

Corporate Policy & Resources Committee



16 January 2023

Title	<p>Capital & Revenue Reserves Strategy</p> <p>This report is subject to the final decisions made by the Committee between mid-January and 20 February around finalising the 2023/24 budget and 2022/23 Outturn Report and therefore may be subject to further change.</p>
Purpose of the report	To note
Report Author	Paul Taylor Chief Accountant
Ward(s) Affected	All Wards
Exempt	No
Corporate Priority	<p>Community</p> <p>Affordable Housing</p> <p>Recovery</p> <p>Environment</p> <p>Service Delivery</p>
Recommendations	<p>Committee is asked to note:</p> <ul style="list-style-type: none"> • That by successfully implementing a prudent approach to developing its Sinking Funds, Spelthorne Borough Council has the highest ratio of usable (cash backed) revenue reserves to Net Revenue Expenditure (NRE) of any district or borough Council in England. • That subject to Council approval, the Outline Budget analysis indicate that Council will require net funding of £6,519,900 from the Rent Equalisation Reserve (sinking funds) – (RER) in 2023/24 and £3,125,300 in 2024/25 From 2025/26 the five year planning cycle currently indicated that the Council would return to making net contributions to the RER. • That based on the Medium Term Financial Strategy (MTFS) Council must look to bridge the £1.25m per annum net contribution deficit from Knowle Green Estates caused by the height restrictions, and adverse movements in interest rates & building cost inflation. • The forecast projections for the reserves from 2022/23 to 2024/25, as set out in appendix D below.
Reason for Recommendation	Effective and sustainable use of reserves is a key element of the Council’s Medium Term Financial Strategy

1. Executive Summary

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1.1 The Council's Earmarked Revenue Reserves have been assigned by Council and can only be used for the purpose they were intended, for example, it is not possible to use the Sinking Fund Reserves to fund an FTE role within the Council.

1.2 Investment Property Sinking Funds

(a) Council have been advised of a challenging two years ahead for the Sinking Funds based on the five year planning cycle, which was why Council approved a £2.5m one off payment into the Sinking Funds as part of the 2021/22 Outturn Report.

(b) The Ukraine War has impacted on our Sinking Funds by just over £4.1m over 2022/23 and 2023/24 and when combined with a couple of tenant issues, Officers are forecasting a net funding situation of up to £10m from the Sinking Fund between 2023/24 and 2024/25.

(c) From 2025/26 onwards the Council will be making net contributions into the Sinking Funds.

1.3 The current depressed property market makes it extremely difficult for Council to consider selling its assets, as any shortfall between the purchase price and sale price would crystallise a loss that would negatively impact on the revenue budget, and Council's General Fund & Earmarked Revenue Reserves.

1.4 The reduction in height, adverse interest rate movements and increased constructions costs has resulted in Knowle Green Estates Ltd (KGE) business model changing dramatically, so much so, that they will not be able to contribute a net £1.25m per annum to the Council (for the next 50 years) and if this contribution gap is not covered off, it will have an adverse impact on our ERR, as Council will have to cover the shortfall, which in turn, will cause significant issues for our MTFs and long term future viability.

2. Key issues

2.1 The last eight years have seen a strong performance from Council's investment property portfolio, which has allowed the Council to grow its Sinking Fund Reserve to over £33m

2.2 As part of the 2021/22 Outturn report, Council agreed to invest part of the surplus for the year as a one off payment of just over £2.5m into the Sinking Fund Reserves.

2.3 This was based upon Officers' recommendations, as the five year planning cycle was indicating that due to external factors:

(a) The war in Ukraine, there was going to be a rental shortfall at one of the Council's investment properties, because of the Government's compounding of certain Russian Oligarch's UK based assets. In turn, the Assets Team believe that because the building will be vacant, this would be the perfect time to upgrade the property and maintain it to its optimum specification for reletting on medium to long term leases, to maximise rental returns for the Council. The lost rental income and capital expenditure would amount to approximately £4.0m up to 31 March 2024.

