Corporate Policy & Resources Committee

20 April 2022

Title	**Knowle Green Estates – financial contribution to Spelthorne Borough Council.**
Purpose of the report	To note the options available to Council for the repatriation of funds and estimate forecast of cash inflows to Spelthorne Borough Council from Knowle Green Estates Ltd.
Report Author	Paul Taylor Chief Accountant
Ward(s) Affected	All
Exempt	No
Corporate Priority	Community Affordable Housing Recovery Environment Service Delivery
Recommendations	**The Committee is asked to note the options available to the Council for repatriation of funds from Knowle Green Estates Ltd to Spelthorne Borough Council and the estimated potential annual cash inflow.** (Once the final plans for the development properties have received Council approval, officers will revisit this report and submit formal recommendations to the Corporate Policy & Resources Committee for approval).
Reason for Recommendation	This report is to enable Council to understand the estimated annual cash inflows that Knowle Green Estates Ltd., could potentially make to Spelthorne Borough Council, to support services, regenerate the Borough or build new homes for private renters. From the initial plans agreed by Cabinet under the old strong leader model of Governance, the size of the buildings and number of apartments being proposes has reduced substantial on several occasions and the Council has seen the potential cash inflows to the council, as agreed by the Knowle Green Estates Board in June 2021, reduce from approximately £88m to £47m, as at 7 April 2022, meaning that the cash flow projections have almost halved. Noting that the projections included with this report are subject to the final Council approval of the size and height of the remaining development properties as at 7 April 2022 and because of the impact of inflationary pressures currently being experienced with

	building materials and labour in the construction sector, officers anticipate that capital costs for each development will increase costs for Spelthorne Borough Council who in turn will pass on these costs to KGE, who currently have the capacity to absorb them.

1. Key issues

1.1 Knowle Green Estates Ltd, (KGE) was established by Spelthorne Borough Council (SBC) to manage the Council's Housing delivery programme, to provide a mix of affordable homes for our residents and keyworkers, and private rental homes and make a positive annual contribution towards the Council's budget for it to fund its regeneration programme, building new homes and support the delivery of services across the Borough.

1.2 SBC are responsible for building the affordable homes and upon completion they are transferred at cost to KGE.

1.3 In 2021 under the former strong leader model, Cabinet agreed the financial projections (and the proposed tenure mixes were shared with Council) for KGE, based on an affordable housing model, with a small amount of private rental tenants. This is because 100% private rental model consumed to much cash in the first ten years and would require a multi-million pound cash backed investment from SBC in to KGE for it to be viable.

1.4 The projections agreed by the KGE Board in June 2021 indicated that based on the original plans for each property, where maximising returns were the key focus, KGE would have approximately £96.7m in the bank and the balance sheet was in a healthy position with a positive position shown from year end 31 March 2055, and would be able to contribute a seven figure sum to SBC to provide funds to support services, regenerate the Borough and contribute to the development of new housing for private rental market, once it had built up sufficient cash reserves. (NB. the updated projections as at 7 April 2022, (appendices A to C) start from the June 2021 projections and have been updated by the material changes highlighted in appendix D)

1.5 Given the transfer from Strong Leader to Committee Structure mode, Council has not formally agreed a strategy for KGE to confirm the level of profit repatriation from KGE to SBC which could then be used to support the provision of Council services, regenerate the Borough or building new homes for private renters. Since the original projections were prepared there have been long delays caused by the Council approved moratorium and reductions in planned height of the buildings, leading to fewer apartments being constructed and therefore reduced rental income for KGE and the revised projections at 7 April 2022, reflect these changes and the reduction in cash inflows to SBC from KGE to a modest six figure number.

1.6 Officers have reviewed the projections for KGE as shown in appendix A, B and C based on the current plans for all our residential developments particularly the Oast House and Thameside and before any considerations of how KGE will repatriate cash inflows to SBC.

1.7 Appendix D highlights the major changes to the projections agreed by the KGE Board and shown to Council in 2021. With the two significant changes being the £34m capital investment in the Oast House by the NHS and the £1.0m per annum, reduction in rental income from the reconfigured Thameside House.

