

Corporate Policy & Resources Committee



20 January 2025

Title	<i>Interim report on the progress of 2025-26 to 2074-75 Sinking Fund Forecast Model (5-year review)</i>
Purpose of the report	To inform and reassure
Report Author	<i>Paul Taylor, Chief Accountant</i>
Ward(s) Affected	All Wards
Exempt	No
Corporate Priority	Community Addressing Housing Need Resilience Environment Services
Recommendations	<p>The Committee is asked to note the progress on the Sinking Fund Forecast model and that a further formal report will be presented to this Committee on 24 March 2025, once Council has approved the 2025-26 Budget.</p> <p>Agree that a demonstration of the model be provided to members of the Committee and of the Commercial Assets Sub-Committee ahead of the further report on 24th March.</p>
Reason for Recommendation	<p>As part of the five-year review process, this Sinking Fund Forecast model has been designed as a decision making tool to assist Council with the process of making strategic choices that help it to achieve its corporate goals, reduce risks, allow for horizon planning, through identifying challenges, gathering relevant data, analysing alternatives and selecting the best course of action.</p> <p>The model will also be used to stress test the resilience of the Council's investment and regeneration property portfolio against future financial scenarios. It will help the Council to gauge the investment risks and adequacy of assets, as well as evaluating medium to long term key performance indicators, internal controls and processes and simulate various scenarios to aid strategic and operational planning.</p>

What is the situation	Why we want to do something
<ul style="list-style-type: none"> • The Council has brought forward its five-yearly review of the Sinking Fund forecast model, • The updated Sinking Fund forecast model is complete and will provide a structured approach to assist Council to make effective medium- and long-term decisions based on rationale thinking and logical analysis to reduce future risks, making the most of future opportunities and challenges with the Council's Investment and Regeneration property portfolio. • The modelling is indicating that there is a need to build funds more quickly than previously anticipated to meet future expenditure within the investment property portfolio and therefore it will be necessary to reduce the flow of funds over a number of years to the Council to support the Revenue Budget. This may change depending on any strategic decisions that this Committee and Council may take in the future. • Going forward, the Budget, Medium Term Financial Plan (MTFP) and Exit Strategies reflect this situation. • Having created the Sinking Fund forecast Model, it can be used to stress test the resilience of the Council's Investment and Regeneration property portfolio, by simulating how the portfolio will fare in both favourable and unfavourable economic scenarios, either using the model to review the impact on a wide range of 	<ul style="list-style-type: none"> • Officers are responding to the observations made in the Public Interest Report by KPMG and the CIPFA/DHULC report. • The model is ready for use by both the Finance and Assets team to assist with short-, medium- and long-term planning, surrounding the Investment and Regeneration property portfolio and will present these reports to the Commercial Assets Sub Committee for consideration. • The Sinking Fund Forecast Model and the ability to stress test the Investment & Regeneration property portfolio across several variable factors, will provide Council with the ability to make strategic decisions to maximise returns on investments and implement hedging strategies to mitigate risk

<p>variables, i.e., floor space, tenants financial standing, occupancy rates, landlord costs, inflation, rent incentives, etc., noting that this is not an exhaustive list.</p>	
<p>This is what we want to do about it</p>	<p>These are the next steps</p>
<ul style="list-style-type: none"> • Note the progress on the Sinking Fund Forecast model • Note the ability to simulate economic scenarios and stress testing of the Investment and Regeneration property portfolio. • Note that the model will continue to evolve over the lifetime of the investment and regeneration property portfolio. • Note that the Budget, MTFP, Exit Strategies and Sinking Fund Forecast model all align. • Note that the Budget, MTFP and Exit Strategies form the basis of the short to medium term planning (up to ten years) and the Sinking Fund Forecast Model forms the basis of the medium to long term planning from five to fifty years). • Note that the Commercial Assets Sub Committee, will be working with officers to model various economic scenarios and will be recommending hedging strategies to mitigate against possible losses or maximise returns and ensure that the Sinking Fund has sufficient resources to meet the Council's short-term commitments and long-range planning. • Note that this current model is a starting point for evolution and development, to suit the needs of this Council. 	<ul style="list-style-type: none"> • Officers will prepare a full stress test report for this committee on 24 March 2025. • As the Budget and MTFP process is still ongoing and will be approved by Council in February 2025, the Sinking Fund Model will need to be updated to reflect the changes that have occurred between December 2024 and February 2025. • A final report will be presented to this Committee on 24 March 2025, once Council has approved the 2025-26 Budget. • Officers to arrange a demonstration of the model for members of this Committee and the Commercial Assets Sub Committee