(b) Further, there were also some challenging times ahead for tenants at another property, which could impact on 2023/24, after the Holding Company guarantee has been received, anticipated in February/March

2023. Discussions are still ongoing regarding how the property will be relet. In the 2023/24 Budget setting process, and based on the latest information, Officers are forecasting that the property will be relet, and this has been reflected in the 2023/24 Draft Budget (This is subject to final Council approval being received for the proposals).

- (c) In October 2022, Council asked Officers to allocate a further £200,000 to support the existing £362,000 set aside by Council for the Cost of Living Reserve, as part of the 2021/22 Outturn report.
- 2.4 Sinking Fund Policy, this was presented and discussed by Corporate Policy and Resources Committee at their meeting on 28 November and based on the Committee's feedback, will be represented at their meeting on 20 February.
- 2.5 The purpose of the Sinking Fund is to essentially smooth out and short fall in investment rental income or unexpected costs, caused by external factors.
- 2.6 In relation to the Council's borrowing of in excess of £1billion (the majority of which currently relates to funding of past acquisitions of investment assets), the current level of Sinking Fund Reserves would be sufficient to cover just over 10 months of loan repayments and the next two years between 2023/24 and 2024/25 will be challenging according to the five year forecasts that supports the Medium Term Finance Strategy (MTFS).
- 2.7 The Council's approved Earmarked Revenue Reserves (ERR) were £62.3m at 31 March 2022 (31 March 2021: £53.9m). Noting that as advised in last year's report, a further £26.9m, relating to COVID-19 support Government Grants was received before 31 March 2022, that were paid out to business and individuals after 1 April 2022 and therefore, it had artificially inflated the Council's official ERR at the year end. The ERR quoted in this report have had these COVID-19 Grants removed to enable direct comparison.
- 2.8 This indicates that on a like for like basis, the Council's ERR grew by £8.4m from 2020-21 to 2021-22.
- 2.9 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 and cannot be used, for example, to fund a new FTE post.
- 2.10 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 from complacency over the next five years 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 potentially see its reserves, reduce to critical levels in a relatively short number of years, based on the current MTFS projections.
- 2.11 This is further compounded by a £1.25m reduction in Medium Term Financial Strategy (MTFS) forecast Council income from its subsidiary Knowle Green Estates LTD (KGE), caused by delays in obtaining planning permission, planned height restrictions, rising interest rates and building materials and labour inflation. Without any plans to replace this lost income, Council will

have to face up to some extremely difficult decisions around what essential services to cut, reduce or mothball.

- 2.12 The current market conditions make it difficult to sell the development assets without it adversely impacting on the residents of the Borough, and Officers and the External Auditors are at a critical point, in respect of the development costs that have been capitalised, because any further delays in finalising our development properties, could see an additional £3m added to the budget deficit for 2023/24.
- 2.13 Officers currently have sufficient cash back reserves to manage the Council's affairs and therefore the Council is a going concern. However, a reuse of reserves, or a large call on our reserves, would cause grave concern for Officers and Council's ability to remain a going concern.

