SOUTH KESTEVEN DISTRICT COUNCIL

COUNCIL

Report of: Councillor Adam Stokes
Cabinet Member for Finance

Report to:	**Council**
Date:	**27th September 2018**
Subject:	**Budget Framework Proposal (CFM473)**

Decision Proposal:	Budget Framework Proposal
Relevant Cabinet Member:	Councillor Adam Stokes, Cabinet Member for Finance
Report author:	Richard Wyles, Assistant Director for Resources r.wyles@southkesteven.gov.uk 01476 406210 Date: 16 September 2018
Reviewed by:	Alison HallWright, Financial Accountant Team Leader a.hallwright@southkesteven.gov.uk 01476 406208 Date: 17 September 2018
Signed off by:	Debbie Muddimer, Strategic Director for Resources Debbie.Muddimer@southkesteven.gov.uk 01476 406301 Date: 18 September 2018
Approved for publication	Councillor Adam Stokes, Cabinet Member for Finance Date: 18 September 2018

SUMMARY

This report sets out the proposed changes to the budget framework for 2018/19 in order to enable the necessary budget allocations to be made during the financial year.

RECOMMENDATIONS

Council is asked to approve:

1. a revenue budget in 2018/19 of up to £100k for initial set-up costs and up to £500k as initial working capital for DeliverSK and to approve the use of the Council's local priority reserve to finance this budget amendment.
2. the necessary capital budget allocation in order to proceed with the acquisition of a parcel of land in the South Kesteven area, and the associated capital financing costs in future year's revenue budgets.
3. That the Governance and Audit Committee is asked to consider any changes necessary to the Council's Treasury Management Strategy to allow the initial and future investments in DeliverSK activities and projects.

1. BACKGROUND TO REPORT

The 2018/19 budget framework was approved by Council at its meeting on 1st March 2018.

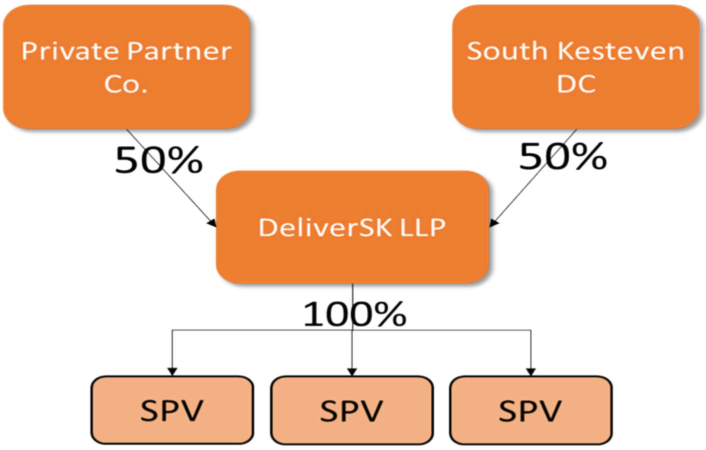
At it's meeting on 6th September 2018, Cabinet made two decisions that require approval from Council to amend the budget framework during the 2018/19 financial year. These are in respect of:

- Deliver SK – an allocation of £600K as an amendment to the General Fund revenue budget.
- Strategic land acquisition – an allocation of capital funding to secure a parcel of land in the South Kesteven area. This will be an amendment to the General Fund capital budget. Furthermore, capital financing costs will need to be incorporated into future years' revenue budgets, as explained later in this report.

1.2 <u>Deliver SK</u>

DeliverSK is proposed to be a 50:50 owned and controlled limited liability partnership (LLP). It will exist at arm's length from the Council, acting as a separate legal entity to deliver the types of physical growth and regeneration activity identified above to support the economy of the district. DeliverSK will work alongside and support South Kesteven District Council and InvestSK.

The proposed ownership of Deliver SK is shown below:



It is important that the Council is clear about what it will need to do and what it can choose to invest into any enterprise like this, and the associated risks. If this report is approved, the Council will commit up to £600k to the company for its set-up and initial project development activities. An indicative breakdown of anticipated spend is as follows:

Estimated set-up costs		**Estimated working capital**	
External legal advice External financial advice Other set-up and professional services costs	£40k £20k £40k	Pay, on costs and associated for first six months Commercial consultancy Architectural services Technical studies Facilities, rates etc Legal, valuations and associated costs Back office functions Contingency	£200k £25k £40k £100k £25k £35k £25k £50k
	£100k		**£500k**

The initial investment of working capital will be recovered through future projects. The timelines that have been calculated show that this should see the first project proposals developed for Q2 2019 onwards.

Cabinet has approved to seek to recover a portion of the establishment costs for DeliverSK from the Partnership's future profits.

