation clauses, as well as a 3% provision for locally negotiated prices. As per the scheme of delegation Corporate Directors are responsible for agreeing locally negotiated contract prices within the average 3% agreed by County Council and are agreeing prices uplifts accordingly. As in previous years there was no provision for general inflation outside of index linked and negotiated contracts on the basis that price increases for other goods and services are offset by efficiencies. It was acknowledged that in the current climate this approach to setting prices does not come without risks, in particular the use of current indices as a guide to future prices and the challenging target for locally negotiated contracts below the latest inflation levels.

4.3 Approximately 2/3 of gross revenue spending is externally commissioned services. £1.3bn of the Council's gross revenue spend of £1.8bn (excluding schools) is directly impacted by inflation. A high-level summary of 2022-23 gross expenditure on commissioned and in-house expenditure and income is set out in table 1. The amounts highlighted in amber are those directly impacted by inflation, totalling £1,275.8m.

4.4 It should be noted that specific grants do not include any inflationary increase and therefore the associated expenditure has to be managed within the available grant, including impacts of inflation and demand changes. Depending on the impact of the recent and anticipated further inflation increases holding expenditure within the available grant could prove to be very challenging and require cost reduction. The total expenditure funded by specific grants is £333.7m.

Table 1 – 2022-23 Budgeted Commissioned and In-house Expenditure and Income

Gross Exp. (In House)	£m	Gross Exp. (External)	£m
Total	**605.0**	**Total**	**1,206.7**
Staff Pay	331.0	Commissioned Services	1,068.6
Other staff costs (pension enhancement, redundancy, travel, etc)	28.1	Home to School Transport	50.9
		Professional Fees	43.2
		PFI Fees	28.2
Building running costs	39.2	Grants & Precepts	12.4
IT systems	21.4	Other	3.4
Other	20.9		
Transfer to/from reserves (incl. MRP)	115.7	**Income**	
Internal recharges	48.7	**Total**	**-629.0**
		Specific Grants	-333.7
Gross Exp	**1,811.7**	Contributions (e.g Health)	-92.3
		Sales, Fees & Charges	-136.8
Net Exp (less income)	**1,182.7**	Other (incl interest/dividends)	-23.4
		Internal Income	-42.8

4.5 The 2022-23 budget includes an additional £28.6m for price uplifts for inflation. Table 2 sets out the individual assumptions included within this amount. The amount covered by price uplifts in Table 2 (£0.9bn) is less than the gross spending on services affected by inflation in Table 1 (£1.3bn), with the difference being the spending funded by specific grant which does not include inflation. As highlighted in 4.4 above, if grant funding is insufficient to cover rising prices those grant funded services will need to find counter balancing savings to contain spending within the available grant.

Table 2 –Inflation Assumptions in the Budget for 2022-23

	Base budget 2021-22 £'m	Assumed %	Uplift for 2022-23 £'m
Local negotiation			
- Adults	483.1	3.0%	14.5
- Children's	125.2	3.0%	3.8
- Growth, Environment and Transport	15.8	3.0%	0.4
- Transport	34.1	Other	0.2
Index linked:			
- CPI	62.3	3.1%	1.9
- CPI business rates	7.8	0.0%	0.0
- Higher of CPI or pay increase	10.9	3.1%	0.3
- RPI	64.7	4.9%	3.1
- Other/hybrid	26.7	Avg 5.28%	1.4
Other:			
- DfE published rates	20.2	Avg 1.96%	0.4
- Laser (energy)	6.4	Avg 17.61%	1.1
- Public Health			1.4
	857.3		**28.6**

4.6 Total budgeted spend on energy costs for 2022-23 is just under £8m. This includes £4.06m for highway infrastructure energy, £3.75m corporate landlord estate, and £0.18m other directorate spend. Within this spend an increase of £668k was included for highways electricity inflation (12%) and £454k for Corporate Landlord energy inflation (including 22.5% on electricity). KCC spending on gas is a relatively small proportion of overall energy spending (£883k).

4.7 Total budgeted petrol/diesel spending is relatively little at just under £0.4m. Budgeted spending on staff and member travel expenses is more significant (£9.4m) although the majority comprises casual user and public transport rates which are set by Revenue and Customs (HMRC) and therefore are not directly affected by fuel costs (although individuals may struggle with fuel costs). Budgeted spending on Client transport costs is £3.4m, largely in adults and children's services and is likely to be directly affected by higher fuel costs.

4.8 Spending on transport contracts (home to school transport, subsidised buses) is covered by the 3% allowance for negotiated prices. Providers will be affected by increases in fuel costs and the impact is covered in the section on supply chain impacts (section 6).