<ul style="list-style-type: none"> Note that the current forecasting model for the Sinking Fund and Stress Testing can deal with most financial scenarios. In some cases where the economic scenario is complex, it may be necessary to involve a third-party specialist to assist, and then input the outcomes into this forecasting model 	
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1. SUMMARY OF THE REPORT

- 1.1 This report seeks to update the Committee on the current progress of the Sinking Fund forecasting model.
- 1.2 The forecasting model is complete and will need to be updated to reflect the changes currently taking place in the 2025-26 Budget Setting Process, which will be approved in February 2025, once this is completed a formal report will be presented to this Committee at the meeting to be held on 24 March 2025.
- 1.3 The Sinking Fund Forecasting model, in the first instance, uses averages to calculate items such as leases incentives, rent free periods. However, it can be adapted to be more granular, if required, particularly when incorporating the budget, Medium-Term- Financial-Plan and exit strategies into the forecasting model.
- 1.4 Included with this report are the following appendices for illustration purposes only and they have been redacted where appropriate, so as not to take this report into a closed session:
 - (a) Scenario A – base line assumptions
 - 1.5 Scenario B – Assumptions for several different options for the property portfolio
 - 1.6 Charts showing the impact on the Sinking Fund of both Scenario A and Scenario B
 - 1.7 The Sinking Fund Forecasting and Stress Testing model is not a complex piece of software, nor is it a macro economic model that considers socio-economic factors, as utilised by HM Treasury or The Bank of England, when modelling global economic output.

2. Key issues

- 2.1 The last Sinking Fund forecast modelling review was carried out in 2020-21 and was due to be reviewed in 2025-26. However, this was brought forward in the light of the Public Interest Report issued by KPMG, the CIPFA/DLUHC Report and the Best Value Inspection review, with the majority of work carried out in September 2024, then put on hold whilst officers dealt with the Best Value Inspectors, BDO Value for Money Reports and audits for the five years to 31 March 2023 and the current audit with Grant Thornton.

- 2.2 Working with the Assets team, Finance Officers considered outsourcing the development of the model to a third party against preparing the model in house
- 2.3 The indicative prices for an external party to produce a model for the Council were between £50-70,000 to build the model and then an unspecified annual fee to maintain the model.
- 2.4 Based on officers' experience of the external modelling with Knowle Green Estates, and the difficulty in updating the model going forward, together with the associated costs of annual updating and evolving the model, it was decided to build the financial model in house, as this will facilitate greater control over the model, provide greater flexibility in modelling scenarios as they arise, as well as being more cost effective. The model will be used on an ongoing basis to explore emerging scenarios.
- 2.5 There have been considerable delays caused by challenges with a former officer due to conflicting priorities, which following their departure have now been resolved.
- 2.6 There are two aspects to this model:
- 2.7 Sinking Fund forecast – is a forecasting tool, incorporating the variables mentioned in 2.13 below, noting that the list is not exhaustive.
- 2.8 Stress Testing – a financial modelling tool used to test the resilience of the Investment & Regeneration property portfolio against potential future financial or economic situations. This can be done based on the variables mentioned in 2.13 below, or the model can forecast:
 - 2.9 what would happen if one building was destroyed by fire or
 - 2.10 all the tenants left a building or
 - 2.11 the Council lost all its tenants across the entire property portfolio, and needed to know how long it would be able to meet its liabilities from the sinking fund reserve, before it impacts on the Council's revenue budget and taxpayers or
 - 2.12 Assess the financial strength of each tenant on a lease-by-lease basis and what would happen if they defaulted on their lease, or left the building or
 - 2.13 What is the impact on the Sinking Fund Reserves, if the Council redevelops a site and it takes, two years longer than anticipated to complete.
 - 2.14 The list above is not exhaustive.

