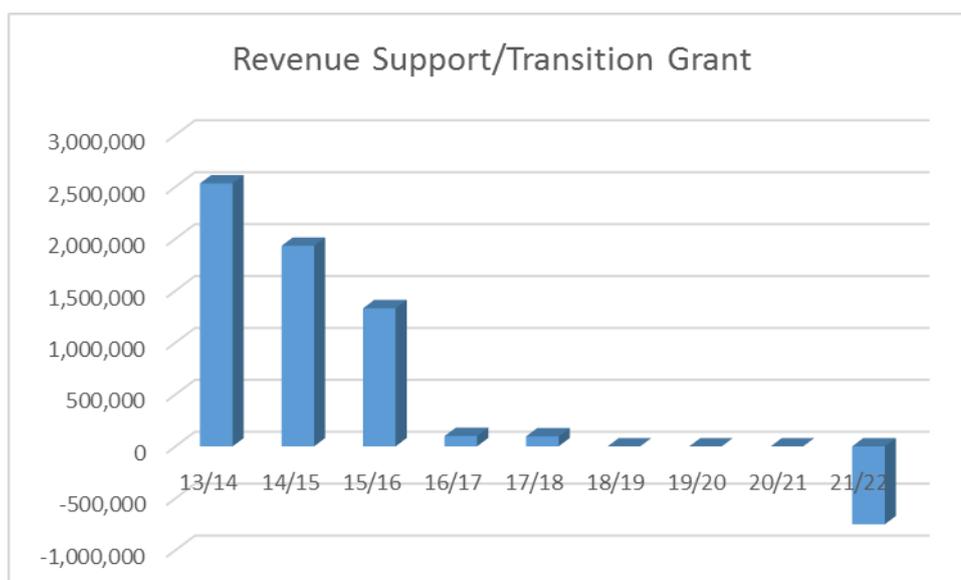


Written evidence submitted by Spelthorne Borough Council

Context

1. This is Spelthorne Borough Council's response to the call for evidence on local authorities' commercial investment activity. We trust the Committee will objectively review the evidence and give detailed consideration to the context that has led to an increasing dependence upon alternative income sources.
2. Spelthorne is located in Surrey on the south-west edge of London, adjoining Heathrow. The ongoing pressure to provide housing, which has led to Spelthorne's delivery programme, is one of the key themes of this submission.
3. The Borough has excellent transport links (M25 and M3), and 35 minutes by rail from Central London. Heathrow has a significant influence on our economic prosperity. Approximately 9% of our working age population depend directly or indirectly on it for employment. It's a key factor for several major companies' HQs, including BP's at Sunbury in Spelthorne.
4. The graph below shows the impact of the changes in RSG received by the Council since 2014. There has been a reversal in government financial support of £2.5m per annum over this period. Whilst the move to negative grant has been postponed (£750,000), this threat remains. When combined with the reduction in NHB Grant Spelthorne faces an adverse movement of more than £5m.



5. Indirect impacts of funding cuts from Surrey (e.g. recycling credits and grants to support independent living services) have added an additional £0.5m per annum pressure.

Response to funding reductions

6. Summer 2016 presented a once in a lifetime opportunity when BP informed the Council it wished to do a sale and leaseback deal. Spelthorne recognised the strategic importance of the site, the quality of the asset and its location, and decided to bid.
7. The purchase price was approximately £380m. There was a perception from some quarters that this was a surprising and risky move. Spelthorne undertook extensive due diligence using best in class advisors, with a particular focus on risk mitigation. Key factors in acquiring were:
 - BP's 100 year history and a very high standard asset
 - 20 year full repairing and insuring year lease with no break clauses, requiring little direct management
 - Lease provides index linked increases for the duration of the term
 - BP and the parent group had the highest covenant possible (credit rating)
 - An evaluation of future uses identified that there were valuable alternatives (clear exit strategy)
 - PWLB rates were at historical all-time lows - We fixed extremely low interest rates over a 50 year period, eliminating interest rate risk
 - A prudent approach to Minimum Revenue Provision was made with the debt being paid off on an annual basis, and fully by year 50
 - Spelthorne with its advisors identified future capital works required at the end of the lease and profiled how much rent needed to put aside annually to build up a robust sinking fund
 - Spelthorne obtained Counsel's opinion on its powers to make the acquisition to ensure compliance with regulatory guidance

After setting aside sinking fund contributions, supervision costs, paying interest and annual debt repayment (we call 'triple net'), the initial acquisition of most of the BP site generated an ongoing net contribution to the Council's Revenue Budget of approx. £3.3m.