1.8 HMRC will look closely at the methodology applied because for every pound that KGE pay to SBC, under legitimate avoidance methods, the Public Exchequer will lose currently 19p in corporation tax.

1.9 Council should be aware that from the financial year 2023-24 the corporation tax rate will rise to 25p in the pound

1.10 During November 2021, officers spent a great deal of time, reviewing the financial viability of KGE, Since that time, Council has approved the increased cost of construction for the Leisure Centre and Victory Place, which amounts to £12m., as a result of these additional and the increased monthly costs for delaying these development projects, officers have had to reassess the viability of KGE and SBC together, rather than just KGE.

2. Options analysis and proposal

2.1 There are three legitimate recognised tax avoidance options available to the Council for the repatriation of profits from KGE to SBC and they are summarised in order of priority and based on the current financial structure of the equity, loans, and rental contribution in KGE.

Option 1 – Loan interest margin - the senior method

2.2 HMRC allow group companies to legitimately charge a margin on the loan interest between the holding company (SBC) and its subsidiary (KGE), up to a maximum of £2m per annum, based on reasonable commercial terms for the environment the subsidiary operates in.

2.3 The next element of the equation is, can the subsidiary (KGE) afford it?

2.4 Therefore, officers have spent a great deal of time confirming to Council the viability of each project as far as KGE is concerned, as after the interest rate margin has been paid, KGE must still be able to pay its debts as they fall due in the ordinary course of business, otherwise KGE will not be able to make the contracted payments which would then require SBC to step in as the 100% owner.

2.5 By complying with this legislation, the interest payments from KGE to SBC are fully tax deductible and this reduces KGE's annual corporation tax liability.

2.6 Council should note that depreciation is not an allowable expense for calculating KGE's corporation tax liability, which is why officers focus on the net profit after interest.

2.7 No formal guidance is given on the rate to charge, and officers need to consider each individual property and KGE, as a whole, when it comes to setting the right level of interest rate margin for Council to approve.

2.8 Further, with variable cash inflows, particularly at times of replacement to, for example, bathrooms, kitchens and windows, makes the task even more difficult and in some years, may give rise to KGE requesting additional short-term funding to manage these replacement costs and maintain the loan repayments to SBC, otherwise it could put at risk, KGE's financial viability over the short term, i.e., for twenty-four months.

Option 2 - Management charges – the junior method

2.9 Applying management charges is a recognised method for repatriation of profits from a subsidiary (KGE) back to its holding company (SBC).

2.10 Subject to the amounts charged and for what type of expenditure, HMRC would expect to see detailed time records and a justification for the charge in respect of any employee related costs.

2.11 Both the S151 Officer and the Chief Accountant are reluctant to introduce a time recording system or recruit staff just to record the time spent by SBC for KGE related work.

2.12 This is because the provision of staff and support resources from SBC to KGE is a short-term issue, as KGE will in the next couple of years, recruit and employ its own team, once it has gained a critical mass, which has been delayed by the issues mentioned in 1.5 above, along with delays to Victory Place and Benwell Phase II.

2.13 At present, SBC officers provide an estimate of the split of work between SBC and KGE duties and this is then recharged from SBC to KGE.

2.14 Another area for SBC to consider as a legitimate management charge, is a management fee and arrangement fee, around the level of borrowing and officers strongly recommend that due to the delays with bringing all the development properties on line, the financial structure and loan facilities are reviewed on a regular basis, say every three years and KGE pays a percentage (to be determined) of the loans outstanding, as a business would through a banking relationship in the ordinary course of business.

2.15 This would assist officers when calculating the interest rate margin in option 1 and provide some flexibility to KGE and certainty of cash inflows to SBC.

Option 3 – last resort methodology

2.16 Dividends are a legitimate way of distributing surplus profits from KGE to SBC. However, it comes with one significant draw back.

2.17 KGE can only distribute dividends from the positive profit and loss reserves, meaning that KGE must be making a profit and the Public Exchequer has taken its (current rate) 19% corporation tax (rising to 25% in April 2023), which leaves 81% of KGE’s profit available for distribution.

