# Late Report Papers for Corporate and Community Overview and Scrutiny Committee

Date: Wednesday, 20 July 2022
(adjourned to Friday 2 September 2022 at 6.00pm)



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| 5. | **Commercialisation of Beach Hut Assets through Special Purpose Vehicle (SPV) Wholly or Majority Owned by the Council** | 3 - 144 |



Published: 24 August 2022

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# CORPORATE AND COMMUNITY OVERVIEW AND SCRUTINY COMMITTEE

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| Report subject | **Commercialisation of Beach Hut Assets through Special Purpose Vehicle (SPV) wholly or majority owned by the Council.** |
| Meeting date | 2 September 2022 |
| Status | Public |
| Executive summary | The purpose of this report is to update Overview and Scrutiny Committee on the Council's work to consider the use of a Special Purpose Vehicle (SPV) to commercialise the Council's beach hut assets and release a £50m capital receipt back to Council for the Transformation Programme.<br><br>Independent advice from KPMG has been sought in the development of this work. The advisory reports from KPMG can be found in the Appendices.<br><br>During the development of this work the Secretary of State for Local Government changed the Flexible Use of Capital Receipts (FUCR) guidance. The change in guidance prevents the use of capital received from the sale of beach hut assets to a wholly or partially owned SPV for transformation purposes.<br><br>Following this change the Council is no longer pursuing the use of an SPV for the commercialisation of beach huts but will now develop proposals for changes to the in-house management, harmonisation of prices and policies, and enabling capital investment. Recommended decisions will be brought forward to Cabinet later in the year. |
| | **It is RECOMMENDED that the Overview and Scrutiny Committee:**<br><br>**1. Notes the Council is no longer pursuing the commercialisation of beach hut assets via an SPV.** |
| Reason for recommendations | To update overview and scrutiny on the Council's work to consider the commercialisation of beach huts via a Special Purpose Vehicle. |

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| Portfolio Holder(s): | Councillor Drew Mellor, Leader of the Council and Portfolio Holder for Finance and Transformation<br><br>Councillor Mark Anderson, Portfolio Holder for Environment and Place. |
| Corporate Director | Jess Gibbons, Chief Operations Officer |

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| Wards | All wards |
| Classification | For decision. |

## Background

1. In February 2022, the Council set out its Budget and Medium-Term Financial Plan (MTFP) outlining recommendations for the 22/23 budget and council tax. This included a future commitment from Cabinet and Council to approve a bold and non-traditional proposal to create a Council owned Special Purpose Vehicle (SPV) that would enable the commercialisation of Council beach hut assets and generate a capital receipt for the Council.

2. In August 2022, the Secretary of State for Levelling Up, Housing and Communities changed the Flexible Use of Capital Receipts (FUCR) guidance, which prevents the Special Purpose Vehicle proposal from generating a receipt which could be used under FUCR where the SPV is within the "group" structure of the Council for accounting purposes.

3. The commercialisation of beach huts aligns to the Seafront Strategy, adopted by Cabinet in April 2022, which sets out a unified vision, ambition, and list of priorities for investment in leisure and infrastructure. It is included in the pipeline of prioritised projects within Section 3.6 of the Seafront Strategy Cabinet Report.

### Special Purpose Vehicle

4. In late 2021 the Council undertook work to consider options to improve the commercial return from its capital assets and release capital receipts to fund its transformation programme. This included work to consider the use of a Special Purpose Vehicle (SPV) to commercialise the Council's beach hut assets and release a £50m capital receipt back to the Council for its Transformation Programme.

5. Independent advice from KPMG was sought in the development of this work. The advisory reports from KPMG can be found in the Appendices.

6. External consultants set out the benefits of a SPV as follows:

   a. Enabling the raising of investment capital to further invest in Beach Hut assets over time to improve their quality and amenity, without using up Council capital resources.
   b. Allowing a streamlined decision making and governance structure, creating a more agile organisation able to respond more efficiently to changing market conditions.
   c. Streamlining the use of Council management and Councillor time.
   d. Ring-fencing of risk within a subsidiary with limited recourse to the Council for non-core commercial activity.
   e. Increasing potential to generate additional revenue, in part through price harmonisation across seafront assets.

f. Generating capital for the Council through the sale of the assets to the subsidiary, to allow the Council to invest in core capital projects or other transformation activities

7. During the development of this work the Minister for Equalities, Local Government, Faith and Communities, Kemi Badenoch, wrote to the Council indicating an intention to change the FUCR guidance (Appendix D). The change in guidance was subsequently confirmed by the Secretary of State for Levelling Up, Housing and Communities (Appendix E) and this prevents the use of capital received from the sale of beach hut assets to a wholly or partially owned SPV to fund transformation.

