By: Nick Chard, Cabinet Member for Finance
Lynda McMullan, Director of Finance

To: County Council – 4 September 2008

Subject: Property Enterprise Fund 2

Classification: Unrestricted

Summary:

This report seeks Council approval for the creation of the Property Enterprise Fund 2 with a maximum overdraft limit of £85m, as agreed by Cabinet on 4 August 2008.

FOR DECISION

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1. Introduction

1.1 The current capital programme between 2008 and 2011 is based on £180m of funding to come from capital receipts. Given the current fall in property and land values which is predicted to continue into next year and potentially for a number of years beyond, achieving the £180m within this time frame is no longer realistic. This means we have to have an intelligent solution to the funding issue over the next three years.

1.2 Unless we provide this solution, the capital programme is in real danger of entering into a stop / start pattern, risking service delivery and value for money. Consequently, a funding model is being proposed that will enable service directorates to continue to plan and deliver capital projects with a degree of certainty that in the current climate, does not exist.

1.3 Our proposal is to create a second Property Enterprise Fund (PEF2). This would be distinct from the existing Fund (PEF1) in that only earmarked receipts would be accounted for through PEF2. Non-earmarked receipts would continue to go through PEF1. Another distinction is that PEF2 would be for the sole purpose of supporting the capital programme, whereas PEF1 is for the strategic acquisition of land and property to add value to the Council's portfolio, aid the achievement of economic and regeneration objectives and the generation of income.

1.4 The financial objective of the PEF2 is to broadly break-even over a rolling five-year cycle. Large profits or losses are not good news in relation to the delivery of the capital programme or our financial standing. Large profits would suggest that we took unnecessary action to remove service improvements from our capital programme. Large losses would mean we have not been sufficiently prudent in our valuation of assets at the date of transfer into PEF2.

2. Mechanics of PEF2

2.1 The proposal for how PEF2 would work are as follows:

i. The Directorate/Portfolio can elect to pass an earmarked property to PEF2 if it requires guaranteed funding for their overall programme;

ii. The project may have already been included in the medium term plan, but new projects will be considered, initially through the Project Appraisal Group (PAG) process;

iii. The property will only be accepted by PEF2 if it meets certain criteria (see appendix 1), and the final decision (documented in writing), as to whether a property can be passed to the fund will lie with Property Group;

iv. A risk factor percentage will be applied by Property Group to reflect the borrowing costs, risk of planning, market conditions, holding costs, plus any individual risks which are linked with the property relating to, for example, title or political issues. It is proposed that the transfer "price" to PEF2 should be within a range of:

   1. a minimum of the current valuation; and
   2. a maximum of 75% (to reflect borrowing costs for 5 years) of the valuation included in the 2008-11 MTP, less projected holding costs. This will be a one off transaction and no further adjustment will be made to the capital sum to be transferred;

   The value is to be negotiated between the holding directorate and Property Group, but should normally remain within the maximum and minimum range shown above. **Where agreement cannot be reached, the Director of Finance will arbitrate in consultation with The Leader.**

v. PEF2 will offer to buy the property from the directorate within the maximum and minimum range set above;

vi. The directorate determines if the valuation is sufficient to fund their programme. If so, that part of the funding can be deemed to be in place. If not, the programme must be reduced by an equivalent amount;

vii. The receipt is then held corporately until Property Group in consultation with the Cabinet Member for Finance feel the time is right to realise an appropriate level of receipt;

viii. Any overall surplus from PEF2 would be recycled into the Council's priorities in the capital programme.

2.2 It should be noted that as per iii) above, not all sites would be eligible for going into PEF2 and specific requirements are detailed at Appendix 1.

2.3 PEF2 is being proposed as providing an option for directorates. Should a directorate not wish to make use of this funding arrangement, they may still seek disposal of a property through Property Group using the existing process. If this route is chosen the Directorate's assumptions around the timing and value of the capital receipt need to be realistic i.e. as advised by Corporate Property Group, and the Property Group, in consultation with the Director of Finance and the Cabinet Member for Finance, may refuse to proceed with the disposal if it does not represent good value for the Council.

2.4 The benefits of the PEF2 proposal are as follows:

i. it brings responsibility and accountability together. In context, that means that those responsible for the valuation then have to deliver;

ii. it avoids boom and bust periods of spend;

iii. it enables us to take a longer term view on getting best value from our assets, thereby avoiding potential fire sales to enable vital capital projects to go ahead;

iv. it puts the disposal decision in the hands of the expert, not the directorates;

v. risks are held centrally rather than be dispersed. This makes managing and mitigating those risks much easier;

vi. it gives certainty to service directorates.