4.9 The forthcoming triennial actuarial review of the Local Government Pension Scheme could be impacted by inflation increases as inflation is one of the factors actuaries consider in assessing the solvency of the fund. This could impact on future employer pension contribution rates although the actuarial valuations are based on a longer-term assessment of inflation and inflation is only one of several factors taken into consideration so the impact may not be significant.

4.10 The provision for future years' prices in the MTFP is based on either individual service forecasts e.g. Commercial Services estimate for energy costs, or the Office for Budget Responsibility (OBR) forecasts for CPI included in the October economic and fiscal outlook published to coincide with the Autumn Budget Statement.

4.11 The Council's budget strategy in recent years has sought to strengthen financial resilience with sufficient reserves to mitigate financial risks. The general reserve has been increased to 5% of net revenue budget with £2.5m increase in 2022-23 taking the reserve to £59.1m. General reserves are held for unforeseen circumstances which would include higher than budgeted inflation. An additional 2% inflation would take up almost half of general reserves.

4.11 Any use of general reserves to support higher spending in 2022-23 due to increased prices would have a significant impact in subsequent years as this would create a budget gap within the Medium Term Financial Plan (MTFP). This gap would be more than the impact of the price increase as the higher price level would need to be added to the base budget on a recurring basis plus a further one-off contribution would be needed to replenish general reserves. For this reason, it is essential that directorates and services strive to contain price increases within budgeted amounts and where this is not feasible to take other alternative actions to contain spending.

4.12 Earmarked reserves are held for specific purposes and thus would not normally be used to cover price inflation. However, as part of the objective to improve its financial resilience the Council has established a risk reserve earmarked for specific risks set out in the budget risk register (this would include the risks arising from increased inflation). As with general reserves, use of this reserve for recurring costs, for example, due to higher inflation would result in a budget gap in future years as the base budget would need to be increased and the reserve would need to be replenished depending on future budget risks.

5.1 The 2022-32 10 year capital programme was published as part of the budget report to County Council on 2nd February 2022 and approved on 10th February. The report included the risks to capital projects which could either affect the viability of schemes or require the Council to take out additional short-term borrowing if no compensating actions are taken. This includes the risk of higher than anticipated inflation on projects that are over and above the contingency element of the projects' budgets. The report identified that the impact of risks can be partly reduced through value engineering of schemes.

5.2 Rolling capital programmes, especially those funded by government grant are at even greater risk from inflation. In many cases the grant funding does not include any inflationary uplift and thus programmes already have an element of real terms reductions due to inflation. Higher than anticipated inflation would increase these real terms reductions as spending on programmes is likely to need to be constrained within the available grant.

5.3 Capital spending is more exposed to the impact of rising commodity, energy and fuel costs than the revenue budget due to the impact on materials and delivery costs. Supply chain delays could exacerbate the impact on both potential cost overruns and/or delays to projects and programmes.

5.4 Assessing the potential impact on capital spending of inflation assumptions within the capital programme is not as straightforward as revenue due to contingency provisions within individual projects. Nonetheless, the more explicit link to energy, fuel and commodity costs on materials is more significant. The mitigation of increased inflation could mean that some projects have to be deferred or de-prioritised.

5.5 Capital financing is at risk from any increase in bank base rates and borrowing costs. Although the existing programme and capital strategy does not include the need for any additional external borrowing as if considered necessary loans can be financed from internal borrowing, this internal borrowing still has revenue consequences due to investment returns foregone.

5.6 Energy shortages could place increased demands on supplies for alternative energy sources. Carbon reduction projects within the capital programme had been impacted by supply constraints and any drive to increase alternative energy solutions would put further pressure on the supply chains for both labour and materials needed for construction.

Conclusions on the impact of Inflation on Revenue and Capital Budgets 6

6.1 The uncertainty over future inflation is highly likely to put added pressure on council spending in the forthcoming year. The inflation provisions built into the 2022-23 budget were robust at the time (albeit with challenging targets for negotiated prices) on the basis that any spike in inflation would be short-term and the expectation at the time was that the rate of increase in inflation would start to decline after April. At this stage it would be speculative to put a precise amount on the impact.

6.2 The Council's direct revenue exposure to specific increases in energy and fuel costs is limited. However, increases in energy and fuel are likely to have a significant impact on suppliers of key council services which in turn could have an indirect impact on the contracts for these services. The impacts on suppliers are covered in section 8 of this report.

