

# Council

8<sup>th</sup> December 2022



<b>Title</b>	<i>Council's Response to Public Interest Report</i>
<b>Purpose of the report</b>	To make a Decision
<b>Report Author</b>	<i>Daniel Mouawad Chief Executive, Terry Collier Chief Finance Officer, Farida Hussain Group Head Corporate Governance</i>
<b>Ward(s) Affected</b>	All Wards
<b>Exempt</b>	No
<b>Exemption Reason</b>	N/A
<b>Corporate Priority</b>	This item is not in the current list of Corporate Priorities but still requires a Full Council decision.
<b>Recommendations</b>	<b>Council is asked to:</b> <ul style="list-style-type: none"><li>• <i>To note the External Auditors' Report</i></li><li>• <i>Agree the response to the report and the five recommendations made in the Report</i></li></ul>
<b>Reason for Recommendation</b>	<i>As a Public Interest Report has been issued the Council needs to consider the report and agree a response.</i>

## 1. Summary of the report

- 1.1 This report sets out the Council's response to the Report in the Public Interest under Schedule 7 of the Local Audit and Accountability Act 2014 ("the PIR") attached as Appendix A, by the Council's external auditors KPMG, relating to discrete aspects of three commercial property acquisitions by Spelthorne Borough Council ("the Council") in the financial year ended 31 March 2018. The PIR addresses certain legal, financial and governance issues in relation to the three acquisitions, from which it then seeks to draw inferences as to the implications of the acquisitions for the Council's "overall finances" (not defined) (paragraph 1.1. of the PIR). The report makes 5 recommendations which this report addresses.

- 1.2 The three acquisitions were of 3 Roundwood Avenue, Stockley Park in July 2017 for £21.4 million ("Roundwood"); World Business Centre 4, Heathrow in September 2017 for £47.2 million ("WBC4"); and Hammersmith Grove in January 2018 for £160 million ("Hammersmith"). All three properties were funded through loans from the Public Works Loan Board with (in summary) the drawdown of the funding being in each case 2 days before completion with interest rates fixed on a long-term basis and financing paid down on an annual basis over 40/50 years.
- 1.3 The Council has over the years, consistently adhered to senior legal advice provided by James Goudie KC, in respect of all commercial property acquisitions and considers that in places within the PIR report, the comments are selective and do not make reference to directly relevant material (including the Council's Sinking Fund methodology). The comments appear speculative, and in places makes subjective commentary including on property transactions which were not part of the 2017/2018 financial year. James Goudie KC, a Leading Silk in Local Government Law, has been the Head of 11 Kings' Bench Walk Chambers since 1997 and is well known to be reputable in advising on local government matters.
- 1.4 The Council considers such references do not accurately reflect the view of matters relating to the acquisitions of Roundwood, WBC4, and Hammersmith, which are properly the subject of the PIR. Specifically, in this regard, the PIR refers to an acquisition made by the Council in 2016/2017 (the BP Campus), which was the subject of separate commentary in KPMG's audit of the Council's 2016/2017 financial statements. KPMG only signed off its audit/value for money report in relation to 2016/2017 on the 19 February 2019, after the conclusion of the 2017/2018 financial year. Such commentary could not, therefore, have influenced the Council's approach in 2017/2018.
- 1.5 For completeness, it should be noted that the Council has complied with the recommendations in KPMG's 2016/2017 value for money report. It was only the indication that the wider modelling should be over a 50 year as opposed to a 20-year period that was brought to the Council's attention prior to the issue of 21 January 2019 draft value for money statement issued by KPMG, and this was addressed.
- 1.6 This report explicitly addresses the recommendations set out in the PIR, with the issues of Legal, Finance and Governance fully covered, and demonstrates that the Council are already meeting the recommendations and sets out how the Authority continue to follow best practice. On that basis the Council has no difficulty accepting the recommendations as laid out in the PIR.

## **2. Key issues**

### **Legal Issues**

- 2.1 At paragraph 1.6 of the PIR, "In our view, supported by the advice of King's Counsel, the Council acted unlawfully in borrowing and then purchasing the three properties in 2017/18." The Council proceeded with its acquisition of Roundwood, WBC4 and Hammersmith on the basis of advice from King's Counsel, James Goudie, to the effect that the acquisition was intra vires. The Council's position is that in so doing, it acted wholly reasonably and conscientiously in any event. It is somewhat disingenuous and inappropriate

that the PIR report only refers to the Auditors King's Counsel's advice at the outset and refrains from referencing the Council's similarly authoritative advice from James Goudie KC, until considerably later in the document (paragraph 4.5.4). It is not correct to suggest as the PIR does in 4.1.1 that the Council did not seek legal advice from its KC as to whether the advice applicable for the 2016/17 transaction was equally applicable for the 2017/18 transactions - the advice the Council received categorically stated it was.