3. Funding of PEF2

3.1 As the proposed mechanism of PEF2 will mean paying money out to directorates in advance of receipts being realised, the funding stream for this will be from prudential borrowing. Therefore it is proposed that the fund have a maximum deficit limit of £85m.

3.2 Revenue implications and funding
If full use is made of the overdraft limit then the revenue costs for a full year's £85m borrowing equates to approximately £4.25m per annum. This is based on interest costs only, as opposed to both interest and minimum revenue provision (MRP), as any borrowing undertaken by PEF2 is expected to be only short term and would effectively be repaid as soon as the capital receipt is realised. A projection of the PEF2 balance will be included in the Medium term Plan each year and that projection will be included in the prudential indicators.

3.3 The proposed funding for the revenue costs associated with PEF2, which would include holding costs of vacant properties within the fund and interest costs on the overdraft, is to use the prudential equalisation reserve. This reserve would be re-imbursed as receipts are eventually realised, at 5% per annum of the value of the disposal. The time will be

calculated from the point the asset transferred into PEF2 to the date of disposal.

3.4 In the event of there being no further funds available from the prudential equalisation reserve, the costs of the PEF2 borrowing would need to be a first call from the revenue budget. It is the view of the Director of Finance that the risk of this is minimal but will be reviewed every year as part of the budget process in any case. This approach has been discussed with the External Auditor.

3.5 PEF2 will also have the ability to temporarily let properties, or agree occupation temporarily by a Directorate/partner/service provider. Any rent received would form a revenue stream of income which could then be used to fund some of the revenue costs.

3.6 Fund surpluses/deficits
Should PEF2 be in overall surplus at the end of the five year period, after repaying borrowing costs and other disposal costs, this balance would be available for investment as Members see fit. This could be used for example, to reduce the level of borrowing the authority undertakes to fund the capital programme, or to fund new schemes to the capital programme.

3.7 Surpluses on individual receipts will not automatically be reinvested into the directorate from which they came, and similarly any losses on individual receipts will be contained and managed within PEF2.

4. Governance

4.1 The governance of PEF2 would follow that of PEF1, the only significant difference being the value of the maximum overdraft of the fund.

4.2 The fund will be operated within the parameters of the Property Management Protocol (PMP) in compliance with the Council's Constitution and Financial Regulations, and within the Local Government Act 2003.

4.3 Properties/sites will only be accepted into PEF2 if they meet the criteria set out in appendix 1, and the final say as to whether a property can be passed into the fund will lie with Property Group.

4.4 The project must already be included in the current medium term plan or have already been approved through the Project Appraisal Group (PAG) process.

4.5 The decision on timing of sale and terms of sale will lie with Property Group in consultation with the Cabinet Member for Finance once the property has been released to the fund.

4.6 All transactions coming within the PEF2 balancing limit of £85m should be authorised jointly by the Director of Property and Director of Finance in consultation with the Cabinet Member for Finance, the Chief Executive and the Leader.

4.7 PEF2 will benefit from any surpluses achieved on the sale of the individual properties, but will also bear the risk of any deficits which will be managed and contained within the fund.

4.8 **Delegation to Officers**
Subject to the authorisations in paragraph 4.6 above, the Director of Property is authorised to:

- Determine and settle the acquisition or disposal of any land or property, or an interest in land or property where the consideration (including any associated works) does not exceed **£1,000,000** in any single transaction.
- Determine and settle the terms of a lease (taken or granted) for any land or property, not exceeding a period of 20 years or where the consideration does not exceed **£100,000** per annum in any single transaction.
- As provided by arrangements made under Appendix 2 Part 4 of the Constitution for the Leader to discharge executive functions, the Chief Executive may exercise any power delegated under this protocol to the Director of Property; and the Director of Property may delegate his/her powers in writing to more junior officers.

4.9 **Financial Regulations**
All of the protocols set out in Financial Regulations and Schemes of Delegation must be adhered to, except where the Property Management Protocol specifically provides for alternative levels of authorisation.

4.10 **Reporting**
Monitoring of the fund will be reported quarterly to Cabinet.