Sinking Fund

- 2.15 There was no guidance provided by either KPMG or CIPFA as to what format the Sinking Fund Forecast Model should take, just that the Council should prepare one. Therefore, Officers have significantly improved on the capabilities of the original Sinking Fund Forecasting model, to provide a more in-depth analysis by, leases, tenant, floor space, rent incentives, rents per leases, rent free periods, occupancy rates and inflation, which will assist Council to make informed strategic decisions, to mitigate risk and maximise opportunities.

- 2.16 The forecasting model, has been based on the financial forecasting model used for all the Knowle Green Estates Ltd projections and the 120+ viability assessments carried out, thus making it easier for Council to understand the detailed set up.
- 2.17 The Forecasting Model can be further adapted to Stress Test against each variable mentioned in 2.12 below, so that Council can see the impact of their decision making on the Sinking fund balances, as well as receiving information from Officers of what would happen in a variety of situations and what mitigating strategies could be developed or applied to reduce the risks to the Council, or maximise any opportunities.
- 2.18 The Sinking Fund Forecast Model is based on the annual business plans for each property as prepared by Assets for the Commercial Assets Sub Committee and considers the proactive input from Cllr Nichols,
- 2.19 This has ensured that Officers have used a consistent approach to modelling that will aid Councillors understanding by being consistent and straightforward and can be adapted to suit the Council's requirements, as it aligns with the annual Budget process, preparation of the Medium-Term Financial Plan and Exit Strategies.
- 2.20 Like the annual business plans, the Sinking Fund Forecast Model has been established on a property-by-property basis, within each property the variables include:
- (a) Rent inflation
 - (b) Cost inflation
 - (c) Occupancy rates
 - (d) Square footage
 - (e) Leases
 - (f) Tenant incentives -rent frees, capital and revenue contributions, together with associated legal costs
 - (g) Maintenance programmes
 - (h) Refurbishments
 - (i) Life Cycle (Componentisation of assets required by the CIPFA Code, with inflation applied)
- It is possible to vary these variables using average figures or specific figures for each tenant or property.
- 2.21 The model is an evolutionary process, and will be adapted to reflect and flex variable elements to provide detailed analysis and forecasting for each property against an explicit scenario, to mitigate risks and maximise opportunities which could include:
- 2.22 Selling a building to generate a capital receipt, as modelled in appendix B
- (a) Refinancing the loans for the building
- 2.23 Changes in occupancy rates
- 2.24 Redeveloping a site, again this has been modelled in appendix
- 2.25 Exit strategy planning

Please note this list is not exhaustive

- 2.26 By flexing the variables in the model, it is possible to perform sensitivity analysis on numerous variables at the same time and provide the Council with Key Performance Indicators to monitor performance.
- 2.27 The model can be used to reflect trends in the above, i.e., cyclical nature of market conditions favouring tenants or landlord or variations in inflation, noting that inflation erodes the real value of money.
- 2.28 It should be noted that there will be some timing differences with respect to accounting for tenant incentives, as Assets report in terms of cashflow received, and Finance report in terms of the requirements of the CIPFA Code and the accruals concept. This is in particular reference to rent incentives, (see the table in 2.17 below).
- 2.29 As previously explained in detail to this Committee and full Council, the Finance team will apportion rent incentives over the period of the lease, i.e., a net rent, whereas Assets will show the rent incentives as £nil in the first period(s) then full rent thereafter. Our external audits have confirmed their expectations around this approach. ~~(OBI)~~
- 2.30 The following table illustrates the difference, based on a 5-year lease, of £1m per annum rent, with £1m rent free:

Rental income	Assets	Finance
Year 1	0	800,000
Year 2	1,000,000	800,000
Year 3	1,000,000	800,000
Year 4	1,000,000	800,000
Year 5	1,000,000	800,000
Total rents	4,000,000	4,000,000

- 2.31 This methodology keeps the processes aligned with budget setting, budget monitoring and the MTFP. It is transparent and less confusing for all councillors based on the feedback received from Chamber.
- 2.32 Refurbishment costs have been treated as revenue costs, i.e., the Council will replace the plant, machinery, onsite equipment, and décor, with like for like replacement there is no capital enhancement, and all costs are treated as revenue.
- 2.33 If there is any capital enhancement, this would have to be modelled to reflect the impact on any borrowings or application of capital receipts, Capital Programme, and market conditions.
- 2.34 The Sinking Fund Forecast Model is not an absolute model, i.e., the balance on the Sinking Fund in 50 years' time will not be a precise figure of say £10,543,260. It is a strategic management tool, providing a direction of travel, indicating that the outcomes will be in the region of said figure.
- 2.35 The Sinking Fund Forecast Model has been designed for horizon planning and what if scenarios, so that the Council can make strategic decisions about the future of the investment and regeneration portfolio, to aid negotiations with tenants and reduce financial risks to the Council.