This income enabled the Council to re-invest in services and reverse the impact of a decade of 'salami slicing', which had materially undermined the sustainability of provision of services for residents.

Throughout, officers and key Councillors worked closely together and benefited from having a Leader with a property background and a Finance Portfolio Holder with a corporate finance background. Officers and the political leadership took time to explain the rationale of the acquisition to all Councillors and other interested parties such as residents associations – when put to full Council for approval, the final decision to acquire was unanimous.

8. If the Council had not generated income from commercial assets it would have needed to make very difficult decisions to reduce the range and quality of

services provided. For example, reducing the discretionary Independent Living services we provide instead of Surrey County. Provision of such services for vulnerable residents during the COVID crisis has become critical.

9. Commentators often suggest that councils lack the experience and expertise to acquire and manage such assets. The Council mitigated this risk by employing the highest quality advisors with extensive relevant experience.
10. The supervision costs set aside as part of the BP deal enabled the Council to start building its internal Assets team, with experience in acquiring and managing properties, including those within the airport, office and retail sectors (please see links to Capital Strategy). Four have come from private sector backgrounds, and are well used to each dealing with investment portfolios in excess of £500m. The Council also expanded supporting resources in Legal and Finance, as well as continuing to use external expertise on larger scale acquisitions.
11. Over time, Spelthorne has become increasingly sophisticated in its approach. A second advisor is employed to independently and robustly scrutinise the approach and methodology of the lead property advisor. The Council models over the 50 year financing period, on both base case and worst case scenarios, the potential financial liabilities arising from tenants exercising lease breaks, leases ending and not being renewed, voids, rent free periods and capital refurbishments (net of dilapidations). Acquisitions are not considered unless sinking funds over the entire period can be built up to cover these liabilities
12. Currently the Council is setting aside approximately £6m per annum into sinking funds. This means at the end of 2019-20 the sinking fund balances were approximately £20m.

Approach to acquisitions

13. Following the BP deal an opportunity arose at Heathrow, which resulted in the Council acquiring a new build quality asset with a single tenant on a relatively long lease. In December 2017, the Council adopted a set of Strategic Parameters to guide consideration of future acquisitions. This included a focus on limiting acquisitions within the Heathrow functional economic area - it has significant economic importance to us and is an area the Council understands. Whilst some acquisitions are beyond the Borough boundary the furthest is only 30 miles from the Council Offices. The Strategic Parameters put an emphasis on:
 - High quality prestigious assets, relatively newly built, in an area of strong demand
 - Assets occupied by financially healthy tenants – the Council uses both Dun & Bradstreet and Deloitte to evaluate the financial health of potential

- tenants, parent companies and guarantors (both on acquisition and if there is a change in circumstances)
- Longer term unexpired leases preferably more than 10 years, which underpins our conservative approach to acquisitions
 - Assets located close to Heathrow or key transport infrastructure – the portfolio the Council acquired in summer of 2018 of three offices in Slough, Uxbridge, and Reading were all located next to stations, and in case of Reading and Slough will benefit from Crossrail
 - A strong focus on understanding and mitigating risk and only considering proposals which enable a robust sinking fund to be built up
14. The Council always carefully evaluates any proposed acquisition and has rejected far more than it has actually pursued. Whilst the balance sheet value of the portfolio is now approximately £1 billion, the number of assets(10), is a manageable number to handle. The Council employs third party management experts to assist in the day to day management of most of the portfolio properties.
15. The quality of the assets acquired is such that even with the impact of COVID19 they have largely retained their balance sheet values. At the same time the equity in the assets is increasing annually as the debt is paid off.
16. The Council has always pursued an open and transparent approach to engaging with external stakeholders including:
- Briefings for Councillors and residents’ associations
 - Overview and Scrutiny presentations
 - FAQs on website
 - Capital Strategy with Executive Summary
 - Inviting MCHLG (twice), NAO, LGA etc to receive detailed briefings, CIPFA (for scenario planning linked to the Financial Management Code)
 - Interviews with Room 151, Estates Gazette and the Financial Times
 - Inviting LGA to undertake a Corporate Finance and Assets peer review (paused due to COVID 19)
17. In discussions with MHCLG and NAO the Council has expressed its surprise at how easy the process for requesting PWLB funds were and that there is no requirement to demonstrate to PWLB the business case or any other form of underwriting for proposals prior to drawdown. We recognise that with the PWLB consultation it is now proposed to refine the process.
18. The Council recognises governance is important and has set up a Property and Investment Committee as a formal sub-committee of Cabinet. There are weekly officer meetings including Management Team and Portfolio Holders to review and scrutinize. Our Assets team produce a quarterly and annual portfolio report. To supplement this further, Deloitte also undertake an annual review. This gives a ‘real time’ view, enables us to understand