3. Background

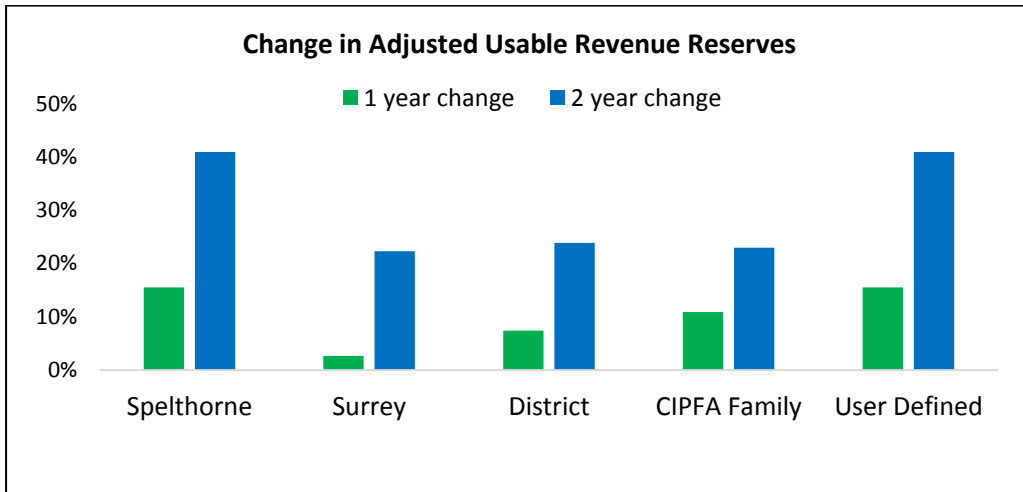
- 3.1 To assist Councillors, there are three appendices attached to the report that cover:
- (a) Appendix A - an introduction to reserves.
 - (b) Appendix B – the background and purpose to Spelthorne Borough Council's reserves
 - (c) Appendix C – the management of Council's reserves
- 3.2 All figures and charts in this report have been independently prepared by LG Futures as part of their annual benchmarking report.

3.3 Usable Revenue Reserves - 2021/22: Spelthorne

Usable Revenue Reserves at Spelthorne, taken from the annual statement of accounts. The figures for 2020/21 and 2021/22 have been adjusted to reflect the COVID business rates relief funding held in reserves at the end of 2020/21 and 2021/22 (information is taken from national NNDR3 data).

	<u>2017/18</u>	<u>2018/19</u>	<u>2019/20</u>	<u>2020/21</u>	<u>2021/22</u>
General Fund Balance	1,000	1,000	1,221	1,352	2,176
Earmarked Reserves	17,802	23,053	43,006	60,364	63,372
Usable Revenue Reserves	18,802	24,053	44,227	61,716	65,548
less s31 grants in 20/21 and 21/22 (RHL and Nursery)				-7,768	-3,213
				<u>£53,948m</u>	<u>£62,335m</u>