- 2.2 To the extent that the legislation and statutory guidance over the intervening four year may lead to more than one interpretation, as appears to be the case here, the Council feels that where the auditors have been provided with the legal advice supporting the Council's interpretation it is not open to the auditors to resolve and declare whether summarily or otherwise, that the Council has acted unlawfully.
- 2.3 Contextually it should be noted that at no previous point did the Auditors indicate in relation in their audit of the Council's 2016/2017 financial statements express any concerns relating to the lawfulness or otherwise of the acquisition of the BP Campus, in circumstances no different from those pertaining to 2017/2018 (no change in the regulatory regime between 2106-17 and 2017-18). Whilst the acquisitions in 2017/18 were as the Report states outside the Borough Boundary they were all within the local Heathrow functional economic area with the furthest investment (Hammersmith Gove) being 14 miles from the Council offices.
- 2.4 The Annual Audit Letter 2016/2017, in which KPMG issued recommendations were limited, in summary to: document trail, costing and financial analysis, publication in line with reg 13 of the Access to Information Regulations and proportionality of investments to be considered. There was no indication then nor in KPMG's report issued in February 2019 to the Audit Committee, that KMPG had any concerns as to the legality of the transactions.
- 2.5 The Auditors state that they are not proposing to apply to the Court for a declaration pursuant to s28 of the Local Audit and Accountability Act 2014; at paragraph 1.9 of the PIR, the Auditor refers to a "*number of developments*" since 2017/2018 which have informed the Auditor's decision to make a public interest report rather than seek a declaration from the Court that "*the Council acted unlawfully*". The developments since 2017/2018 which appear to have persuaded the Auditors not to make such an application, are:
  - (a) that the Council, while it disagrees with KPMG's legal analysis, "*has since brought its policy of borrowing to invest in commercial property to an end*". To the extent that the Auditors seek to identify a link between their legal analysis and the Council's then ceasing to invest in commercial property, that is wholly mis-placed, as it was an evolving strategy which determined that-decision along with a clear view as to how much target income the Council was seeking to generate. The Council had a clear strategy as set out in the Capital Strategy approved by Council in February 2019. From the outset the objective was to protect services by offsetting loss of Government grants and rebuild resilience but then to focus the asset expertise of addressing housing delivery and regeneration. In any event, the Council's financial and investment strategy post 2017/2018 is irrelevant to the assessment of

whether any item of account in the 2017/2018 financial statements is contrary to law;

- (b) an update to the "*relevant guidance discussed in this report*" to make it clearer that local authorities should not borrow more than or in advance of need purely to profit from the extra sums borrowed. Again, the Council consider that this is wholly irrelevant to the assessment of whether any item of account in the 2017/2018 financial statements is contrary to law, save only that it favours the Council's interpretation of its legality (vires), as supported by the advice of King's Counsel at the time of the acquisitions;
  - (c) a change to the terms of borrowing from the PWLB "*which essentially prohibit local authorities borrowing from that source for the purpose of acquiring assets to make a profit.*" Again, the Council consider that this is wholly irrelevant to the assessment of whether any item of account in the 2017/2018 financial statements is contrary to law, save only that it illuminates that the Council's contemporaneous interpretation of the terms of borrowing from the PWLB was not unreasonable. As has been clarified from Government sources, Councils can still invest in maintaining investment assets which were acquired in the past i.e. before 2019.
- 2.6 In a situation where the Auditors have decided not to make an application to the Court but prefer to make a public interest report asserting that the Council has acted unlawfully, fairness and transparency require the inclusion in the PIR of a proper exposition of the Council's position on the legal issues, not just the Auditor's views, understanding and interpretation. The Council's King's Counsel maintains that the Council acted lawfully in relying on section 120(1)(b) of the Local Government Act which specifically authorises acquisition of land, including expressly outside the authority's area for the "benefit" of the authority's area. There is a difference of opinion between the Councils and Auditors King Counsel on the interpretation of "benefit". Until such time that the interpretation of this term is tested through the courts, it remains subject to differences of opinion.
- 2.7 Since issuing the PIR, the Council has sought further advice from James Goudie KC on the legal matters raised therein. King's Counsel maintains that he considers that the investments purchases made in 2017/18 were lawful and is "unpersuaded by the legal arguments made by KPMG in the PIR".

### **Finance Issues**

- 2.8 The Auditors PIR (1.8 a) correctly state that the Council has been able to meet its loan repayment commitments from the rental income it has received though negate in communicating the full case – the Council has been covering not only financing costs, management costs but also making an average contribution of £10m towards the Council's revenue budget as well as making an annual setting aside averaging £7m per annum into Sinking Fund Reserves and paying the loan off on annual basis plus covering the interest costs. Clearly in the shorter term the Council should still be able to meet its loan repayments, but the auditors say that it is not clear whether this can be maintained, and that the

reason for Auditor's uncertainty is the "*lack of sophisticated analysis contained in the Council's financial models that it has developed.*" However, the report outrightly fails to acknowledge, as part of the Council's risk mitigation strategy it has additionally been setting aside, each year part of the rental income to build up sinking fund reserves to provide a safety net against any future dips in income, by the end of 2021/22 the Council's sinking fund balances were £34m.

