

# Corporate Policy & Resources Committee



7 February 2022

<b>Title</b>	<b>Capital &amp; Revenue Reserves</b> <b>This report is subject to the final decisions made by the Committee between mid-January and 7 February around finalising the 2022/23 budget and may be subject to change</b>
<b>Purpose of the report</b>	To note and make a recommendation to Council
<b>Report Author</b>	<b>Paul Taylor Chief Accountant</b>
<b>Ward(s) Affected</b>	All Wards
<b>Exempt</b>	No
<b>Corporate Priority</b>	Community Affordable Housing Recovery Environment Service Delivery
<b>Recommendations</b>	<b>Committee is asked to note:</b> <ul style="list-style-type: none"> <li>• that the Council approach (as referenced in Capital Strategy and Reserve Strategy reports) of modelling on a fifty year basis but with more detailed focus and scrutiny on the first twenty years on a rolling basis of sinking fund reserves continues to strengthen Council's earmarked reserves position.</li> <li>• that by successfully implementing the above approach, Spelthorne Borough Council has the highest ratio of usable revenue reserves to Net Revenue Expenditure (NRE) of any district or borough council in England</li> <li>• that subject to Council approval, the Outline Budget analysis indicate that Council will make a £2,988,286 net contribution to the rent equalisation reserve (sinking funds).</li> <li>• that due to the successful redevelopment of the West Wing for affordable rental units, the Council should explore 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 and improve the Council's carbon footprint</li> <li>• that Council remains on track to build up its reserves and protect services and the residents of the Borough.</li> <li>• that officers will review and produce a 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.</li> </ul>

<b>Reason for Recommendation</b>	<b>Effective and sustainable use of reserves is a key element of the Council's Medium Term Financial Strategy</b>
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## 1. Key issues

- 1.1 The continued strong performance from Council's investment property portfolio approach of modelling on a fifty year basis but focusing particularly on the first ten years (now being extended to first twenty years) and adherence to the approach (as referenced in Reserves Strategy and Capital Strategy) 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 relatively strong position. As shown in the unaudited accounts for the year ended 31 March 2021, where Council's approved Earmarked Revenue Reserves (ERR) were £79.5m.
- 1.2 Included 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 the 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 in the total reserves. (This has impacted on the majority of Councils in the UK).
- 1.3 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.
- 1.4 The increase in reserves is due mainly to the adherence to the Council's 20 year sinking fund reserves approach, which is coming to the end of its first five-year cycle and will need to be updated for 2023/24.
- 1.5 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.
- 1.6 A strong performance from Council's investment property strategy over the last five years, which has generated over £10m per annum to support Council services and assist with the regeneration of communities, is only part of the good news story. Whilst the Council has been put into a strong position, there is no room for complacency and Council still needs to have a strong and clear medium term reserves strategy, together with regular monitoring of Council's reserves, as without one, Spelthorne Borough Council could see its reserves, reduce to critical levels in a relatively short number of years, based on officers understanding of the challenges faced there.
- 1.7 Therefore, it is critical that the Council implements a strong Reserves Strategy that continues to strengthen the 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 Council look to invest in and deliver in a variety of transformation projects.

## 2. Background and keys risks

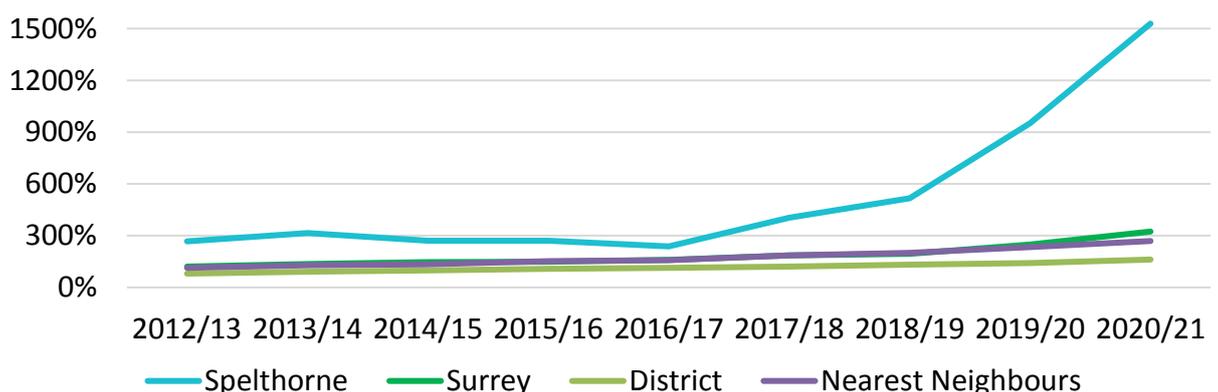
2.1 To assist Councillors, there are three appendices attached to the report that cover:

- (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 Council’s 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). At Spelthorne Borough Council officers took a prudent approach and ensured that as part of the annual Budget recommendation to Council, that a full provision for MRP is charged to revenue expenditure, and as a result, the Council’s finances and reserves are not adversely impacted by this issue. The MRP is then applied annually to ensure the Council gradually pay down the debt on a year-by-year basis.