Stress Testing

- 2.36 The Second element of this exercise was to develop the capabilities for the Council to stress test its Investment & Regeneration property portfolio.
- 2.37 Stress testing is a technique used to test the resilience of the Council's property portfolio against potential future financial and economic situations.
- 2.38 The Global COVID pandemic was one factor that proved that the portfolio was robust and indeed survived a significant stress test, as rental yields were maintained, which was the main purpose of the Investment & Property portfolio, when it was established in 2016.
- 2.39 The other side of this equation, is the downturn in property values since the portfolio was acquired, which has seen values fall dramatically, which would incur a substantial capital loss, if the portfolio was to be liquidated, which would indicate a significant issue, only if Council made a decision to sell the portfolio, based on current market valuations.
- 2.40 Fortunately, all the Councils borrowings for the property portfolio are fixed for their duration until fully paid off, and therefore, there is no risk to the Council from favourable or unfavourable movements in loan interest rates.
- 2.41 **How stress testing helps?**
- 2.42 It is a financial model that is used to analyse how the Council's property portfolio would fare in drastic economic and financial scenarios
- 2.43 Stress testing assists the Council to gauge and manage its risks and the adequacy of each asset.
- 2.44 Stress testing can use historical, hypothetical, or simulated scenarios to model the impact on the Council's finances, enabling Council to develop strategies to mitigate risks, reduce financial losses, or increase contributions to the Council's Revenue Budget and or Sinking Fund.
- 2.45 Stress testing can also be used to demonstrate the impact of disposing of a particular property or properties, both in terms of short term and long-term results.
- 2.46 Companies that manage assets and investment property portfolios use stress testing to determine portfolio risk, then set in place hedging strategies to mitigate possible losses.
- 2.47 One of the stress tests to be carried out, which does not form part of the Sinking Fund forecast model, will be to review the current property valuation and the loans outstanding, to assess the impact on the Comprehensive Income & Expenditure Statement (CIES). Once completed it can be assessed and replicated in the model. (As mentioned in 2.25 above, the current valuations compare to the loans outstanding make it financially unviable to liquidate the portfolio, without a substantial capital receipt in reserve).
- 2.48 However, on a property-by-property basis, it is possible to consider selling a smaller property, to realise a capital gain, and rather than repay the loans outstanding to the Public Works Loan Board (PWLB), repurpose those loans against another asset, for example, the new leisure centre.
- 2.49 **Why would repurposing loans be a good strategy?**
- 2.50 The average interest rate of the Investment & Regeneration portfolio is approximately 2.3%. Current PWLB fixed interest loans are above nearer

6%. By repurposing loans there is an average saving of interest of approximately 3.7%, and on a fifty-year loan of £30m that would save the Council £34.3m in interest charges.

- 2.51 As this is a Treasury Management decision it would need to be discussed by this Committee at the proper time, if this were to be considered, if the Commercial Assets Sub Committee agree to recommend such a sale to full Council.
- 2.52 There is no regulatory stress testing required by the CIPFA Code, nor was any information provided by them or KPMG in their Public Interest Report as to the required format for each model, so therefore, limited guidance available from these two organisations.
- 2.53 The model can be used to deal with:
- (a) Historical stress testing – taking a previous crisis, i.e., the COVID pandemic and preparing a simulation based on these outcomes.
- 2.54 Hypothetical stress testing – is more specific, often focusing on how a particular tenant, property may weather a particular crisis, this can also be used for ‘blue sky,’ i.e., what happens if building partially collapses.
- Under this type of stress testing modelling, Officers can also be more scientific by adjusting several variable factors, such as, occupancy rates, landlord costs, lease expiry, at once to assess the outcomes and probability of the event happening.
- (a) Simulated stress testing – this can be used for modelling probabilities of various outcomes given specific random variables and is used to understand the impact of risk and uncertainty this may require third party specialist input, depending on the complexity of the test.
- 2.55 In summary, stress testing is a forward-looking analytical tool that will help Council to better understand its financial position and risks. The outcomes of stress testing can be feed into the Sinking Fund Forecast model to update the forecasts and assist Council to define what measures need to be taken if certain events arise, to mitigate risks, reduce threats and the likelihood of failure, whilst assessing how assets perform during economic downturns.
- 2.56 Officers have created the framework and processes to develop the stress testing model, which will:
- (a) Enable Council to mitigate risks
 - (b) Enable improved financial planning for the property portfolio
 - (c) Highlight each properties strength and weaknesses
- 2.57 Working with other models, e.g. from managing agents regarding lease renewals expectations and data it will be possible to use this information with this model to stress test and evaluate the outcomes of a variety of economic challenges.

