

Corporate Policy & Resources Committee



19 January 2022

Title	Capital & Revenue Reserves Strategy
Purpose of the report	To note and make a recommendation to Council
Report Author	Paul Taylor Chief Accountant
Ward(s) Affected	All Wards
Exempt	No
Corporate Priority	Community Affordable Housing Recovery Environment Service Delivery
Recommendations	<p>Committee is asked to note:</p> <ul style="list-style-type: none"> • that the Council approved fifty year sinking fund reserves policy has been adhered to over the last five years and continues to strengthen our earmarked reserves position. • that by successfully implementing the above policy, Spelthorne Borough Council has the highest ratio of usable revenue reserves to Net Revenue Expenditure (NRE) of any district or borough, council in England • that subject to Council approval, the Outline Budget workings indicate that we will have to withdraw funds from our rent equalisation reserve (sinking funds) and this will achieve broadly a breakeven situation, i.e., the same amount of money will be withdrawn as paid in during 2022/23. • that due to the successful redevelopment of the West Wing for affordable rental units, we are looking into the feasibility of moving the council offices to take advantage of the new Hybrid working era and redevelop the remaining two wings to generate much need capital receipts. • that Council remains on track to builds its reserves and protect services and the residents of the Borough. • that officers will review and update the 50-year sinking fund strategy, with a particular focus on the next five years for Council approval as part of the 2023-24 budget setting process.
Reason for Recommendation	Effective and sustainable use of reserves is a key element of the Council's Medium Term Financial Strategy

1. Key issues

- 1.1 Our continued strong performance from our investment property portfolio and adherence to our 50 year sinking fund policy of using some of the net contribution to fund services and regeneration programmes (today) and some to put into earmarked reserves (tomorrow), such as rent equalisation reserve (sinking funds) has put Spelthorne Borough Council in a strong position.
- 1.2 As shown in our unaudited accounts for the year ended 31 March 2021, where Council's approved Earmarked Revenue Reserves (ERR) were £79.5m.
- 1.3 Including in the above figure, was an amount of £26.9m, which relates to COVID-19 support Government Grants received before 31 March 2022, that were paid out to business and individuals after 1 April 2022 and therefore, it has artificially inflated our Earmarked Revenue Reserves at the year end, it will distort closing year balances and make both past and future benchmarking and analysis exercises more difficult to interrupt due to the material impact of this sum on our total reserves. (This impacts on all Councils).
- 1.4 Adjusting for this element the Council's underlying (cash backed) ERR as at 31 March 2021 are £52.6m (As shown in Appendix D) and shows a modest (but still significant) increase of £8.4m from the previous year, when comparing like with like.
- 1.5 The increase in reserves is due mainly to our adherence to the 50 year sinking fund reserves policy, which is coming to the end of its first five-year cycle and will need to be updated for 2023/24.
- 1.6 The approved ERR can only be utilised for the purposes they were established for, for example, revenue grants unapplied, relates to monies received from Central Government and other third parties that must be spent on a specific project, usually with a deadline and after the deadline any unapplied grants for that purpose are returned to the provider.
- 1.7 A strong performance from our investment property strategy over the last five years, which has generated over £10m per annum to support our services and assist with the regeneration of communities, is only part of our good news story. Whilst we have been put into a strong position, we can't be complacent and Council still needs to have a strong and clear medium term reserves strategy, together with regular monitoring of our reserves, as without one, Spelthorne Borough Council could see its reserves, like those of Croydon Council reduce to critical levels in a relatively short number of years, based on discussions of events that led up to their demise with our external advisors.
- 1.8 Noting that an essential use of our earmarked reserves will be the transfers to and when required transfers from our rent equalisation reserve (sinking funds), to equalise our rental income streams as required.
- 1.9 Therefore, it is critical that the Council implements a strong reserves strategy that continues to strengthen our financial position and protects future service delivery and regeneration projects, which will include using funding from the rent equalisation reserves (sinking fund) as indicated in the 2022/23 Outline

Budget report, as we buy time to invest in and deliver our transformation projects.