3.4

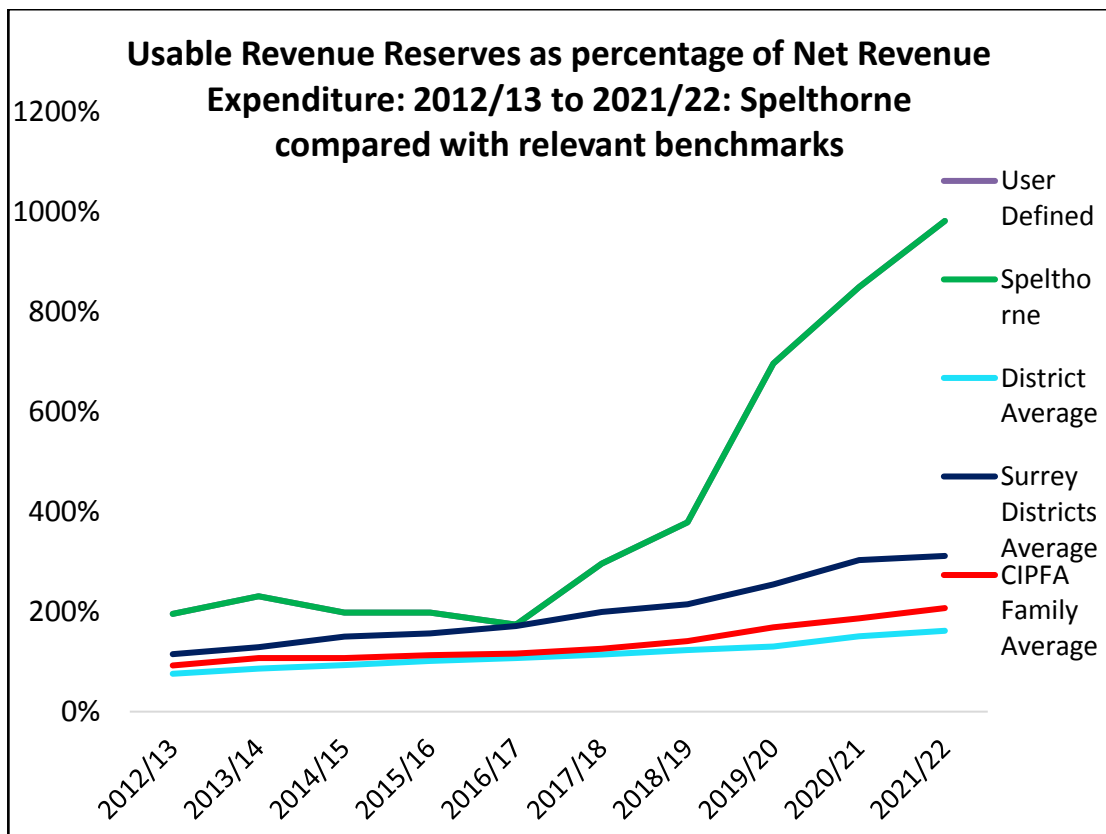


(CIPFA Family – this is a basket of the Districts and Boroughs in England who have borrowed similar amounts to Spelthorne, and forms part of the benchmarking analysis, Officers advised last year, was going to be provided to Council for reference and comparison purposes).

(The user defined bar is Spelthorne and was added by LGFutures for control purposes).

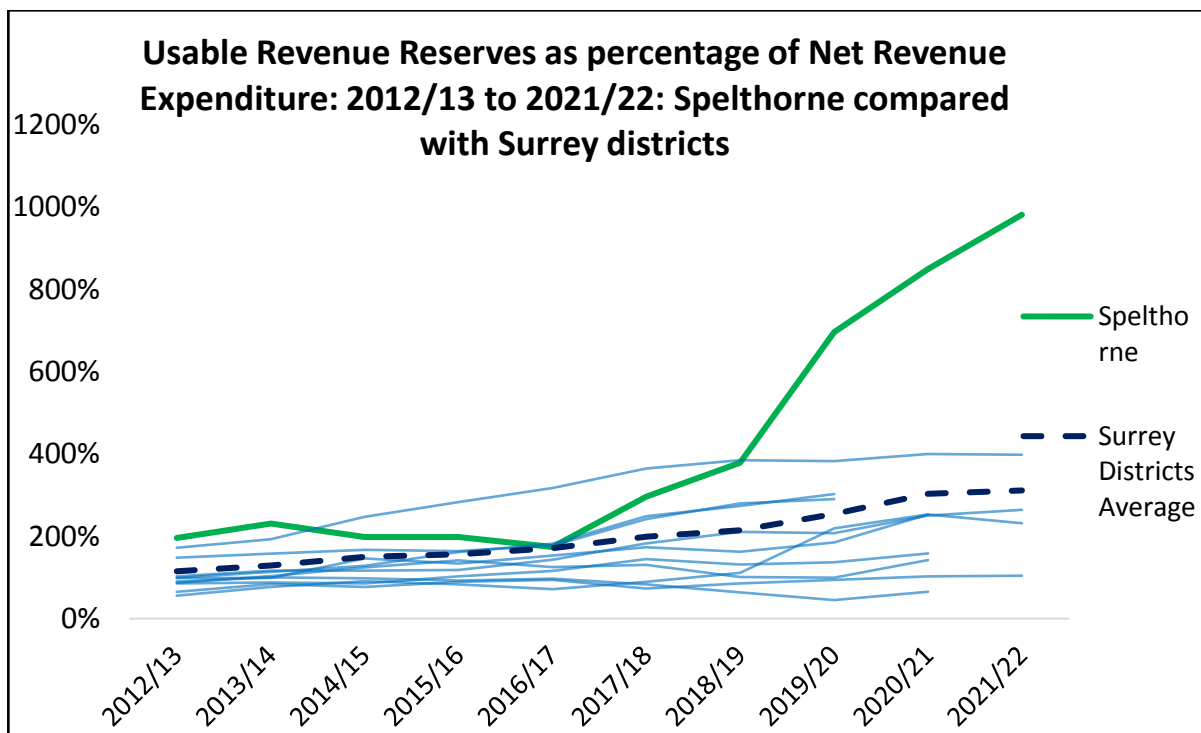
3.5 As can be seen from the above chart, the Investment Portfolio has provided the Council with strong cash backed reserves over the last eight years, and with the Council approved £2.5m used to top up the Sinking Fund in the 2021/22 Outturn Report, has provided additional support, as we enter some challenging times ahead.