3. Options analysis and proposals

- 3.1 So far officers have reviewed two main scenarios:
- (a) Scenario A – business as usual, which forms the base case, for future scenarios to be modelled against.

- 3.2 Scenario B – redeveloping some sites (redacted information) via a joint venture partnership in XXXX (redacted) and disposing of a building in XXXX (Redacted).

The modelling of these variables indicates that these options are something that Council should seriously consider at the right time and will be discussed in detail at the Commercial Assets Sub Committee at the proper time. Noting that some of these options have already been built into the Exit Strategy reports presented to Commercial Assets Sub Committee

- 3.3 Additional modelling can be carried out to assess the viability of redeveloping any site. With all the indicative returns on investment provided for risk analysis. This information would be made available in the relevant report to the relevant committee.

Options include what if the Council redevelops a site ten years earlier than planned, again, the outcomes would be considered and presented to the Commercial Assets Sub Committee for consideration, with stress testing revisited to evaluate the economic and financial risks associated with each option.

4. Financial Management Comments

- 4.1 The Sinking Fund Forecast model is based on the 2025-26 Budget and Medium-Term Financial Plan for the four years from 2026-27 to 2029-30 and is a forecast of the next 45 years (making a fifty-year model) based upon certain key assumptions and timing of expenses. It is a tool for horizon planning and strategic decision making, providing a direction of travel based on the variable elements considered.
- 4.2 The Stress Testing Model is designed to test a variety of economic and financial scenarios and then use the Sinking Fund Forecast model to project the likely outcomes of this scenario on the Sinking Fund, particularly if Council and Officers decide that the scenario is likely to occur.
- 4.3 Once the 2025-26 Budget has been approved by Council in February, officers will provide a full report on the Sinking Fund for the 50 years to 31 March 2075
- 4.4 This will enable the Council to consider develop mitigating strategies to reduce the risks of financial loss and protect the Councils finances.
- 4.5 By highlighting both challenges and opportunities ahead, it will be providing Council with many opportunities to discuss options, carry out further modelling, and have a short to medium term plan for dealing effectively with whatever outcomes lays ahead
- 4.6 In scenario A, is the base model, and is on a like for like refurbishment, it is clear that the Council will have to find a substantial amount of funding to deliver the refurbishment plans proposed to keep the existing buildings, up to the same Category A standard, as when the Council acquired them.
- 4.7 By providing this information well in advance, it will provide the Commercial Assets Sub Committee with the opportunity to implement mitigating strategies to manage each property and the tenants' expectations, whilst reducing risk to the Council, through stress testing.

- 4.8 Under Scenario B, officers have modelled joint venture partnership, which could be an option for the Commercial Assets Sub Committee to consider
- 4.9 By modelling the disposing of a building, the Commercial Assets would be able to consider the benefits of taking such action for the Council.
- 4.10 As mentioned above the direct replacement of the plant, equipment, and décor, have been assumed as revenue, as there will be a like for like replacement to maintain the buildings as category A,
- 4.11 Should the Council approve capital enhancement to these assets, they would need to be capitalised. This would increase either internal or external borrowings and will need to be modelled, particularly if the enhancements were to be recovered through the service charge. Again, using the model this would be something for the Commercial Assets Sub Committee to review as appropriate
- 4.12 This model does not consider any impact on the service charges for each building.