2. Background and keys risks

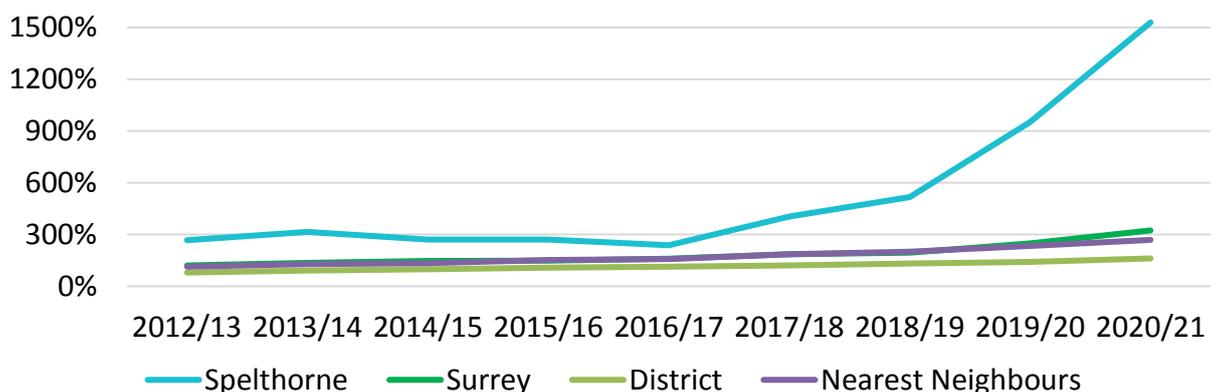
2.1 To assist Councillors, there are three appendices attached to the report that cover:

- (a) Appendix A - an introduction to reserves.
- (b) Appendix B – the background and purpose to Spelthorne Borough Council’s reserves
- (c) Appendix C – the management of our reserves

2.2 Many Councillors will have heard of some of the issues facing other councils in respect of their failure to make adequate provision for Minimum Revenue Provision (MRP). Spelthorne officers took a prudent approach and ensured that as part of the annual Budget recommendation to Council, that we agree the full provision for MRP, and are therefore our finances and reserves are not adversely impacted by this issue. The MRP is then applied annually to ensure we gradually pay down the Council’s debt on a year-by-year basis.

2.3 Throughout the year, officers in the Finance team, regularly attend external meetings and presentations with our Treasury Management Advisers, Central Government, Local Government Association, Chartered Institute of Public Finance and Accountancy (CIPFA) and LGImprove who benchmark and provide feedback on our performance against other Councils. This benchmarking has highlighted that Spelthorne, as part of its risk mitigation strategy for its investment assets, now has the highest ratio of usable revenue reserves to Net Revenue Expenditure (NRE) of any district or borough council in England, as shown in the graph below:

URR as % of NRE: 31/03/13 to 31/03/21 compared with County and all districts average



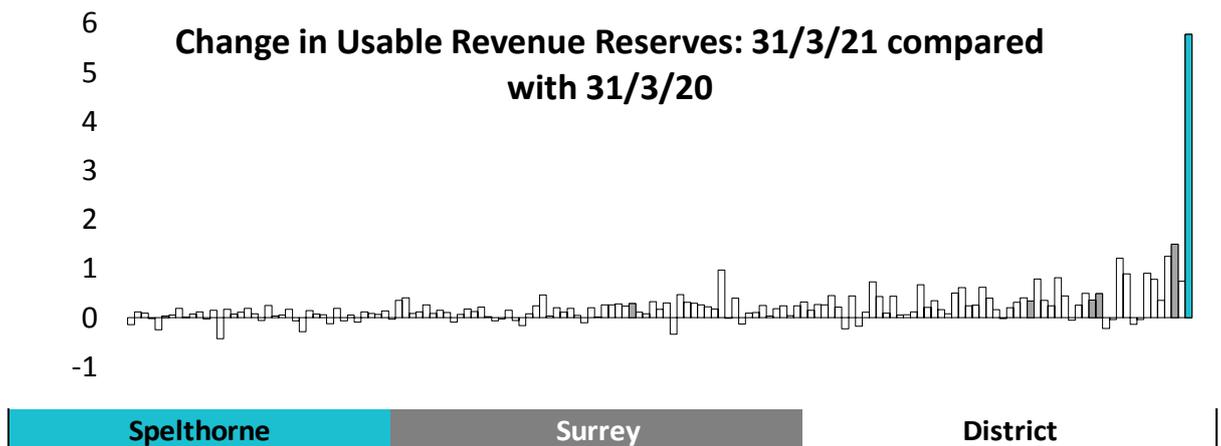
2.4 It needs to be remembered that the Councils’ approved Revenue Reserves, including the sinking funds reserves are earmarked and set aside for specific purposes and cannot be used for any other purpose.

2.5 One of the key messages received is that because of a prudent approach by Council over the last few years, we have managed to grow and build resilience into our useable reserves, which has allowed the Council to generate additional interest income to support our services.