As projects come forward in the future, the Council will be able to commit property and finance to the development of those projects. The choice, however, can be made at the time and the Council is not compelled to do so, which limits its risk. The detailed implications of any future investment would be explored on a case-by-case basis, going through the Council's governance process in the usual way.

Any profits made by DeliverSK will be shared between the partners in accordance with their respective investment inputs.

The allocation of £500k is an investment in the company and a loan note will be attached to this in order to secure the Council's investment. To make an investment of this nature, an amendment will need to be made to the Council's Treasury Management Strategy. It is within the remit of the Governance and Audit Committee to "monitor, review and amend as appropriate the Council's approved Treasury Management Strategy paying particular attention to the inherent risks of the prevailing economic/financial climate". This report, therefore, recommends that the committee is asked to consider any changes necessary to the Council's Treasury Management Strategy to allow the initial and future investments in DeliverSK activities and projects.

Although a loan note will be put in place, there remains a risk that the investment of initial working capital may not be repaid in full. Further investment into the company by the Council will be made subject to the receipt of business cases from the company, and decisions on these will be made through the Council's normal governance, i.e. Cabinet or Council as appropriate.

Furthermore, advice will be taken to ensure that the financial implications and financial reporting requirements are fully understood. The £100k budget that is requested includes provision for such advice.

1.3 Strategic Land Acquisition

The Council has the opportunity to purchase a freehold parcel of land with vacant possession in the South Kesteven area which is considered to be strategically important for the Council's growth ambitions. The Council needs to move at pace to secure its position regarding the land to satisfy the vendors aspirations for disposal.

The details of the site in question are set out in an exempt appendix attached to this report to preserve the Council's commercial position. Paragraph 3 of Schedule 12A of the Local Government Act 1972 applies to exempt the information contained in the enclosed appendix. Having regard to the public interest test, it is considered that on balance it is necessary to protect the Council's and the vendor's respective commercial positions by applying this exemption.

Council is asked to approve the capital budget for this acquisition. The recommendation will be to finance this from prudential borrowing, with the associated capital financing costs to be funded from the Local Priorities Reserve. Income received from New Homes Bonus is set aside in this reserve and will therefore be used for the capital financing costs of the borrowing for this scheme.

The total financing cost over a 3 year period (the estimated time the Council will require to complete the development of the site) will be in the region of £0.930m.

Financing costs of the debt will be incurred for the period the Council holds the land and these costs will not be fully offset by the temporary income available from the existing buildings on the site. However, the Council will be exploring a mixed use scheme with early disposal of various areas of the site to receive capital receipts which would reduce the Councils debt obligations. Further information is set out in the enclosed appendix.

Redevelopment of the site will require further capital investment. Proposals will be brought forward on a project/sub site specific basis as required and alternative financing options, such as joint ventures, developers etc. will be explored.

The options for financing capital expenditure are as follows:

- Use of capital receipts
- Use of reserves
- Borrowing.

There are insufficient capital receipts or reserves available to meet this expenditure in full therefore it is recommended that it is financed through borrowing.

The decision about the need and timing of any external borrowing is delegated to the Council's Chief Finance Officer, as set out in Section c.16 of the Financial Regulations. In accordance with the Treasury Management Strategy, the cash position of the Council will be managed in the most effective way possible to maximise investment income and minimise borrowing costs.

The Council's revenue budget does not include any resources to finance new borrowing, the annual cost of which will range from £230k - £310k, depending on the timing of any external borrowing. The financing costs could be met either from working balances or from earmarked reserves. The current policy of the Council is to transfer the income from New Homes Bonus to the Local Priorities Reserve, a reserve which was created to provide funding for the Council to spend on its key strategic priorities. As this is a regeneration and economic development project, it is recommended that the Local Priorities Reserve is used to fund the capital financing costs for the duration of the period that the Council will hold the asset. Once the asset is sold then the capital receipt will be used to repay the debt in full. Any income received from lettings on the site will be used to offset the financing costs, thereby reducing the amount needed to be used from the Local Priorities Reserve.

Because there are a number of factors that could affect the financing costs, it is prudent to consider the maximum costs that could be incurred. If external borrowing was required from the date of completion, and there was no income from any short term lettings of the site, then the total annual call on the reserve would be:

Interest	£150k
Minimum Revenue Provision	£160k
Total	**£310k**

Under part 1 chapter 1 of the Local Government Act 2003, a local authority may borrow for any purpose relevant to its functions or for "the prudent management of its financial affairs". The total amount that a local authority may borrow is governed by the requirements of CIPFA's Prudential Code for Capital Finance in Local Authorities; and by the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003.