5. Risk Management comments

- 5.1 Whilst the addition of the new Independent Lay Member will strengthen the expertise of the Committee, there is an ongoing need to improve the financial knowledge and capabilities of committee members to understand strategic decision making issues, this is proposed to be addressed as a training issue, if not, it would be inappropriate to rely purely on one or two Members that are more financially minded.
- 5.2 The key focus and purpose of having sinking funds is as risk mitigation measure to seek to protect the Council and Council taxpayers during periods when there is turnover of tenants and tenants break leases, or do not renew leases which results in void periods when no rent is received. Having sinking funds balances ensure that there are funds to offset the impacts of such dips in rental income.
 - 5.3 The purpose of the Sinking Fund Forecast model is to project into the future, to see if the Council is building up the funds sufficiently fast to have enough funds to cover future pinch points.
 - 5.4 Based on the history, particularly in relation to development sites, Members have not grasped the need to make strategic decisions.
 - 5.5 Delays caused by officers in finalising the Sinking Fund Forecasting and Stress Testing model. Now that there has been a change of personnel in a key position, this roadblock has been removed and based on the work carried out with officers, this should not occur again.
 - 5.6 Challenges understanding the purpose of the Sinking Fund Forecast and Stress Testing model, it is hoped that this report has allayed many of those concerns for both Councillors and Officers.
 - 5.7 As mentioned above, the next review of this model will be planned for 2030-31 and will probably be in the hands of the devolved larger Council body, based on the Devolution White Paper.
 - 5.8 Whilst this forecasting model is essentially a finance driven model, the Group Head of Assets and the Principal Asset Manager provided the

information that went into the model, based on the variables mentioned in 2.13 above.

- 5.9 The outputs from the Sinking Fund Forecast Model, were reviewed by the individual officers responsible for each property and variations in outcomes against their business plans and exit strategies were evaluated, resulting in some changes to the model and some changes to the exit strategies figures and assumptions.
- 5.10 Officers have also spoken with the new Lay Member of Commercial Assets Sub Committee on a high-level basis to glean information and insights into the format of a Sinking Fund Forecasting Model. This was a useful conversation, and it confirmed that in the main, investment property companies do not share their sinking fund models. One area that was requested, was the ability to forecast and indeed manage leases in the period before a property is refurbished, or redeveloped and for major refurbishments, the floor(s) and occasionally the building is left vacant. The Sinking Fund Forecasting Model has been designed to accommodate this scenario.
- 5.11 The Sinking Fund Forecasting and Stress Testing model, is not an Enterprise Risk Management tool, i.e., a Council wide strategy that helps identify and prepare the authority for potential risks to its operations, finance and objectives, however, it does provide information to assess risks associated with the Investment & Regeneration Property Portfolio, so that Council can implement processes for dealing with any eventuality and therefore minimise its exposure to risks and maximise opportunities.

6. Procurement

- 6.1 None.

7. Legal comments

- 7.1 Section 151 of the Local Government Act 1972 requires local authorities for the proper administration of their financial affairs.

8. Other considerations

- 8.1 None.

9. Equality and Diversity

- 9.1 There are none directly. However, indirectly reducing the level of subsidy from the investment assets because of putting more into the Sinking Funds could result in a reduction of provision of services over time and equality impact assessments would need to be undertaken. The decision made a result of acting on the modelling will have to be assessed on a property-by-property basis.

10. Sustainability/Climate Change Implications

- 10.1 There are no direct implications on sustainability or climate change, however, this Committee will need to consider any implications on the individual projects, when they are presented.

11. Timetable for implementation

- 11.1 This is part of a five-year review process and scheduled for a major review in 2030-31, noting that the model will be used during the next five years to model various scenarios, impacting on the Council's investment and regeneration portfolio, to assist with strategic decision making and risk mitigation
- 11.2 A demonstration of the capabilities of the Sinking Fund Forecasting Model will be held for members of this Committee and the Commercial Assets Sub Committee
12. **Contact details** - Paul Taylor Chief Accountant P.taylor@spelthornee.gov.uk

Background papers:

2025-26 Outline Budget report

2025-26 Reserves Strategy Report

Individual Exit Strategies for investment and regeneration properties

Appendices:

Appendix A – Scenario A Business as usual, cashflow summaries

Appendix B – Scenario B Redevelop XX site and sell XX property

Appendix C – Projected Sinking Fund balances for:

- Scenario A
- Scenario B