3.6



3.7 The chart above shows the comparison between Spelthorne, other Surrey Districts and Boroughs and the CIPFA Family average, over the period 2012/13 to 2021/22. This highlights the prudent approach taken by the Council of providing annual cash backed deposits into our Sinking funds and demonstrates, why the Council is less susceptible to going concerns issues, that have befallen other Council's across the country.

3.8



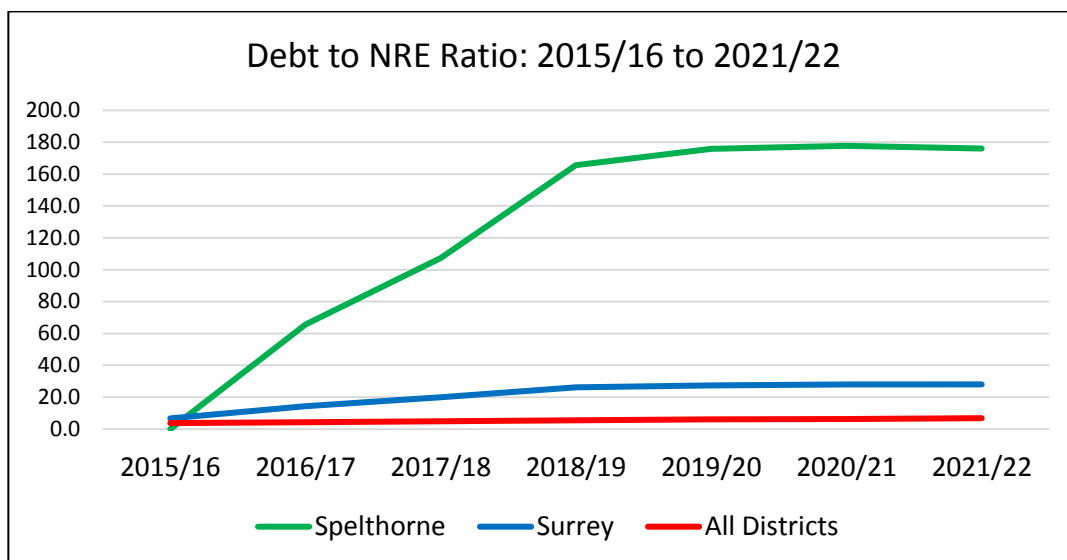
3.9 The chart above shows the comparison between Spelthorne, other Surrey Districts and Boroughs, over the period 2012/13 to 2021/22. This highlights the prudent approach taken by the Council of providing annual cash backed deposits into our Sinking Funds and demonstrates, the Council sound judgement that has set it apart from other similar Council's in the Surrey District.

3.10 **Debt compared to Net Relevant Earnings (NRE)**

3.11 The level of reserves built up over the last eight years has provided a strong cash backed reserves situation for the Council.