**Useable Revenue Reserves (ERR) from 2012/13 to 2020/21:
Spelthorne**

£000s	2016/17	2017/18	2018/19	2019/20	2020/21
General Fund Balance	951	1,000	1,000	1,221	2,176
Earmarked Reserves	10,102	17,802	23,053	43,006	79,503
Usable Revenue Reserves	11,053	18,802	24,053	44,227	81,679

- 2.6 This is a positive situation. Council can be assured that it is meeting its Value for Money requirement for the external audit review of its arrangements, it is striking a sensible balance between providing support for services (today) and protecting the future (tomorrow) by ensuring that sufficient funds are put away into earmarked reserves for specific future use.
- 2.7 The current Council approved 50 year sinking fund reserves policy is in its infancy and whilst it is on course to deliver its objectives for the Council, the Borough and its residents, we cannot become complacent, as there are many challenges for us to resolve, particularly in the short term, i.e., over the next two to five years, some of which are highlighted below, so that our reserves strategy remains fit for purpose.
- 2.8 To assist Officers to advise Council and to fully understand the situation, we have requested that a bench marking exercise be carried out comparing the top 25 Councils who have the largest borrowing, as the current benchmarking exercises compare all Councils in the UK, which is distorting our view as seen with the diagram below, which shows the change in useable revenue reserves from 31 March 2020 to 31 March 2021, (noting the warning given in 1.1 above) with Spelthorne Borough Council highlighted in blue at the far right of the bar chart and other Surrey Districts and Boroughs shown by the grey bars.



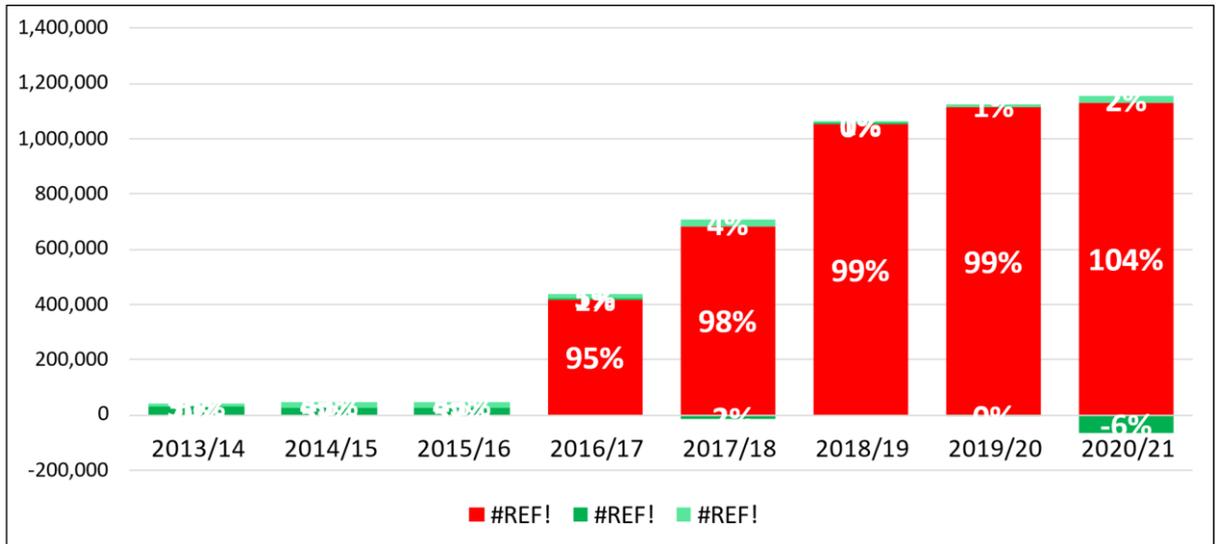
- 2.9 The next item on our agenda is property valuations, and as Councillors are aware the property market is experiencing short term valuation fluctuations, both upward and downward, because of the COVID- 19 pandemic, which means that we must take a medium to long term view on our property portfolio, particularly as the current Capital Strategy highlights that we have

no intention to sell any of our property portfolio, to third parties. (Noting we will transfer properties to Knowle Green Estates Ltd., our wholly owned subsidiary at cost).