2.18 Because of the payment of corporation tax this methodology should only be used as a last resort by KGE to pass positive cash inflows to SBC.

3. Financial implications

3.1 Please note that the financial projections included in appendices A, B and C are solely based on the revised capital costs and reconfigurations for our development properties, at 7 April, which are subject to Council’s final approval.

3.2 They do not reflect the detailed changes for each repatriation option mentioned below. Officers are showing the high-level indicative position, based on the options and the impact on the revised projections in the table below 3.20.

3.3 Each option has different financial implications, and is based on each development, as at the 7 April 2022.

3.4 The largest changes are surrounding the Oast House & Thameside House, initially approved by Cabinet for 350 and 120 apartments respectively. Then in the 2021 projections these were revised down to 216 and 140 respectively, now at the 7 April Council is looking at proposals to construct 182 and 104 apartments. Please refer to appendix D.

3.5 This reduction in the number of apartments has consequences for both KGE and SBC.

3.6 In the case of the Oast House monthly rental income has fallen by 8% and for Thameside House by 32% and this has reduced cash flow in to KGE by just over £1m per annum. Coincidentally, the capital investment of £34m by the NHS into the Oast House site reduces our annual cash outflow by approximately £1m per annum. Making the revised projections, almost cash neutral. Based on the current configuration, this indicates that the NHS investment is critical to the current plans of SBC and ultimately KGE.

3.7 This fluctuation and the fact that Council has yet to formally approve the plans for these development projects makes it difficult to provide a definitive answer as to the interest rate margin to be charged by SBC to KGE, or how much SBC should charge by way of management charges or indeed, should dividends be used.

Therefore, detailed below is an indicative interest rate, together with estimated average forecasts of the cash inflows that SBC can expect to receive from KGE on an annual basis, to support services, regeneration projects and new housing throughout the Borough.

Option 1 (as referred to above) – interest rate margins

3.8 Officers will recommend that as well as an interest rate margin, Council approves the establishment of a KGE sinking fund to be held by SBC on its Balance Sheet. This will operate in the same way as the investment property sinking funds, in that each year the net commercial income is fixed at circa £10m and the transfers in to and out of the sinking fund are approved by Council and will smooth out any issues of support to KGE, particularly as it will be responsible for a housing portfolio of £250m (based on cost) with there being years when the Company will need to undertake significant bathroom and kitchen refurbishments in the future.

3.9 This would enable Council to control the flow of funds from KGE, leaving enough to manage its day to day finances and meets its liabilities, with all the surplus funds retained within SBC and covered by their treasury management team.

3.10 Interest would be credited to the KGE sinking fund in SBC accounts, in the same way as the investment property sinking fund.

3.11 This means that by reviewing the cashflows, KGE should retain sufficient funds to meet the main creditor, SBC, when it submits the annual interest and capital repayment invoices in November.

3.12 Therefore, the approach would be to leave a, say, 50% of the multiple of the next payment to SBC, say, twice the annual interest and capital repayments to SBC.

3.13 In the unlikely event that KGE needs more funds than this it would provide officers and Council with a safety valve that something is going astray and needs to be reviewed urgently.

3.14 KGE would have to submit annually in advance detailed plans of its replacement programme together with costings for Council to approve and for the funds to be released back to KGE, again, another control mechanism to provide Council with the assurances it needs that everything is on plan at KGE.

3.15 Therefore, for this exercise and subject to a review once all the plans for the remaining development properties have been approved by Council, officers are recommending that on average from 31 March 2027, KGE bank balances does not exceed £13m at 31 October each year, made up of £8.7m of annual capital and interest repayment, due out in November each year, multiplied by a factor of one and a half.

3.16 This is because KGE currently pay its capital and interest annually in arrears and is an area that officers will be reviewing once Council has approved all the development properties, and this is something that officers can review and make recommendations to Council, after this exercise has been completed.

Option 2 – management charges

3.17 The projections would indicate that on a regular basis, SBC should charge KGE an arrangement fee and a figure of between £125-175,000 per annum should be achievable once all the development properties are built, transferred to KGE at cost and fully occupied, which is anticipated to be from 1 April 2026, as the last property is due to be transfer under practical completion in February 2026.