- 2.9 The Council consider the position as set out in paragraphs 5.1 and 5.2 is broadly correct, subject to two observations, that it ought to have been acknowledged: (1) the assets have been purchased in the expectation that they will be held for a very long time, potentially at least 50 years. Accordingly, short term fluctuations in land value caused by a temporary factor such as the pandemic is less of a concern. In the long term, it is reasonable to expect that land values will appreciate; and (2) in the year after any property acquisition it is common practice to include a significant write-down on the balance sheet of the capitalised costs associated with the purchase such as stamp duty, legal and adviser fees.
- 2.10 **Paragraph 5.4:** the criticisms lack specificity, and rest on generalisms or speculation, so it is difficult to provide a comprehensive response.

The Council do not accept that the models were simplistic (PIR paragraph 1.8 a), although it is true to say that they became more sophisticated post 2017/2018. We note that Auditors commented to our Audit Committee during the process of the 2016/2017 audit that although the model for BP was relatively simple it was appropriate as the transaction was simple. We would state that the same can be said for both WBC4 and Roundwood. The more complex modelling for Hammersmith is addressed below.

- 2.11 As the Auditors acknowledge unlike a lot of other councils, the Council is paying debt off annually and not relying on future receipt to pay off. The Council has prudent Minimum Revenue Provision (MRP) arrangements. However, the PIR is incorrect in asserting that:
- "*No rental growth factored into most of the models. Normally a commercial real estate investor would model the lease terms agreed to forecast the revenue.*"

Our models for 3 Roundwood Avenue and World Business Centre 4, allow for 1.50% annual rental growth (base case) and 0% rental growth (worst case). Similarly, the model for 12 Hammersmith Grove allowed for 1.80% annual rental growth (base case) and 0% rental growth (worst case). These rental growth forecasts were provided by the Research department of JLL and are location/asset specific.

To demonstrate the effect of the Council deliberately erring on the cautious side with respect to assuming rental growth, for BP the Council assumed 1% per annum average growth whereas in fact for first five years actual was just over 2% per annum which has resulted in a much larger initial indexation uplift than we allowed for. For some of the sites we did not assume rental growth. Furthermore, the PIC clearly is incorrect in its further assertions, namely *"The Council's estimated rental value and rental value at renewal are hardcoded directly into the models and the logic behind the assumptions is not apparent. There also appears to be an inconsistent approach between the various financial models. Commercial property investors would normally undertake a consistent approach based on statistical analysis rather the one [sic] the council has taken."* and

*"The Council's financial models assume that tenants will not exercise their break options. Typically, it is common that some tenants will exercise their break options."*

Roundwood Avenue is the smallest of the three transactions and represents a very small percentage (1.91%) of the Council's portfolio in terms of asset value. WBC4, like BP does not have any break options. Hammersmith represented the first truly multi-tenanted property. Cushman & Wakefield ("C&W") provided considerable analysis on multi-tenant schemes and fed that into the model. With Hammersmith due to the multiplicity of tenants the Council additionally sought the advice of Deloitte on the robustness of the tenants (and this practice has continued).

Appropriate risk consideration has been taken into account. Specifically, break options were assumed to have been operated at the earliest opportunity by both tenants at 3 Roundwood Avenue in both our Expected and Worst-Case scenarios. At 12 Hammersmith Grove, where there are limited break options, we have modelled for void when leases expire at the earliest opportunity.

It is generally accepted that multi-tenanted property investments allow greater scope for capturing rental growth than single let assets, due to the amount of lease events and ability to drive rents forward based on other lettings/settlements in the building. This is a deliberate element of the Council's diversification strategy.

The robustness of the Council's approach has been demonstrated by the performance of the portfolio during this pandemic. There are no rent arrears for Roundwood and WBC4 and for Hammersmith there is only 2% of the rent outstanding but with rent deferral provisions in place. Over the whole of the Council's portfolio there was only £10,000 out of £50million rental income written off during 2021/22 and none outstanding as at the end of the 2021/2022 financial year.

- *"The Council has assumed a void period of 12-15 months for a 10-year lease. According to Avison Young the convention would normally be for*

*a 12-24 month void period for a 10-year lease. The Council could be overestimating its income."*

Our more recent financial cashflows for 3 Roundwood Avenue and 12 Hammersmith Grove allow for 15 months letting void and 24 months' rent free on 10-year leases. For WBC4 we have allowed 12 months letting void and 12 months' rent free (Expected Case) and 18 months void plus 24 months' rent free (Worst Case). These assumptions have already been provided to KPMG.