- 2.10 The COVID-19 pandemic is influencing valuations in several ways:
- (a) Our tenants financial standing may have changed, positively in the case of IT sector, negatively in others, such as hospitality.
 - (b) Tenants rightsizing as hybrid working means they no longer require large office premises
 - (c) Business failures
 - (d) Incentives provided to new tenants
 - (e) Approved changes in leases
 - (f) Uncertainty about the future
- 2.11 At the 31 March 2021, our property portfolio reduced in value by £51m. This represents a paper loss and based on the upward trend in commercial investment properties experienced over the last 300 years, we expect to see this upward trend return over the next three to five years and reverse these short-term paper losses to overall paper gains.
- 2.12 As well as impacting on the valuation figures, COVID-19 will continue to impact on our services, over the next few years, as highlighted during the budget briefing session with Councillors in November 2021, so we are not 'out of the woods' yet and are facing challenges over the next four years around:
- (a) Shortage of both labour and materials for our capital projects.
 - (b) Reduced fees and charges, including car parks.
 - (c) Reduced funding from Business Rates.
 - (d) Uncertainty due to new COVID-19 variants.
- 2.13 Our next area for officers to monitor closely is our Capital Finance Requirement (CFR) because of the aggregate value of our borrowings to the aggregate value of our property portfolio
- 2.14 The CFR is a measure of the Council's financial health, as shown in the chart below

£000s	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Capital Fin. Requirement	0	0	0	416,250	681,984	1,051,121	1,116,100	1,128,532
Capital Adjustment Acc.	28,234	26,987	26,897	2,377	-12,617	871	-2,857	-66,215
Revaluation Reserve	12,095	20,766	20,094	20,538	25,054	10,698	10,754	24,005
Balance Sheet Capital Assets	40,329	47,753	46,991	439,165	694,421	1,062,690	1,123,997	1,086,322

Capital Health: CFR, CAA, and RR at Spelthorne from 2013/14 to 2020/21



- 2.15 The CFR shows that in 2020/21, because of the paper losses on our property portfolio, are funding 104% of our assets and officers will need to monitor this variable carefully over the next two to five years and liaise with Councillors.
- 2.16 What the impact of 104% CFR means is that book value of our properties is lower than the aggregate of our total borrowings and if we sold all our properties and achieved the valuations quoted Council will have an excess of borrowing to repay, therefore it is an important variable to monitor.
- 2.17 The reality is that Spelthorne Borough Council would be unlikely to sell all its investment properties in one year, going for a planned disposal rather than a forced sale. (The Capital Strategy for 2022/2027 will deal with this in more detail).
- 2.18 As indicated in the past, the Council is in this for the long term and whilst our rental income continues to be maintained, we will be able to prudently manage our finances over the coming years and at present, Council is on track to deliver its long-term strategy for reserves and sinking funds
- 2.19 Our 2022/23 budget modelling is showing that our net rental income is holding up, improving considerably after the recent rental increases, and we need to ensure that the Charter Building obtains more tenants over the next 18 months, as highlighted in the recent report submitted to the Development Subcommittee 10 January.
- 2.20 Again, we cannot take everything for granted and as the pandemic drags on, this could put even more financial pressures on businesses, which could lead to an increase in company liquidations and because of this challenge, officers recommend a cautious approach through the next twenty-four months to enable the Council to see clearly the revised financial landscape.
- 2.21 **Knowle Green Estates Ltd. (KGE)**, the Council, as sole shareholder has yet to provide a clear long-term strategy on how to utilise the contributions that will flow from KGE or how to extract this money in a tax efficient way, to contribute towards the financial stability of the Council.
- 2.22 The current plan was to provide a significant number of affordable and keyworker rental housing, to support the current funding strategy and a notional equity investment £1 and the rest in loan finance, rather than a

substantial equity investment and smaller loans, which would reduce our useable earmarked reserves.