5. Risks

5.1 The main risk is that the property market does not recover significantly within the next 3-5 years. This could potentially result in:

- The prudential equalisation reserve being insufficient to continue to fund the revenue costs of PEF2.
- The debt charges budget needing to be increased to pay for extended borrowing costs.

5.2 To mitigate these risks, a maximum and minimum range has been set for the value that will be applied to each property going into PEF2. This lower and upper limit is suggested as it offers certainty to Directorates so that capital projects can continue, but is also realistic enough so that when the properties are disposed of in the future, KCC recovers the costs of holding the asset in the short term.

6. Recommendations

6.1 County Council is asked to approve the establishment of PEF2, with a maximum deficit balance of £85m.

APPENDIX 1

Criteria for Properties to Qualify to be Passed into PEF2:

The property will only be accepted by PEF2 if it meets certain criteria and the final say as to whether a property can be passed to the Fund will lie with Property Group.

The criteria for properties to qualify to be passed into the fund are as follows:

1. The property/land must have freehold unencumbered title. A full title report will be required prior to agreement to fund.

2. The boundaries must be agreed with the directorate and marked clearly on site (and on a plan).

3. The risk of a village green application being made is minimised and in the event that this is assessed at a high risk and the risk factor will be adjusted accordingly.

4. There must be an agreed and guaranteed date for vacant possession. This is the latest date on which the directorate and any other KCC partners/service providers will vacate the property. A signed undertaking that vacant possession will be given on this date will be required. Where third parties are occupying the property they must enter into a legal agreement to vacate the property by the agreed date.

5. The vacation date can be no longer than three calendar years after the date the property is passed to the Fund.

6. The property may be occupied (if prior agreement has been reached with Property Group) by a third party, only if the terms of the occupation are scrutinised by Property Group and deemed to pose no threat to the disposal of the property.

7. A surplus declaration must be provided by the Directorate. In the case of properties which are not vacant, this surplus declaration will contain the agreed vacation date by all internal and external parties and will be contractually binding.

8. In the case of properties which are not vacant at the time of hand over to the Fund, the Directorate will agree to pay the running costs of the property up to the date of vacation. For the avoidance of doubt this will include rates, utilities, cleaning costs, security, maintenance and repair of fabric and services.

9. In the case of properties which are not vacant at the time of hand over, the Fund will become the landlord and the Directorate will sign a simple agreement covering the terms of occupation. This will include maintaining the property in a condition no worse than at the point of hand over to the Fund. This is vital to ensure value is not

diminished in the interim period before vacation. If necessary a photographic schedule of condition can be prepared on transfer.

10. The following special criteria apply:

    CFE

    i. A section 77 consent must be provided. If this is not possible a higher risk factor will have to be applied to reflect the possibility of consent to dispose not being granted.
    ii. The school must declare the land/buildings surplus prior to handover.
    iii. School closure procedures must have commenced and a time scale agreed for the date of completion of the process.
    iv. Where a school is being amalgamated or a new school built the consultation exercise must already have commenced (statutory consultation and notice served), so there is no deemed risk of the land being taken into the schools ownership.
    v. If the school is still in occupation, they must enter into the agreement as detailed (9) above.
    vi. Agreement in writing must be provided from the school confirming the land can be released and they will not lay claim to ownership of the land.
    vii. If the land is connected to Diocese school then confirmation must be provided that land to be sold is KCC's title.
    viii. If the planning application for the redevelopment of the site will be linked by the District Council to a planning application for a new school, then the Directorate must undertake to submit the planning application by an agreed date. If the Directorate subsequently do submit a planning application or decide not to build a new school, then the funding for the property released will be reclaimed by the Fund, in the event that this renders the land un-developable.

    E&R (Highways)

    ix. Stopping up orders for land designated, as Highways must have been obtained.

    All Directorates

    x. Service closure or relocation procedures must have been undertaken together with all relevant consultation.

11. Where the property to be released is adjacent to KCC retained land or where land is acquired subsequently adjacent to the property, Property Group must be consulted regarding any use and/or development of the adjacent land and must approve any terms of PFI or other contracts on the land. This is to prevent any reduction in value of the Fund's land.

12. Property Group will undertake any representations to Districts regarding Local Development Frameworks (LDF) in respect of the Fund’s property, however Directorates must undertake to safe guard the LDF allocations of property which will be released for disposal over the forthcoming LDF period (10 years).