3.12 A major risk to the Council is the level of gearing, this is the percentage of aggregate debt to aggregate reserves, and with borrowings exceeding £1bn and reserves of £63m, the Council is highly geared and susceptible to long run market challenges. Over the long term the investment assets debt (the interest rates on which are wholly fixed) will be paid down on a year by year basis, however we have in our programme a further £250m of funding requirement for residential schemes.

3.13



3.14 The chart highlights that the Council has the largest ratio of debt to net relevant earnings of all the district and boroughs in England, and explains why, the Council is being scrutinised.

3.15 This also highlights why Council must focus on increasing its cash backed reserves to protect residents over the coming 15 years, when the trend in borrowing will be downward, resulting in a decrease in the debt to NRE ratio above.

4. Risks

4.1 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, including on investment assets, 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,.

4.2 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, still has the highest ratio of usable revenue reserves to Net Revenue Expenditure (NRE) of any district or borough Council in England.

4.3 Whilst this is good news, and as mentioned above, the Council needs to assess this alongside the aggregate loan liabilities of 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 funds).

- 4.4 The Council's approved Revenue Reserves, including the Sinking Funds reserves are earmarked and set aside for specific purposes and cannot be used for any other purpose.
- 4.5 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.
- 4.6 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.
- 4.7 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 initially the COVID- 19 pandemic, and now the cost of Living crisis, 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 residential properties to Knowle Green Estates Ltd., a wholly owned subsidiary at cost).
- 4.8 The results of the COVID-19 pandemic and the Cost of Living crisis 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
- 4.9 At the 31 March 2022, the Council's property portfolio reduced in value by £23.3m. (31 March 2021: £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 five to ten years and reverse these short-term paper losses to overall paper gains.
- 4.10 As well as impacting on the valuation figures, the pandemic and now the Cost of Living Crisis will continue to impact on Council's services, over the next few years, as highlighted during the budget briefing session with Councillors in June and November 2022, the Council is not 'out of the woods' yet and is 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.

(e) Reduced income from KGE.

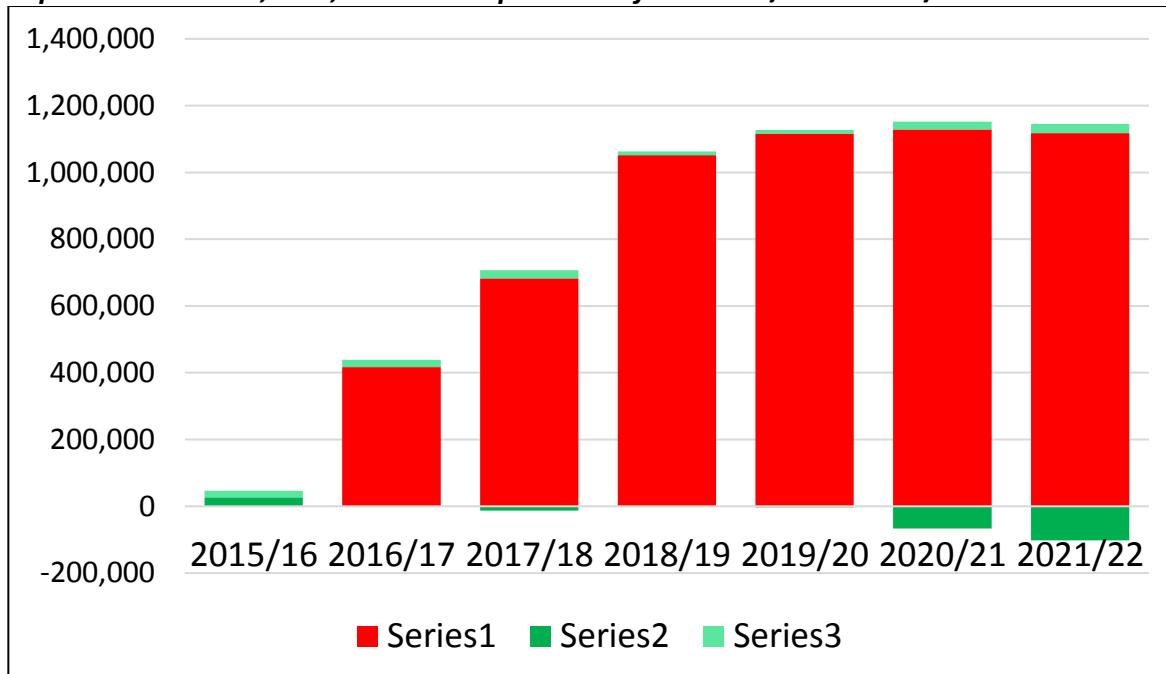
4.11 During 2022, the Council was subject to a Public Interest Report from KPMG and additional scrutiny from the Department for Levelling Up, Housing & Communities (DLUHC), and as can be seen from the benchmarking charts above, Spelthorne Borough Council, is in a much stronger position to deal with any short term fluctuations and maintain a strong going concern model.