The key objectives of the Prudential Code developed by CIPFA are to ensure that the capital investment plans of local authorities are affordable, prudent and sustainable. The Council's compliance with the Prudential Code is covered in the Treasury Management Strategy which is approved by full Council each year.

The prudential indicators that are most relevant to this decision are

- Operational boundary for external debt – the limit beyond which external debt is not normally expected to exceed. For the general fund, this is set at £20m for period 2018/19 to 2020/21;

- Authorised limit for external debt – the intended absolute limit that has to be set by the full council. For the general fund, this is set at £38m for period 2018/19 to 2020/21.

In conclusion, the proposed borrowing set out within this report is in accordance with the Council's Treasury Management Strategy and compliant with the approved Prudential Indicators.

1.4 Impact of both decisions on Council Reserves

The table below shows the **combined** impact both of the proposals contained in the report will have on the forecast balances on the Local Priorities Reserve

Actual Balance 31 Mar 2018	Latest forecast balance 31 Mar 19 (per Council July 2018)	Updated Forecast balance at 31 Mar 2019	Updated Forecast balance at 31 Mar 2020	Updated Forecast balance at 31 Mar 2021
£10,921,000	£5,553,000	£4,953,000	£6,312,000	£7,213,000

2. OTHER OPTIONS CONSIDERED

2.1 Cabinet has approved both of these proposals subject to Council approval for the required funding so no other options have been considered.

3. RESOURCE IMPLICATIONS

3.1 These are contained and detailed in this report.

4. RISK AND MITIGATION

Category risk	Action/controls
The joint venture partner wishes to pursue project or course of action with which SKDC does not agree	As a 50:50 joint venture partnership, all decisions require the agreement of both parties before they can go ahead. If either partner disagrees, a project will not be pursued. Furthermore, each time additional funds are required to be invested (above the initial investment referred to in this report) or council land needs to be transferred to DeliverSK for a project, it will be subject to the usual council approval and governance procedures. This process applies to each individual project.
No projects come forward, leaving the £500k of initial working capital investment unrepayable	This is a unlikely risk, as projects are already being identified and there is a clear approach for establishing a pipeline to build on these.
Projects return less than needed to repay investments from the parties	Part of the development process is to assess the viability of a scheme, which includes market estimates for the ultimate sale price and regard for factors that could result in this varying. It is unlikely either partner would wish to proceed with a scheme that presented significant risk to returns in this way. There may, however, be an occasional case where a scheme is highly attractive for non-financial reasons (such as a community regeneration project), and the Council wishes to proceed because of the wider economic benefits. One of the benefits of the proposed

Category risk	Action/controls
	model is that the council could decide at that point to use profits from previous schemes to offset any viability gap present, allowing a site to be redeveloped where it would otherwise be unable to be. It is also possible that two sites could be linked to create an overall viable proposal where one profitable site supports delivery of one that is not commercially viable.
Costs for scheme development – such as for obtaining planning consent, or for physical construction where appropriate – could exceed estimates	Careful estimates of costs for taking a project forward are put together through the development process, which details the assumptions around those to ensure they are robust and transparent. Costs will be monitored as projects come forward, including forecasting forward against the baseline plan, and any variation from this is addressed by the executive team the first instance, who will try to bring the expenditure back in line with the baseline. In the event that additional funds are needed, it would be for the partners to decide to fund at that point.
Schemes submitted do not obtain planning consent	The Council's planning authority role is independent and would treat DeliverSK as any other developer. It is entirely possible that a planning application could be turned down, but it is also considered unlikely as DeliverSK will engage with the Local Planning Authority at the earliest possible opportunity, with extensive pre-application dialogue, making the risk of refusal low.
The partners within DeliverSK cannot agree how to develop a scheme that the Council's representatives are happy with.	The Council will go through a careful process in order to establish the appropriate partner to enter into DeliverSK. That partner will be aligned with the Council's objectives for the vehicle. Decision making is by consensus and as such it is in both party's interests to work together collaboratively to avoid any disagreement. However, in the event this took place, the scheme would simply not progress; the Council as a partner cannot be forced to do anything it does not wish to.
That schemes are not taken forward quickly enough, or not at all, after the Council has agreed an investment, or sale of land	A key part of the business planning that supports each land sale or investment decision will be the timescales to which schemes will be delivered. The Council will also wish to consider what conditions (of sale/investment) to apply.
Strategic Land Acquisition	
Planning restrictions	Prior discussions with Planning to ensure any proposed change of use and development supports the national and local planning policies.
Contamination and ground investigation	Risk is mitigated by ground investigation survey.
Title deed restrictions	Legal due diligence and negotiations if required to release any existing covenants
Interest rates increase thereby increasing the financing costs of the debt.	An increase of 0.5% would increase the financing costs by £40k. This risk will be managed through the treasury management process.