- 2.23 Should Council consider changing the balance of units to include Private Rental residential units, the funding model would change significantly, due to State Aid implications and therefore this would require a substantial equity investment of several million pounds, to enable KGE to meet its debts as they fall due in the normal course of business. (Noting that an investment of this type would require the Council to physically transfer the funds in return for equity share capital)
- 2.24 Based upon the projections prepared for Cabinet and Council in February and March 2021, indications were that KGE could contribute approximately £100m towards funding Council services, over the next 50 years.
- 2.25 Council has a range of options for dealing with the cash surpluses in KGE and it could decide to leave the funds in KGE to enable it to build more housing stock in the Borough (this would incur Corporation Tax and in 2023/24 the main rates rise to 25%) or the Council could receive between £500k to £2m per annum in management charges and loan interest arbitrage to support its services in the Borough, once all the properties, in the current delivery pipeline, are transferred and fully occupied from 2025/26.
- 2.26 Noting that due to the current delays on obtaining planning permission on some of these development properties earmarked for KGE, not only is the Council incurring additional monthly costs of £100k, but it could also reduce the positive aggregate projected cashflow by over 25% and delay the occupancy by between 2 and 5 years, i.e., between 2027/28 and 2030/31.
- 2.27 This could exasperate the short-term challenges in funding highlighted in the 2022/23 Budget Briefing given to Councillors in November 2021, to support services across the Borough, which could lead to increased Council tax, reduced services, redundancies, or a mix of all these options, particularly if the number of apartments to be built is significantly reduced, from the 663 originally planned for.
- 2.28 Climate change is another area that is going to create a challenge for the Council, as we explore how to reduce our carbon footprint, we are on track to spend over £4m building our new leisure centre to be the first Council fully mixed dry and wet leisure centre to be fully compliant with Passivhaus standards, another first for Spelthorne Borough Council and the UK.
- 2.29 The successful development of the West Wing at our Knowle Green offices, where we have made an additional 25 new apartments available for key workers, young families, and some physically impaired residents of the Borough, has provided the Council with the option of moving premises and redeveloping the remaining two wings and generating much needed capital receipts to fund our Capital Programme.
- 2.30 The final item is that as shown in appendix D – forecast useable reserves, in particular the revenue element, are all approved earmarked reserves, meaning as shown in Appendix A 1.4(b) that these are Council approved reserves, set aside for a specific purpose, i.e., there are currently no unallocated funds for Council to utilise to fund any budget gaps in 2022/23.
- 2.31 These represent the main challenges and items for Council when considering the reserves and sinking fund strategy for 2022/23.

3. Options analysis and proposal

- 3.1 Officers considered a wide range of proposals for the utilisation of the Council's reserves, and considering the challenges and issues highlighted in section 2 above:
- (a) Limited bench marking of like for like councils
 - (b) Short term paper fluctuations in property valuations
 - (c) Higher than expected borrowing to property valuations ratios in the short term
 - (d) Financial pressure on local businesses due to the continued pandemic and the impact on our rental properties
 - (e) The requirement for a clear Council led financial strategy for KGE
 - (f) Apart from the General Fund balance, all our revenue reserves are earmarked and cannot be used for any other purpose.
 - (g) COVID-19
- 3.2 Officers are recommending that Council continue with the current strategy for reserves and sinking funds as shown in the 2022/23 budget until a full review of our reserves is carried out by 15 March 2022

4. Financial implications

- 4.1 Appendix D shows our earmarked revenue position: actual as at 31 March 2021; and the forecast position for the three years to 31 March 2024, subject to any changes made during the budgeting process for 2022/23 by Council.
- 4.2 Noting that subject to Council approval of the 2022/23 Budget at their February 2022 meeting we are looking to utilise the earmarked reserves as follows:
- (a) £150k from the Bronze Field Reserve to fund the proposed public realm enhancements (capital) to the River Ash Boardwalk
 - (b) £100k from the NNDR Reserve to fund the extension of two temporary posts (Revenue) within the Economic Development Team
- 4.3 The Council is continuing with its 50-year sinking fund policy for 2022/23.
- 4.4 The Outline Budget workings indicate that there will be a need to utilise the rent equalisation reserves (sinking funds) for 2022/23 and possible 2023/24, which new will address next year. The forecast indicates a breakeven position, i.e., the same money is drawn out and was paid in during the year.
- 4.5 Officers will be carrying out a reviewing Council policy on the sinking funds and the wider reserves position, including KGE, the adequacy of our General Fund Reserve and how our Reserves, particularly the Asset Improvement Reserve might be used to assist Council to meet any future deficits over the next 5 years without jeopardising the financial stability of the Council, as part of the 2023/24 budget setting process.

5. Other considerations

- 5.1 Included in section 2 above.

6. Equality and Diversity

6.1 Detail how the recommended proposals will impact equality and diversity and mitigation measures being taken.

7. Sustainability/Climate Change Implications

7.1 Included in 2022/23 budget setting proposals.

8. Timetable for implementation

8.1 Implemented as part of the 2022/23 budget setting process.

8.2 Review of sinking funds for the five years to 2028/29 to be carried out as part of the 2023/24 budget setting cycle.

Background papers: None

Appendices:

Appendix A – Introduction to reserves

Appendix B – Background and purpose to Spelthorne Borough Council's reserves.

Appendix C – Management of Reserves

Appendix D – Earmarked Revenue Reserves (ERR) at 31 March 2021 (Actual) and 2022, 2023 and 2024 (Forecast)