2.3 Throughout the year, officers in the Finance team, regularly attend external meetings and presentations with the Council’s Treasury Management Advisers, Central Government, Local Government Association, Chartered Institute of Public Finance and Accountancy (CIPFA) and LGImprove who benchmark and provide feedback on the Spelthorne Borough Council’s performance against other Councils. This benchmarking has highlighted that Spelthorne Borough Council, 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 Whilst this is good news, the Council needs to assess this alongside the borrowing figures shown in 2.15 below, as the aggregate loan liabilities are more than £1bn, making the Council highly geared and vulnerable to fluctuations in the day-to-day course of business, hence why the Council needs to continue to build its earmarked reserves (sinking fund) in accordance with the approved strategy.

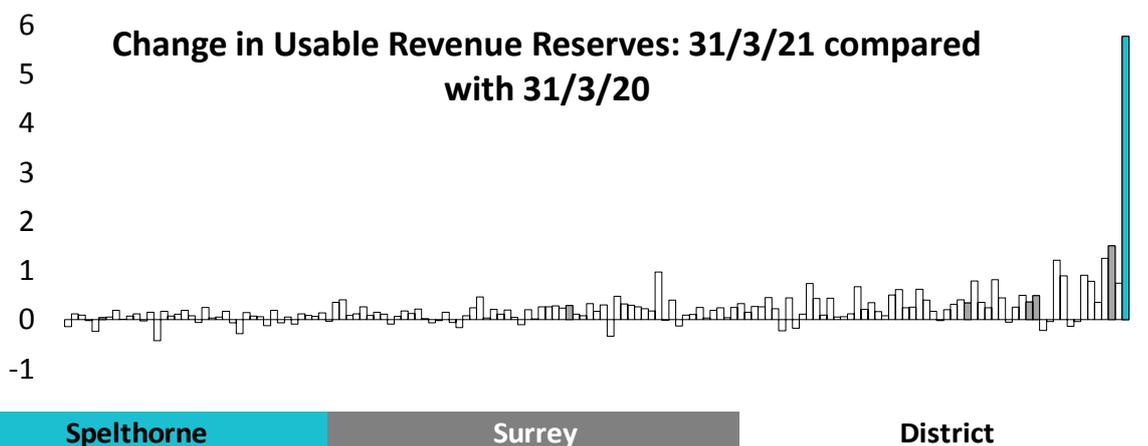
- 2.5 It needs to be remembered that the Councils' approved Revenue Reserves, including the sinking funds reserves are earmarked and set aside for specific purposes and cannot be used for any other purpose.
- 2.6 One of the key messages received is that because of a prudent approach by Council over the last few years, it has been possible to grow and build resilience into the useable reserves, which has allowed the Council to generate additional interest income to support the delivery of services and the regeneration programme.

**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

- 2.7 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.
- 2.8 The current Council approved 20 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, Councillors and officers 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 the reserves strategy remains fit for purpose.