8. Following this change the Council is no longer pursuing the use of an SPV for the commercialisation of beach huts but will now develop proposals for changes to the in-house management, harmonisation of prices and policies and capital investment. Recommended decisions will be brought forward to Cabinet later in the year. These will include proposals for delegated authority to the seafront team to seek to galvanise as far as possible the benefits of the in-house model.

9. The Council considered whether to continue with a wholly owned SPV, without using a capital receipt to fund the transformation programme, to gain some of the wider benefits external consultants had identified as set out in paragraph 6. This option was discounted for the following reasons:

   a. The future tax liability of approximately £20m over 20 years makes the viability marginal.
   b. While an SPV could raise capital without using up Council resources, capital budget could be used to generate an increase in future income allowing a revenue return to support the Council's short-term revenue position.
   c. To gain some of the benefits of streamlined governance and management that an SPV would achieve the Council will seek delegated authority from Cabinet in the report to be brought forward later in the year.
   d. The price harmonisation and investment for beach huts can be delivered in house.

10. The Council also considered whether to progress with a wholly externally owned SPV which would mean the sale of the Council's beach hut assets outside of the Council's control. While this would provide the Council with a Capital receipt that could be used under the Flexible Use of Capital guidance to fund the Council's transformation programme this option would reduce the Council's annual revenue budget without the benefit of an improved future return to the Council.

**Engagement**

11. The four Beach Hut Associations have been kept up to date during the process of considering a SPV for the commercialisation of beach huts. Officers and members responded to questions at the Poole and Bournemouth associations public meetings. Offers to attend meetings have also been made to the Friars Cliff and Mudeford Sandbank Associations. The Beach Hut Associations will be sent a link to this report and are welcome to attend the O&S meeting. Further engagement will take place with the beach hut tenants as the in-house commercialisation model is developed.

## Summary of financial implications

12. Prior to the change in guidance the commercialisation of beach hut assets via an SPV would have generated a £50m capital receipt back to the Council. The SPV would have invested £450k per annum in improvements to the beach huts, while harmonising policies and prices.

13. Officers are in the process of drafting a beach huts commercialisation business plan, which will take learning from the advice received so far and develop plans for investment and policy development to commercialise our beach huts in-house. A report to Cabinet later in the year will set out the financial implications of this business plan.

14. A finance update and Q1 22/23 budget monitoring report will be considered by Cabinet on 7 September and is due to be considered by a special scrutiny meeting. This report will identify the effects on the Council's budgets of not proceeding with the original proposal and will set out an alternative financial strategy to balance the Council's budget in the short and medium terms. Details of how the Council can commercialise its beach hut stock will be brought forward with a business plan, to Cabinet later in the year.

## Summary of legal implications

15. Legal advice was sought throughout the development of this work. The change in guidance by the Secretary of State means a capital receipt received by the Council from the sale of beach huts assets to a SPV could no longer be used to fund the Council's Transformation programme.

16. Retention of the assets in-house will mean that the ongoing provision of beach huts will be in accordance with the Council's existing powers.

17. Further, specific, legal advice will be provided at the appropriate time, as the proposals for in-house commercialisation are developed.

### Human resources implications

18. The decision not to proceed with the use of an SPV has no human resource implications.

## Summary of sustainability impact for the SPV

19. A Sustainability Decision Impact Assessment was completed for the SPV and will be updated for future proposals for the commercialisation of beach huts.

## Summary of public health implications for the SPV

20. There are currently no public health implications related to this report.

## Summary of equality implications for the SPV

21. A full EIA (Equality Impact Assessment) was completed and was approved by the EIA (Equality Impact Assessment) panel on 21 April 2022 for the formation of the SPV.

22. Separate assessments will now be undertaken for the in-house option.

## Summary of risk assessment for the SPV

23. The decision not to proceed with a SPV for the commercialisation of beach huts removes any risks associated with a SPV.