6.3 The Council's budget strategy means there are sufficient reserves to cover short-term risks of rising inflation. However, using general reserves may be expedient in the short term but if inflation adds to spending pressures over the coming months it is essential that further compensating spending reductions are identified and implemented during this year to avoid creating a significant budget gap for subsequent years. Rising prices in 2022-23 will have medium term consequences as higher spending would need to be built in the base budget spending in subsequent years and reserves would need to be maintained at adequate levels to mitigate future financial risks.

6.4 The Council's regular budget monitoring and reporting will include specific information on the progress being made on delivering the savings agreed by the County Council and the inflation targets set. Where these appear to be off track or at risk, alternative mitigating actions will be identified to ensure the Council's budget and financial resilience is not adversely impacted.

7.1 Traditionally, in response to high geo-political tensions and wars, investors move to safe haven assets such as government bonds and away from risky assets such as equities, leading to declines in government bond yields. Following the invasion of Ukraine gilt yields and risky asset prices did indeed decline, but there are other issues at play that have prompted substantial volatility in gilt yields and mitigated the impact of safe haven buying. Guilt yields have subsequently moved back upwards and the 10 year gilt rate is now higher than before the invasion. Markets are currently more concerned about inflation and potential higher bank rates. On 17th March the Bank of England MPC agreed to raise the base rate 0.25% to 0.75%.

7.2 The FTSE 100 is currently down 2.75% since the close of Wednesday 23rd February, with most of this decline happening a week after the invasion. After an initial sharp fall on 24th February, the index recovered when it became apparent that Western nations were reluctant to sanction Russian energy, reducing the potential growth and inflation impact on the global economy. However, intensification of the military action and the likely detrimental impact on global growth, as noted by the World Bank prompted the more recent sharp decline. This pattern has been followed quite closely by other European and US indices.

7.3 Historically previous conflicts have had different impacts on equity prices in terms of the scale and duration of falls and length of recovery.

7.4 Reductions in equity values will impact on the capital values on KCC's longer term investments in pooled equity funds and Pension Fund investments. We will keep in close contact with treasury advisors (Arlingclose) and pensions advisors (Mercers).

7.5 The vast majority of the Council's external borrowing is at fixed interest rates and there is little risk of increased interest costs in the short term as the forecast rates remain historically low. Higher interest rates would provide increased returns on short term cash investments although these are generally held for liquidity purposes rather than for investment returns.

8.1 Commissioned service providers, like the council, are directly impacted by spikes in inflation, predominately through increases in commodity prices. Depending on the terms and conditions of the contracts they hold with the council, these costs will need to be absorbed within their agreed contractual price, which could require a review of or reduction in the specification leading to reduction of the specification.

8.2 Service providers, in particular social care providers have highlighted that they are facing spending pressures from inflation and increased pay and national insurance costs in excess of the average 3% provision for locally negotiated price uplifts that was affordable within the 2022-23 budget. The 3% was set taking into account the Kent pay scheme recommendations for 2022-23, the significant financial support given to providers over the last two years, and the available funding for 2022-23 raised through council tax and government grant settlement. The average 3% increase recognised that providers would be expected to find efficiency and other savings to offset some of the spending pressures as indeed the Council is having to do. There is some additional grant for the reforms to adult social care through the Market Sustainability and Fair Cost of Care Fund and this has been set aside pending further information from government on the grant conditions. Any funding required for inflationary increases above the average 3% in the 2022-23 budget will need to be offset by compensatory spending reductions and savings.

8.3 The rise in fuel costs affects operational delivery both directly and indirectly across all our services. From 6th April, the tax rate for red diesel increases for most. The increase in fuel costs will impact the construction industry which in turn will impact the council's capital programme and is also impacting transport services, from buses to home to school transport.

8.4 While it is essential that the Council has regard to the supply chain impacts of inflation and economic uncertainties, it is also important that the Council looks at the mechanisms at its disposal to ensure continuity of supply whilst at the same time maintaining an affordable price for goods and services. This is likely to require some reprioritisation and cost reductions, including savings, within both revenue and capital budgets and where necessary reviewing service levels and specifications to offset unaffordable price increases. It is recommended that Cabinet agree that the quarterly finance monitoring reports include the identification of compensating actions, including potential cost reductions and savings to offset any projected overspend for 2022-23, to avoid unsustainable drawdowns from reserves and to mitigate increased demands on future years' budgets.

8.5 Officers are working with providers to help with their costs, including accessing grants to make their businesses more energy efficient and accessing better energy deals through Commercial Services as well as support on how they can review their general operational costs.