- *"The Council assumed a rent-free period of 12-24 months for a 10-year lease. According to Carter Jonas, in their London office rent and period guide - Q1 2020, most 10-year leases had a rent-free period for 19-25 months especially for a space above 5,000 sq. ft. Again, the Council could be overestimating its income."*

The Council is surprised by the inappropriate reference to the Carter Jonas guide as that is focused on central London submarkets and does not offer any commentary on the Thames Valley/Western Corridor, where the Council's assets are located. The report quoted is also produced by Carter Jonas' Tenant Representation department and is a tool for generating new business from occupier clients seeking to relocate within Central London.

As stated above, the market has shifted since C&W reported on acquisition. For lettings of quantum, i.e. 20,000 sq. ft and above, we would expect rent free periods to be up at 40 months' for a 10-year term. However, we are transacting at around 17- 22 months for a 5-year term certain and between 21 - 32 months for a 10-year term at present.

- 2.12 **Paragraph 5.5:** It is stated in general terms at paragraph 1.8 that the Council "does not follow industry best practice, we are concerned whether appropriate comparisons have been made". The auditors have not evidenced their comparison source, but we would suggest that IRRs are less relevant to a Council due to our position as a long-term investor focused principally on income return (main purpose was to generate surplus income to offset the loss of grant funding and to support service provision for residents). In any event, it is difficult to draw comparisons as there are only a few office focused funds that publish data. Most UK Balanced Funds reported 5 year returns of between 4.1% and 11.4% (as at Sep 21), although the higher end reflects specialist Charity funds which enjoy a SDLT saving. If we were to calculate our IRR over a similar short-term period from purchase, then the returns would be higher. The point is that a 3-5% IRR over a 20-year period factors in volatility over the shorter term.
- 2.13 The Council has included within its set aside calculations, which have been provided to the auditors, management costs, voids, break periods, MRP and refurbishment costs at the end of lease.
- 2.14 IRR is a money weighted calculation whereas a Total Return is time weighted, so this is not comparing like with like. Also, the Council have deliberately not factored in capital growth into the exit yield, so the IRRs are conservative. That reflects the conservative and risk averse nature of our assumptions.

- 2.15 **Paragraph 5.6:** The Council is looking to hold the assets on a long-term basis for at least the duration of the financing period. Whilst true the original BP model only modelled 20 years (this was supported by C&W 20-year site options report) in light of the representation from KPMG, in 2020, we subsequently revised our models to work on a 50-year basis. A commercial real estate investor would be highly unlikely to ever achieve a loan fixed for 50 years. As stated above the Council has taken a conservative approach to sinking funds reserves and furthermore to date the Council have not factored in the reversionary value of land in the future
- 2.16 **Paragraph 5.7: Contrary to the PIR assertion,** the Council has taken into account the future potential of the sites (possible residential potential at the BP site) and have fully considered voids in the letting of those sites which only lend themselves to office provision. The Council has taken into account that the credit rating of leaseholders can fluctuate over time. This is one of the reasons for investing in some multi-let buildings to diversify risk; the Council has spread the risk of only having single tenant occupied premises.
- 2.17 **Paragraph 5.9-5.11:** The Council consider that the Auditors may have misinterpreted the cashflow, which highlights income in real terms but then in the PIR at paragraph 5.9 this is expressed as income on a net present value basis discounted at a rate of 3.50% as recommended by the HM Treasury Green Book as guidance for appraising government projects, policies, and programmes. The Council has made these investments for good reason for the running of the Borough: the rental performance of these investments during Covid 19 has been strong. We would welcome, as previously sought, information from the Auditors as to the details of the source benchmark for the figures in 4.11 of the PIR.
- 2.18 **Paragraph 5.12:** To date, in spite of the pandemic and, the Council collected in 2021-22 99.98% of rent invoiced across the whole investment assets portfolio. This clearly demonstrates the robustness of the assets acquired. It is considered that the location of these assets outside central London and sitting atop major transport interchanges has contributed towards retaining tenants and rent payment levels during this period.

### **Governance Issues**

- 2.19 Paragraph 6.1 summarises KPMG's outdated criticisms of governance arising from its audit of the Council's 2016/2017 financial statements. Paragraph 6.2 asserts "*similar weaknesses*" in relation to the 2017/2018 investment property acquisitions: "*the record keeping remained poor and long-term loans (50 years) were used to purchase the properties. A key difference for the 2017/18 investment property purchases, is that the lease terms are significantly shorter than the 20-year BP lease.*"
- 2.20 It is acknowledged that the leases are shorter for the subsequent acquisitions compared to the BP acquisition. At purchase Roundwood provided a weighted average unexpired lease term of 9.28 years, WBC4 was 15 years and Hammersmith one of 13 years. It should be noted that Roundwood represents a 1.91% share of the portfolio.
- 2.21 KPMG did not, in fact, complete its audit of the 2016/2017 financial statements, and present its associated, final recommendations, until 19 February 2019. However, in response to the earlier 21 January 2019 indications from KPMG



as to the likelihood of such recommendations, the Council actively addressed some years ago its relevant governance processes as follows:

- Weekly review of performance of acquisition, progress of developments, and evaluation of possible acquisitions commenced firstly from October 2017 as part of an expanded Corporate Management Team meeting and then subsequently by a separately weekly scheduled senior officer Development and Investment Group (DIG) on which sits the Chief Executive, Monitoring Officer, Chief Finance Officer, Deputy Chief Executive, Property and Development Manager, Group Head for Regeneration and Growth, Housing Policy Manager, Development Manager. The DIG meetings commenced 9<sup>th</sup> April 2018
- Monthly meetings of Investment and Property Committee on which Leader and Finance Portfolio Holder sat, to review and discuss investments performance of investments and developments and to consider and evaluate possible acquisitions and whether to put forward to Cabinet for consideration. The Investment and Property Committee meetings commenced 6<sup>th</sup> February 2018. This committee is no longer in existence, but with a change to the Committee System of governance and to monitor the impact of COVID-19 on the investment portfolio a fortnightly meeting now takes place with senior officers and the Leader/Deputy and the Chair and vice-Chair of the Development Sub-Committee - the Assets Portfolio Working Group.
- The Council has significantly expanded its in-house professional and commercial property expertise, bringing in a number of staff with significant commercial property experience both with respect to acquisitions and developments and with respect to managing property funds. The Council appointed its Property and Development Manager on 3 July 2017, and its Asset Manager on 19 February 2018
- The Council brought in (November 2017) additional advisers to provide a second opinion on lead advisers advice and to produce reports on the financial robustness of tenants in potential acquisitions. Periodic update reports on the health of tenants in acquired assets are produced. More regular updates can be provided where necessary.
- The Council has subscribed, since January 2018, to S&P's credit rating database (and subsequently Dun & Bradstreet) and set up watch lists for its tenants to alert it to any deterioration in the health of its tenants. Where there is any deterioration the potential impact of this is reviewed by the internal team.
- Quarterly performance review reports have been produced since August 2018, on the Council's overall investment portfolio.

2.22 The auditors are misplaced in asserting that *“by investing over £1 billion in property through borrowing the Council has established itself as an institutional investor with a large investment portfolio.”* This is particularly apparent with the reference in 6.4 to the Chartered Financial Analyst (“CFA”)

Institute, and the processes for which it advocates, which are applicable to private sector enterprise. The CFA reference is wholly mis-placed in the context of borrowing by a public body from the PWLB, the main lender to local government. The Council are subject to its own all-encompassing legislative regime governing the actions it takes including the Local Government Act 1972, 2000, the Localism Act 2011, the Local Government Finance Act 1988 and 1992 and numerous regulations and guidance which come from such primary legislation. The Council has acted in accordance with all relevant provisions (the legality (vires) being confirmed by the Council's KC advice).