Option 3 – dividends

3.18 Based on the revised projections, KGE will not have positive cumulative profit and loss reserves until September 2067 and therefore will not be able to pay any dividends.

3.19 Further, the increase in the interest margin and the management charges indicated in 3.7 and 3.8 above would further reduce the positive profit and loss reserves and therefore, officers are ruling this approach out until after 31 March 2074.

Summary of annual cash inflows to SBC

3.20 Based on the figures above, the table below shows the forecast consolidated cash flow position on SBC for the 50 years. The options are not mutually exclusive and it is possible to use a mixture of all three options, subject to the comments made in section 2 above.

	Impact on SBC **£**	**Impact on KGE** **£**	**Consolidated impact** **£**
Closing KGE bank balance per revised projections at 31 March 2072.	0	47,239,380	47,239,380
Option 1 – estimate interest margin leaving £13m average closing balance in KGE (2.2 to 2.8 above refers)	26,500,000	-26,500,000	0
AND (not mutually exclusive)			

Option 2 – estimated £150k p.a. management fee (2.9 to 2.15 above refers)	7,500,000	-7,500,000	0
Option 3 – dividends (2.16 to 2.18 above refers)	0	0	0
Revised bank balances after adjusting for profit repatriation	34,000,000	13,239,380	47,239,380

This would result in an annual average cash inflow to SBC of £680,000 of which officers be suggesting to council that between one quarter and a third, i.e., £170-225,000 is charged to the KGE sinking fund, leaving between £455-510,000 per annum available to support services, for regeneration projects or building new homes, within the Borough.

Risks

3.21 Council has already seen a significant increase in the capital costs of construction with the current annualised interest rates ranging from 15-22%. Should there be further delays to the construction of the projects, this will increase the burden on KGE, and would result in the interest margin adjustment having to be reviewed downwards to rebalance the cash flows within KGE, to ensure that it remains viable and can meet its debts as they fall due in the ordinary course of business.

3.22 These figures are subject to Council's final approval on all the remaining unapproved development projects.

4. Other considerations

4.1 The projections agreed by the KGE Board in June 2021 showed a closing cash balance of £91.8m as at 31 March 2071.

4.2 The major factors changing the projections from June 2021 to the revised projections (7 April 2021) are as follows:

	£m savings (costs)	**£m**
Closing cash balance from KGE Board approved projections (June 2021)		96.7
Reduction in housing rental income (appendix D)	(51.4)	
Reduction in commercial rental income (appendix D)	(32.3)	
Capital contribution from the NHS (1.7 above)	34.2	
Subtotal of savings (costs)		(49.5)
Closing cash balances 7 April 2022 £m		**47.2**

5. Equality and Diversity

5.1 In meeting the housing needs of local residents and by utilising the surplus funds for the benefit of most of the residents in the Borough, these proposals meet with the Council's requirements for equity and diversity.

6. Sustainability/Climate Change Implications

6.1 Whilst these proposals do not impact on the sustainability and climate change, they will provide SBC with the funds required to support service and regeneration initiatives that do.

6.2 Further, the development properties are being designed with the environment and current fuel crisis in mind, for example, the installation of heat pumps, within our latest property to be approved at Victory Place. We fully expect to see further changes that will benefit the environment into the remaining properties once approved.

7. Timetable for implementation

7.1 The above information is indicative at this stage as Council is yet to approve the building height for several development properties and therefore, the due to the current uncertainty, officers are recommending that this is implemented from 1 April 2027.

7.2 Proposal also to go to the KGE Board in April 2022

Background papers: There are none.

Appendices:
Appendix A – Projected cashflow for the 50 years ended 31 March 2072 as at 7 April 2022
Appendix B – Projected profit and loss account for the 50 years ended 31 March 2072 as at 7 April 2022
Appendix C - Projected balance sheet for the 50 years ended 31 March 2072 as at 7 April 2022
Appendix D – Summary of the major changes in assumptions between the projections agreed by the KGE Board in June 2021 and circulated to Council and the revised position as at 7 April 2022, which is subject to final approval from Council.