upcoming risks and take proactive steps to address risks. We have adopted the practices of the private sector, whilst ensuring our expenditure stays within our prudential borrowing limits. Internal Audit have undertaken regular reviews of the commercial assets acquisitions.

Housing and economic development

19. The Council embraced the introduction by CIPFA in 2018 of the requirement for Councils to publish Capital Strategies as an opportunity to communicate the investment journey it was on. By this time the Council had recognised it was generating sufficient income to offset and reverse past funding cuts. We could now use the additional income generated to kick start and offset upfront costs of an ambitious housing delivery programme to meet the needs of its residents.
20. Over the next five years, from a standing start in 2018, the Council is aiming with its housing delivery arm Knowle Green Estates to deliver in the region of 1,000 homes. These will include a significant proportion of key worker housing, emergency accommodation for families, a new single person homelessness hostel, affordable rent, as well as private rental accommodation.
21. The Council needs to directly intervene as the private sector and Registered Providers have singularly failed to provide the level of affordable housing residents need. In 2018-19 and 2019-2020 they have provided a mere 6 affordable units (when the number on the housing register is several thousand). In comparison, the Council with its first two completed schemes provided 3 affordable homes and 8 affordable flats. One of the schemes currently nearing completion is the conversion of one wing of the Council Offices into 25 affordable flats. By the end of 2020 Spelthorne will have delivered at least a further 37 affordable flats with plans to deliver a key worker development of 115 units the following year.
22. By directly delivering housing units the Council is improving its chances of meeting the Local Plan housing number targets imposed on it by central government. The housing pipeline being delivered by the Council will account for more than 20% of the housing numbers target for the next five years. Without the income which we have secured from our Investment Portfolio we would not be in a position to deliver any of this ambitious housing programme.
23. As set out in the Capital Strategy, since 2018 the Council has suspended pursuing income generating asset opportunities. It is now focused on housing delivery and economic regeneration within the Borough. Economic development is one of the Councils four priorities and reflects the importance we place on stimulating investment and jobs and therefore prosperity. Our significant landholdings have been supplemented by several acquisitions to cement our strategic position in place shaping our main town centre, Staines-upon-Thames. These capital investments will enable us to ensure that future regeneration opportunities are delivered on the ground.

Withstanding the Impact of COVID19

24. The Council's sinking fund currently stands at approximately £20m. With the onset of the COVID19 emergency in March 2020, the Council has had to pro-actively engage with some of its tenants and discuss their cashflow issues. At the time of writing, more than 90% of the March quarter rent due on commercial assets has been received, and of the 10% outstanding all but 0.01% has been addressed through rent deferral plans agreed between the Council and the tenants.
25. While balance sheet value post Covid-19 has largely remained at acquisition levels, net income has been significantly increased through leasing and pro-active asset management during the Council's ownership
26. We believe that the above position is confirmation of:
 - a) Quality and location of the Council's investments
 - b) Robustness of health of the tenants, and their guarantors
 - c) A reflection of the high quality negotiating skills of the internal assets team and the advisors they work with
27. Despite this initially strong position, the Council recognises that COVID19 poses the most extreme economic stress test for more than two centuries. The Council has updated its sinking fund scenario modelling, focusing on the next five years, running a number of worst case scenarios. With even the most adverse of these scenarios the sinking funds are sufficient to offset potential drops in rental income. This means the Council is confident that its sinking funds are sufficient to insulate the Revenue Budget and Council taxpayers from any adverse impacts of COVID19.
28. Obviously we do not yet know how long COVID19 will impact and how the lockdown will be wound down. The Council will continue to keep under active review its sinking funds projections.
29. As a result of our investments, we have improved the financial resilience of and increased service delivery resources in areas such as homelessness and independent living. This has enabled the Council to pro-actively and rapidly move in response to COVID19 to meet the needs of its vulnerable communities without reliance on government funding in advance. As an example, even though it is not our role, we have put in place arrangements for our staff to contact 93% of Category A (shielded) residents in the borough and arrange food parcels and welfare support for those in need.