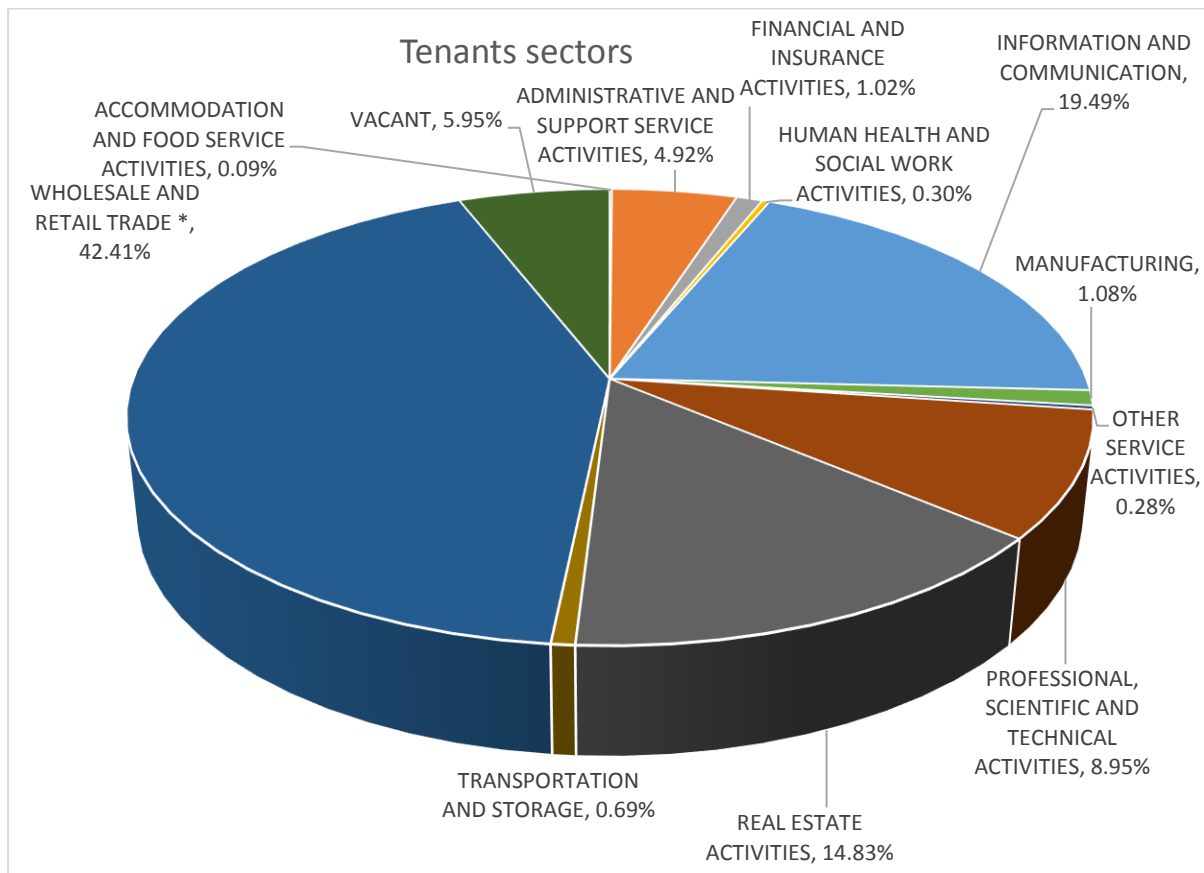
**Specifically:**

- 2.23 The Council had a defined Treasury Management Strategy (recommended by Cabinet on the 25 January 2017 and approved by the Council on the 23 February 2017) and on the 12 December 2017 the Cabinet approved a set of Property Investment Strategic Parameters. These were not required to be approved by Council. These strategic parameters were publicised and presented to the Council's resident associations, MHCLG, National Audit Office etc. In summary, the strategy comprised: a clear focus on investment within the Heathrow functional economic area, to align with the plans for LHR's growth as an area of economic generation extending from Reading to Hammersmith; seeking to diversify tenants by sector; avoiding risk sectors such as retail (in this regard, we note that although the Council has subsequently purchased the Elmsleigh Shopping Centre, it did so by way of regeneration strategy).
- 2.24 The Council has refined its record keeping and reporting mechanisms as stated earlier in this report.
- 2.25 It is clear that the 2017/2018 acquisitions are, not just appear, profitable. The Council is making a surplus after all costs and considerable sinking fund provisions (£5-£9 million per annum) have been made.
- 2.26 There is not a lack of diversification in the investments – although all three of the purchases are office accommodation these are multi-sector and diversified within that office market with Hammersmith being truly multi-tenanted, Roundwood with just 2 tenants and WBC4 a comprising single tenant without a break clause. The Council deliberately did not seek to stray from its core geographic area which it understands. The Council's lack of exposure to other asset classes, (i.e. retail) has, on balance, served it well since acquisition. All Property Total Returns during the 12 months to Q4 2020 were - 2.3% compared to the South East Office return of -2% (-12.4% for retail). MSCI/Investment Property Database is forecasting total returns of 5.1% for offices in 2022 (5.3% All Property and 4% retail) and 5.2% in 2023 (5.1% All Property and 4.3% retail). As a consequence of investment portfolio returns and the expansion of its internal asset management capacity, the Council is better able to progress with residential development (Benwell House, Victory Place and Thameside House) that will, in turn, add further diversification going forward.

**Investment Portfolio - % of rental value by industry sector**

<b>SECTOR (by standard industrial classification - SIC codes)</b>	<b>Percentage</b>
ACCOMMODATION AND FOOD SERVICE ACTIVITIES	0.09%
ADMINISTRATIVE AND SUPPORT SERVICE ACTIVITIES	4.92%
FINANCIAL AND INSURANCE ACTIVITIES	1.02%
HUMAN HEALTH AND SOCIAL WORK ACTIVITIES	0.30%
INFORMATION AND COMMUNICATION MANUFACTURING	19.49%
OTHER SERVICE ACTIVITIES	1.08%
PROFESSIONAL, SCIENTIFIC AND TECHNICAL ACTIVITIES	0.28%
REAL ESTATE ACTIVITIES	8.95%
TRANSPORTATION AND STORAGE	14.83%
WHOLESALE AND RETAIL TRADE *	0.69%
VACANT	42.41%
	5.95%

\* includes BP International Ltd



2.27 There is an assertion that there is a high asset concentration with four investments exceeding 80% of the value of the portfolio, thereby increasing the risk of the portfolio. This wholly ignores the fact that some of the properties have space for multiple tenants and are rented out to tenants in several different sectors, which reduces risk. This also ignores the fact that the Council has set out strategic parameters (Cabinet 12 December 2017) as to the types of investment it would make, and these properties fit within those parameters.