4.12 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

4.13 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	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Capital Fin. Requirement	0	416,250	681,984	1,051,121	1,116,100	1,128,532	1,117,687
Capital Adjustment Acc.	26,897	2,377	-12,617	871	-2,857	-66,226	-101,825
Revaluation Reserve	20,094	20,538	25,054	10,698	10,754	24,005	27,851
Balance Sheet Capital Assets	46,991	439,165	694,421	1,062,690	1,123,997	1,086,311	1,043,713

Capital Health: CFR, CAA, and RR at Spelthorne from 2015/16 to 2021/22 in £000s



Series 1 = Capital Fin. Requirement

Series 2 = Capital Adjustment Acc.

Series 3 = Revaluation Reserve

- 4.14 The CFR shows that in 2022/23, because of the paper losses on the property portfolio, the total funding is 107% of the Council's total assets and officers will need to monitor this variable carefully over the next two to ten years and advise Council accordingly.
- 4.15 What the impact of 107% 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.
- 4.16 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 2023/2028 will deal with this in more detail).
- 4.17 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
- 4.18 The 2023/24 budget modelling is showing that the net rental income is anticipated to fall by approximately £10m and additional costs of £5m will be incurred, noting the £4m relates to the conflict in the Ukraine war.
- 4.19 The rent guarantee period negotiated when the Council acquired the Thames Tower, Porter and Charter buildings came to an end in September 2022, and this has had an impact on the forecast revenue, which is one of the main factors in the internal reorganisation, that see the Assets Team responsible for the budgets on rental income and landlord costs, passing the remaining cost responsibility over to the Finance Team, which will enable the Assets Team to put their time into seeking new tenants rather than administration duties.
- 4.20 Again, the Council cannot take everything for granted following the pandemic and the Cost Of Living Crisis is forecast to 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.
- 4.21 **Knowle Green Estates Ltd. (KGE)**, the Council, as sole shareholder is responsible for agreeing the strategy, which is stalling slightly, due to the imposed high restrictions, rising interest rates, and building cost inflation
- 4.22 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.
- 4.23 Should Council consider changing the balance of units to include Private Rental residential units, the funding model would change significantly, due to having to consider Commercial issues around both State Aid and HMRC Thin Capitalisation Rules (transfer pricing constraints) 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).

- 4.24 Based upon the projections prepared for Cabinet and Council in February and March 2021, indications were that KGE could contribute up to £100m towards funding Council services, over the next 50 years.
- 4.25 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.
- 4.26 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 £170k, 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.
- 4.27 This could exasperate the short-term challenges in funding highlighted in the 2023/24 Budget Briefing given to Councillors in June & November 2022, to support services across the Borough, which could lead to increased Council tax, reduced services, redundancies, or a mix of all these options, particularly as the number of apartments to be built has been reduced, from the 663 originally planned for.
- 4.28 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.
- 4.29 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.
- 4.30 The final item is that as shown in appendix D – forecast useable reserves to 2024/25, 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 2023/24.
- 4.31 These represent the main challenges and items for Council when considering the reserves and sinking fund strategy for 2023/24 and beyond.