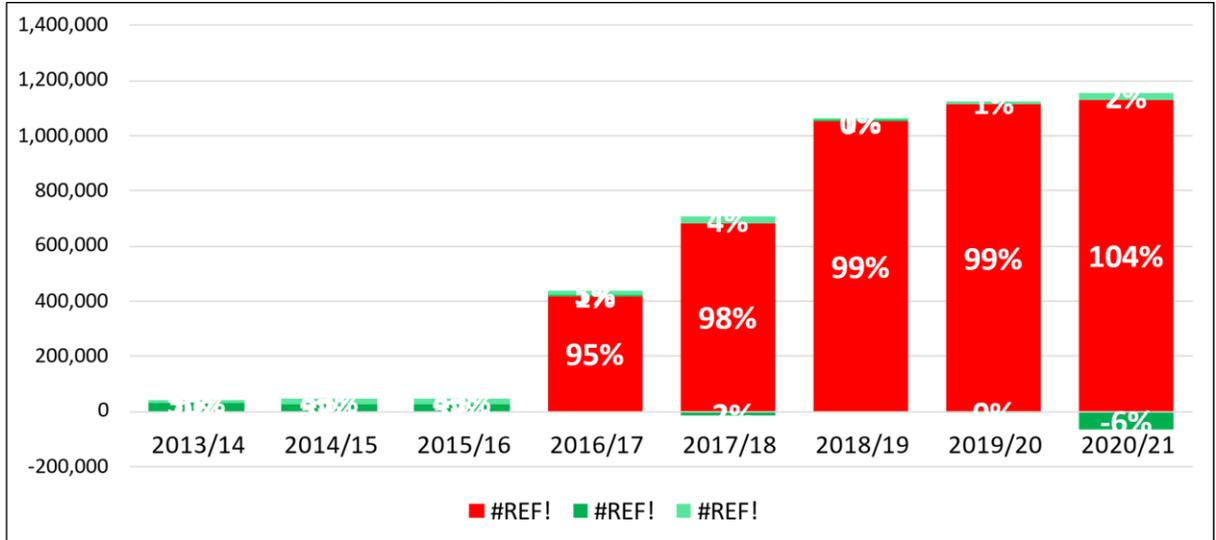
To assist Officers to advise Council and to fully understand the situation, the Council's external advisors have been requested to carry out a bench marking exercise to compare the top 25 Councils who have the largest borrowing, as the current benchmarking exercises compare all Councils in the UK, which is distorting the 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 the 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 the Council must take a medium to long term view on its property portfolio, particularly as the current Capital Strategy highlights that the Council has no intention to sell any of the property portfolio, to third parties. (Noting that the Council will transfer properties to Knowle Green Estates Ltd., a wholly owned subsidiary at cost).
- 2.10 The COVID-19 pandemic is influencing valuations in several ways:
- (a) 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, the Council's 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, officers 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 Council's services, over the next few years, as highlighted during the budget briefing session with Councillors in November 2021, the Council is not 'out of the woods' yet and are facing challenges over the next four years around:
- (a) Shortage of both labour and materials for the approved 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 The next area for officers to monitor closely is the Capital Finance Requirement (CFR) because of the aggregate value of the Council's borrowings to the aggregate value of its property portfolio
- 2.14 The CFR is a measure of the Council's financial health, as shown in the table below which is graphical shown in 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 in £000s**



#Ref = Capital Fin. Requirement

#Ref = Capital Adjustment Acc.

#Ref = Revaluation Reserve

- 2.15 The CFR shows that in 2020/21, because of the paper losses on the property portfolio, the total funding is 104% of the Council's total assets and officers will need to monitor this variable carefully over the next two to five years and advise Council accordingly.
- 2.16 What the impact of 104% CFR means is that book value of the Council's properties are lower than the aggregate of the Council's total borrowings and if all the properties were to be sold 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 the net rental income contributions continue to be maintained, the Council will be able to prudently manage its 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 The 2022/23 budget modelling is showing that the net rental income is holding up, improving considerably after the recent rental increases, and officers 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, particularly as the rent guarantees come to an end in September 2022.

- 2.20 Again, the Council 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 on the use of Council reserves 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 the useable earmarked reserves, was actioned.
- 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. A further paper will come to March 2022 Corporate Policy and Resources Committee on short term cashflow support for KGE and this will also set out a suggested approach to managing longer term repatriation of surplus funds from KGE to the Council.
- 2.25 Subject to any further planning delays on developing Oast House and Thameside projects in particular, the projections indicated that cash outflows to the Council would be small (tens of thousand) in the first five years and once all the properties had been handed over at 31 March 2026, the cash outflows would rise considerably (hundreds of thousand) each year thereafter. This would be subject to an updated financial strategy.
- 2.26 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 rises 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.
- 2.27 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.

- 2.28 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.
- 2.29 Climate change is another area that is going to create a challenge for the Council, as it explores how to reduce its carbon footprint, it is on track to spend an extra £4m, to be the first Council fully mixed dry and wet leisure centre to be fully compliant with Pasivhaus standards, another first for Spelthorne Borough Council and the UK.
- 2.30 The successful development of the West Wing at the Council's Knowle Green offices, where an additional 25 new apartments have been made available for key workers, young families, families from the Council's housing lists 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 the Council's Capital Programme.
- 2.31 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 show 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.
- 2.32 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 the Council's rental properties
  - (e) The requirement for a clear Council led financial strategy for KGE
  - (f) Apart from the General Fund balance, all 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.

### **4. Financial implications**

- 4.1 Appendix D shows the 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 approval of the 2022/23 Budget at their February 2022 meeting Council are looking to utilise the earmarked reserves as follows:
- (a) £150k from the Bronzefield 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 20-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 review of the Council policy on the sinking funds reserves and the wider reserves position, including KGE, the adequacy of its General Fund Reserve and how its 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)