2.28 The Council established a dedicated Asset Management Team in 2017/2018 and appointed a Property & Development Manager (with explicit expertise in Heathrow market related acquisitions) in the same year (3 July 2017) an Asset Manager on 19 February 2018 then followed two further Property & Asset Managers in 2018/2019 and 2019/2020. All, but one, are chartered surveyors, including a RICS registered valuer, bringing over 90 years' combined experience in the commercial property sector from different sources: fund management (ING), investment and asset management (JLL/Carter Jonas) and property management (JLL). Roundwood was the lowest value and simplest of the three transactions made in the 2017/2018 period but before the WBC4 transaction the Property & Development Manager was in post and with his Heathrow commercial background played a particularly important role in that transaction and that of Hammersmith. To support the in-house team, the Council has engaged professional advice from: Cushman & Wakefield (acquisitions, property management, facilities management, building surveying), Clyde & Co (legal), Carter Jonas (valuations), JLL (property and facilities management, leasing, rating), Marsh (insurance brokerage), Deloitte (audit, financial covenant analysis), Knight Frank (leasing), CBRE (leasing), Landid (Asset Management support) and Lambert Smith Hampton (leasing). For the 2017/2018 transactions specifically the Council relied on advice from

Cushman & Wakefield for the acquisition advice (including modelling, viability, negotiation and building surveying), and Deloitte for financial covenant analysis on Hammersmith and going forward.

## **Responses to the Recommendations**

2.29 A general point, though it may best be placed here before we systematically go through the recommendations - namely, that this report has been released more than 4 years after the audit year in question and consequently, we are able to confirm that we accept the recommendations wholeheartedly as we have already been attending to these very matters for some years!

2.30 **4.1.2 Recommendation: The Council should obtain legal advice on its powers to enter into specific transactions where those transactions are unusual or high value.**

Agreed. The Council will always obtain legal advice as to its powers to enter into specific transactions where those transactions are unusual or high value or the regulatory regime relating to that type of transaction has changed recently. The Council obtained their KC's advice prior to purchasing the BP site in 2016. In 2017-18 whilst the regulatory regime was unchanged from that applying in 2016-17 when the Council purchased the BP site, we consulted the KC to check whether any additional legal issues to be considered as a result of the purchases being made slightly outside the Council boundaries (furthest distance being approx. 14 miles). The KC confirmed that the advice provided for BP acquisition equally applied.

Moving forwards the Council will continue to obtain legal advice when undertaking transactions (it ceased acquiring investment assets in 2018).

2.31 **4.1.3 Recommendation: Officer reports should clearly identify the legal powers relied on in relation to decisions or transactions and ensure that decision makers are aware of the relevant legal test to lawfully exercise those powers.**

Agreed. All reports to decision making committees or Council include a section titled "Legal considerations" which clearly set out the legal basis for the recommendations proposed and highlight any legal risks.

2.32 **4.7.7 Recommendation: The Council should ensure that it has regard to all relevant statutory guidance, including specific aspects of that guidance that apply to particular decisions or transactions, and specifically record its reasons for departing from such guidance if it decides to do so**

Agreed. The Council has always had regard to all relevant statutory guidance seeking relevant expert advice and will continue to do so. It will in future more clearly record reasons for departure. Note moving forward the Council's Capital Programme and Capital Strategy is focused on ensuring that all capital spend is consistent with the revised terms of the Public Works Loans Board and the CIPFA Prudential and Treasury Management Codes.

**2.33 Recommendation: The Council should develop its investment property portfolio modelling to bring these in line with the expected practice of an institutional investor. This should include robust stress testing and sensitivity analysis which incorporates scenarios that cover the highest level of risk for expenditure, revenue, tenant behaviour and external socio-economic factors. Consideration should also be given to the diversification of the portfolio and whether this should be addressed over medium to longer term.**

Agreed. Since the commencement of the Pandemic, the Council has been refreshing and reviewing on a weekly basis scenario modelling on a worst case and expected case basis to assess the adequacy of its sinking funds reserves. It is notable the PIR report omits to make any reference to the Council's use of Sinking Funds reserves as its key mitigation measure against the risk of not being able to cover financing payments at any point in the future.

The Council sought to invest within the borough and close to the Borough within the Heathrow Economic Functional area which it understands well and which drives the prosperity of the Borough. This is the rationale for the geographic concentration of the portfolio. Whilst the Council is managing a small number of investment assets it has a considerable number of tenants who are operating across a wide range of economic sectors this is monitoring in the investment reports. There is therefore considerable diversification by tenant sector.

The Council is already committed to undertaking a review of its Sinking Fund Strategy covering the next 50 years bringing independent consultants to review assumptions about future income levels, rental activity and to make recommendations around levels of sinking funds contribution to reserves to ensure that we continue to have a sufficient level of reserves to cover any dips in income and to cover all financing and management costs.