5. Options analysis and proposal

- 5.1 Officers considered a wide range of proposals for the utilisation of the Council's reserves, and considering the challenges and issues highlighted in section 3 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
 - (h) Cost of Living Crisis
 - (i) Height restrictions placed on the Council's development, which has reduced the income available for KGE by £2m per annum to make available to the Council and the impact on services, and a reductions to the Council's affordable housing and regeneration programme.
- 5.2 Officers are recommending that Council continue with the current strategy for reserves and sinking funds as shown in the 2023/24 budget.

6. Financial implications

- 6.1 Appendix D shows the earmarked revenue position: actual as at 31 March 2022; and the forecast position for the three years to 31 March 2025, subject to any changes made during the budgeting process for 2023/24 and 2022/23 Outturn, as approved by Council.
- 6.2 This indicates that the Council's Earmarked Reserves will reduce by £12.2m by 31 March 2025, noting as mentioned in 2..2 above, Council approved an additional contribution of £2.5m to earmarked reserves, to cover the known challenges that were going to impact on the Council's finances, from Officer's five year financial planning modelling, which means that the real impact on the Council is £9.7m (£11.6m less £2.5m).
- 6.3 The net impact of £9.7m is broadly made up as follows:
- (a) £4.1m due to external uncontrollable factors, the war in Ukraine, as mentioned above
 - (b) £3.16m due to commercial trading challenges with existing tenants.
 - (c) £2.5m is due to the year to year movement in Reserves, for example, as we receive or utilise more Contributions from Developments, or in terms of the Green Initiative Fund, pay for an FTE, all of which will be Council approved.
- 6.4 Please note that the above figures are subject to Council approval of the 2022/23 Outturn report and any recommendations for dealing with any surplus or deficit at the year end and 2023/24 Budget, which is due for approval at the February 2023 Council meeting
- 6.5 Subject to the finalisation of the 2023/24 Budget Setting process, Council are looking to utilise the earmarked reserves as follows:
- (a) £564k to be reallocated to the Cost of Living Reserve.
 - (b) £103k from the Retained Business Rates (NNDR) Reserve to fund the extension of two temporary posts (Revenue) within the Economic Development Team

- (c) £400k from the International Financial Reporting Standard (IFRS) 16 Reserve.
- 6.6 The Council will implement the new Sinking Fund Policy once approved in February 2023 at the Corporate Policy & Resources meeting.
- 6.7 The Outline Budget workings indicate that there will be a need to utilise the rent equalisation reserves (sinking funds) for 2023/24 and 2024/25. With the MTFS indicating that from 2025/26 the Council will return to making contributions towards the Rent Equalisation Reserves (sinking funds).
- 6.8 Once the Sinking Fund Policy has been approved, Officer will revisit the planning for the next five, ten, twenty and fifty year planning horizon and report back to Council in the autumn.
- 7. Other considerations**
- 7.1 Included in section 2 above.
- 8. Procurement considerations**
- 8.1 There are none
- 9. Legal considerations**
- 9.1 There are none
- 10. Risk considerations**
- 10.1 Addressed in section 3 of the report.
- 11. Equality and Diversity**
- 11.1 There are none
- 12. Sustainability/Climate Change Implications**
- 12.1 Included in 2023/24 budget setting proposals.
- 13. Timetable for implementation**
- 13.1 Implemented as part of the 2023/24 budget setting process.
- 13.2 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:

Outline Budget Report 2023/24 and the MTFS Forecasts

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 2022 (Actual) and 2023, 2024 and 2025 (Forecast)