Category risk	Action/controls
There is a downturn in land prices and the Council has to hold the asset for longer than 3 years	The Council would seek to maximise the income generated from the site through short term leasing arrangements. The debt financing costs would continue to be incurred therefore this would need to be considered as part of the Council's budget and financial management.

5. ISSUES ARISING FROM IMPACT ANALYSIS (EQUALITY, SAFEGUARDING etc.)

5.1 There are not considered to be any issues arising.

6. CRIME AND DISORDER IMPLICATIONS

6.1 There are not considered to be any crime or disorder implications.

7. COMMENTS OF FINANCIAL SERVICES

7.1 These are contained throughout the report.

8. COMMENTS OF LEGAL AND DEMOCRATIC SERVICES

Deliver SK

8.1. The Council has, in this report, set out how it intends to select an investment partner.

The creation of a co-investment partnership as proposed in this report does not in itself involve the procurement of works or services from the prospective partner. Therefore the Council is not under an obligation to run a fully regulated competition as set out in the Public Contracts Regulations 2015, as it is purely seeking an investor who can contribute or provide access to funding (and investment skills) into DeliverSK.

Following the *Peters v Haringey* case it has been established that where local authorities wish to participate in limited liability partnerships for the purpose of economic development, regeneration and/or local well-being and growth, then they may do so using the General Power of Competence contained in section 1 of the Localism Act 2011, provided that this is the main objective in entering into the LLP. This report, and any business case will demonstrate that this is a reflection of the Council's aims and so the formation of an LLP is considered lawful.

Where the Council is providing funding to a third party operating in the open market (ie the LLP) it will need to ensure that any such funding is injected in a state aid compliant manner. State aid is any advantage or benefit provided by a public body or using state resources to any undertaking (an entity deemed to be carrying out economic activity). The Council is a local government body funded using State resources. Where the Council provides these State resources to an undertaking (such as the LLP), which results in this entity receiving a selective advantage, it must ensure that it does so in line with a recognised state aid solution or exemption. Where unlawful state aid is provided to an undertaking, it can be clawed back with interest. Where the Council is able to demonstrate that no selective advantage is provided to an undertaking, no state aid passes to that entity. This means that where a loan is provided to an entity on market terms, no unlawful state aid is being provided as the entity is not receiving any advantage beyond what it would get on the market.

In order to assess whether a particular investment, or investment decision confers an advantage that would not otherwise be available on the open market, the Market Economy Investor Principle Test ("MEIP Test") should be applied to the assessment. The MEIP Test involves an assessment of the support provided by the public body in question, i.e. *Would a private investor in comparable circumstances have provided such sums or support to the recipient if it were operating under normal market economy conditions?* The MEIP test is deemed to be automatically satisfied if the public sector investor in question is investing on similar terms as a private sector entity. If the investment is not entirely on the same terms, *pari passu,* it is still possible for it to be deemed to be state aid compliant, provided the terms of the investment are such that a hypothetical reasonable private sector investor, in comparable circumstances, would agree to these. To evidence this, the Council could appoint an independent commercial advisor review the terms of the transaction and confirm that this is the case. This will require a review of the terms of any loan, including its length and interest rate.

The governance of any joint venture will be key to ensuring it is able to operate effectively and meet the best interests of the Council. The Council will interact with the activities of the joint venture as a landowner, a member of the LLP and through appointees to the LLP company board of directors. Executive decisions to be made in respect of the LLP should be subject to scrutiny and the business plan will determine which decisions will be reserved to the Council.

8.2 **Land Acquisition**

A local authority has power to purchase property by virtue of s.1 of the Localism Act 2011, the general power of competence. In addition, s.111 of the Local Government Act 1972 provides as follows:- Subsidiary powers of local authorities.
Without prejudice to any powers exercisable apart from this section but subject to the provisions of this Act and any other enactment passed before or after this Act, a local authority shall have power to do anything (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions.

Any purchase of property must be subject to the terms of the contract to be negotiated and the relevant searches and enquiries required to ensure that the property to be purchased is fit for the purpose for which it is intended and at best value. Where restrictions exist, we must ensure the restriction does not impact on potential uses and that indemnities are secured against any potential outstanding breaches prior to purchase. We need to be fully aware of third party rights and how they will impact on future proposals.

9. APPENDICES

9.1 Appendix 1 – Strategic land acquisition information – Exempt

10. BACKGROUND PAPERS

10.1. Cabinet Agenda 6th September 2018
http://moderngov.southkesteven.gov.uk/ieListDocuments.aspx?CId=164&MId=3625&Ver=4