**2.34 Recommendation: The Council should develop an action plan as part of the management of its investment portfolio which addresses each of the weaknesses identified in paragraph 6.9. This should be linked to a portfolio risk register, which monitors each of the KPIs, tenant performance and risk to the debt repayment strategy for each investment property asset**

Agreed. Investment Strategy- as the PIR recognises the Council approved a set of Strategic Investment Parameters in December 2017. The Council during the period (up to 2018) when it was evaluating investment asset opportunities had a set of criteria focused on

- Best in class assets
- Located within the Heathrow functional economic area
- Located in close proximity to either the airport or public transport infrastructure
- Undertaking due diligence on the financial strength of existing tenancies

Whilst the Council has a small number of investment assets (8) which makes them relatively easy to manage, it has a significant number of tenants ( 43 excluding its

retail and industrial tenants). This means that whilst the Council has the bulk of its assets in a relatively tight area around the Borough and the Heathrow functional economic area in the form of offices it does have diversification by the sectors across which the tenants operate.

Additional to the investment assets portfolio the Council does own a regeneration portfolio which includes the Elmsleigh Centre and Communications House in Staines-upon-Thames and the Summit Centre in Sunbury. The PIR highlights the concentration of investment in four assets. Drilling down into this one asset BP accounts for more than 40% of the portfolio. Currently BP is financially extremely healthy and whilst there are longer term threats to its operating model it has time to shift to other energy sectors such as photovoltaic. BP always pays its rent slightly early. If BP were to leave the site or reduce the proportion of the site it wished to retain at the end of the lease then (from the alternative use report we commissioned at the time of acquisition) we could develop the site for residential accommodation which would have a significant value given the location of the site.

At the time the acquisitions were made in 2017-18 the Council had recruited an experienced property professional from the private sector who had worked for Heathrow. We also used the world's largest property consultancy to provide advice and for the Hammersmith Grove acquisition we also used Deloitte to scrutinise the assumptions of the lead advisers and undertake financial due diligence of the tenants.

Since 2017-18 the Council has grown the internal Assets team significantly such that there are now 18.2 FTEs in the team. The team have consistently performed an excellent job in pro-actively managing the Council portfolio. Despite the impacts of the COVID-19 pandemic on the economy in 2020-21 the Council collected 100% of investment rental income invoiced and in 2021-22 it collected 99.98%

The Council's Governance arrangements have evolved since 2017-18, in part because in 2021-22 the Council moved from a Cabinet governance system to a Committee system. There are now the following in place:

- Corporate Policy and Resources Committee
- Development Sub-Committee
- Assets Portfolio Working Group
- Development Investment Group

The PIR refers to the debt repayment risk, the Council has always been very focused on mitigating that risk. Hence from the beginning with the BP acquisition it has every year, set aside a portion (ranging from £5m to £9m to date) of rental income to build up earmarked sinking fund reserves, to be available to cover future dips in rental income arising when some tenants exercise lease breaks or do not renew leases resulting in void periods and then rent-free periods. The current sinking fund reserves balance is just under £34m. These reserves are the main reason why Spelthorne has the highest ratio of revenue reserves to net revenue budget of any district or borough council in England (source LG Improve Benchmarking).

In contrast to some councils the Council has always pursued a sensible and prudent approach to Minimum Revenue Provision paying off debt on an annual basis and alignment MRP with the debt repayments.

THE PIR recommends having KPIs in place, the Council's Asset Management Plan has a set of approved KPIs which are regularly reported on in annual investment and regeneration performance reports. The most recent annual report is appended (Appendix B) to this report.

### **3. Options analysis and proposal**

3.1 The Council has the option of rejecting the recommendations set out in the report or accepting them. Given that as set out in the response above the Council is largely already undertaking the actions recommended it is recommended that the recommendations are accepted, and the responses set out agreed.

### **4. Financial implications**

4.1 Addressed in the body of the report

### **5. Risk considerations**

5.1 Addressed in the body of the report

### **6. Procurement**

6.1 Not applicable.

### **7. Legal considerations**

7.1 The Council is required to consider the recommendations in the PIR further to Schedule 7 of The Local Audit and Accountability Act 2014 and decide if any action should be taken or if the recommendations made by the Auditor should be accepted. The decision in this report demonstrates statutory compliance with the requirements under the 2014 Act further to the issuing of the PIR.

### **8. Other considerations**

8.1 Not applicable

### **9. Equality and Diversity**

9.1 Not applicable

### **10. Sustainability/Climate Change Implications**

10.1 Not applicable

### **11. Timetable for implementation**

11.1 It is anticipated that following acceptance of the recommendations, KPMG will sign off their 2017-18 Statement of Accounts and Value for Money opinions by end of December. In the New Year BDO will be able to commence their work

### **12. Contact**

Terry Collier, Farida Hussain, Daniel Mouawad

**Background papers: There are none.**

### **Appendices:**

**Appendix A: KPMG Public Interest Report**

**Appendix B Investment Assets and Regeneration Assets Annual Report for 2021/22**