Regeneration

30. Recently the Council acquired the long leasehold interest (already being the freehold owner) in the Elmsleigh Centre, one of two retail centres in Staines-

upon-Thames. The rationale for the acquisition was not in order to generate a net revenue income stream to support the Council's budget but rather for regeneration purposes, to take control of a key site in the town and manage a transition towards a more sustainable environment where a broader mix of uses can provide greater vibrancy and vitality as well as providing greater resilience for its retail interests. Away from retail the Council is also progressing a town centre masterplan and this asset will give Spelthorne greater control in delivering its ambitions.

31. There was a secondary motivation, as the acquisition enables the Council to avoid significant future capital commitments (to a number of multi storey car parks) which would otherwise have been triggered.
32. Unsurprisingly in contrast to its commercial assets tenants a high proportion of the retail tenants have approached the Council with cashflow issues following the March quarter. The Council has responded pro-actively and supportively and has received a higher level of rental and service charge payments than many retail landlords. The impact of COVID19 has indeed reinforced the rationale for the Council's acquisition and it will be accelerating plans for diversification of use on the site.
33. We do have to observe that recent Government policy decisions limiting the levers available to landlords do not sufficiently differentiate between tenants who would pay if they were able and those who could pay but choose not to.
34. With regard to our current housing schemes underway, our team's early intervention in imposing requirements in excess of PHE requirements has led to all our sites remaining active despite COVID-19. They are also mainly on programme and on budget with very limited slippage to date.
35. Having signed a major development opportunity during the COVID crisis gives a strong signal that even in these challenging times, businesses can see the untapped potential of the town and are keen to invest in Spelthorne.

External Auditors

36. The Commission will be aware that the Council has had issues with its external auditors and that it is still waiting for the outgoing auditors KPMG to issue their 2017-18 VFM Opinion. The Council has been extremely disappointed by the speed and lack of engagement of KPMG. We have always sought to be totally transparent with the external auditors. It appears to the Council that KPMG did not appear to be clear about their role on such complex and sensitive issues. As a result, they appeared to be hesitant about giving their VFM opinions. We are strongly of the view that some of the recommendations made in the 2016-17 VFM opinion focused on relatively immaterial matters, such as the delay of publishing the decision on BP acquisition on the Council's website.

37. We believe the Council's ability to withstand the current COVID19 storm will prove to be the strongest possible demonstration of the Council's robust approach to risk mitigation.

Conclusion

The government effectively has three options for funding local authorities:

- To continue to give grant funding for which it will see no return
- For Councils to take out loans which enables Councils to invest in order to repay loans and interest
- To take over the running of Councils directly as they cannot survive without adequate funding

38. The approach we have taken has allowed us to ensure:

- No cuts to services
- Below inflation council tax rises for the past 4 years
- No disposal of assets
- No drawing on reserves

39. The Council hopes the Commission finds this submission useful and would like to highlight that its officers and Leader of the Council, Cllr Ian Harvey, would be very happy to present oral evidence if the Commission felt that would be useful.

Website links

Capital Strategy (executive summary and main document)

<https://www.spelthorne.gov.uk/capitalstrategy>

Property Investment FAQ's

<https://www.spelthorne.gov.uk/article/18023/Property-investment-FAQs>

Property Investment Strategy

<https://www.spelthorne.gov.uk/article/18024/Property-investment-strategy>

Press release on affordable housing delivery programme

<https://www.spelthorne.gov.uk/article/19275/Working-to-deliver-affordable-homes>

May 2020