## Appendices

Appendix A - KPMG Commercial and financial options, September 2021
Appendix B – KPMG Commercialisation of assets, February 2022
Appendix C – KPMG Commercialisation of Council Owned beach Huts, July 2022
Appendix D – Letter from Kemi Badenoch, Minister for Equalities, Local Government, Faith and Communities to Cllr Drew Mellor, 16 June 2022
Appendix E - Letter from Greg Clark, Secretary of State for Levelling Up, Housing and Communities to all Council Leaders, 1 August 2022

**Background papers**
Published works

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# Commercial and Financial Options Structuring

**Bournemouth Christchurch and Poole Council**

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September 2021

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# Important Notice

This report has been prepared on the basis set out in our engagement letter addressed to Bournemouth Christchurch and Poole Council ("the Client") dated 3rd August 2021 (the "Engagement Letter") and should be read in conjunction with the Engagement Letter.

Please note that the Engagement Letter makes this report confidential between the Client and us. It has been released to the Client on the basis that it shall not be copied, referred to or disclosed, in whole or in part, without our prior written consent (except as specifically permitted in our Engagement Letter). Any disclosure of this report beyond what is permitted under the Engagement Letter will prejudice substantially this firm's commercial interests. A request for our consent to any such wider disclosure may result in our agreement to these disclosure restrictions being lifted in part. If the Client receives a request for disclosure of the product of our work or this report under the Freedom of Information Act 2000 or the Freedom of Information (Scotland) Act 2002, having regard to these actionable disclosure restrictions the Client should let us know and should not make a disclosure in response to any such request without first consulting KPMG LLP and taking into account any representations that KPMG LLP might make.

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This report has not been designed to be of benefit to anyone except the Client. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the Client, even though we may have been aware that others might read this report

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In particular, and without limiting the general statement above, since we have prepared this report for the benefit of the Client alone, this report has not been prepared for the benefit of any other local authority nor for any other person or organisation who might have an interest in the matters discussed in this report.

Our work commenced on the 5th August 2021 and the report was completed on 22nd September 2021. We have not undertaken to update our presentation for events or circumstances arising after that date

In preparing our report, our primary source has been information received by the Client and representations made to us by management of the Client. We do not accept responsibility for such information which remains the responsibility of management. We have not, however, sought to establish the reliability of the sources by reference to other evidence.

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# Executive Summary

# Executive Summary

**Background & Scope**

- Bournemouth Christchurch and Poole Council (BCP or ' the Council') has an ambitious capital programme in order to deliver its regeneration vision for the city region, comprising approx. at least 18 investments with an estimated gross development value of Council-owned sites alone nearing £1bn over the next 5 years.
- Each investment within the programme varies considerably in terms of scale, complexity and the level of business planning and feasibility assessment undertaken to date. These range from small, discrete housing schemes (approx. £2m), redevelopment opportunities in town centres to large mixed use regeneration projects on significant sites of regional interest such as the former power station at Holes Bay seeking to deliver 800+ new homes in new communities.
- The Council has appointed KPMG to undertake an options appraisal of the different commercial and delivery models available to BCP to deliver their capital projects based on its objectives and constraints.

**BCP's objectives and constraints**

- In order to assess the different commercial and delivery options available to the Council to deliver its capital plans, a set of criteria were developed in discussion with the Council. These are aligned to the Council's short, medium and long term objectives, seeking to evaluate the following:
  - the scale and pace at which delivery of the Council's regeneration aims is achieved;
  - the extent to which the proposed structures generate capital receipts in line with the timing constraints of BCP's wider regeneration and transformation plans;
  - the level of financial returns generated by the option for the Council both in the short and longer term;
  - the extent of control retained by the Council over the development including land use, design/specification and operational activity;
  - the level of risk retained by the Council including construction, demand/sale risk, operational and financing risk; and
  - the complexity involved in delivering the structure in terms of required management capacity and skills.

**Commercial delivery structures under consideration**

- Based on the above objectives, several delivery structures have been considered as follows:
  - Option 1 where the Council finances, develops and lets/sells the completed developments to third parties itself;
  - Option 2a where a Council owned subsidiary develops and manages the assets using debt and equity funding provided by the Council;
  - Option 2b is as per Option 2a with the SPV securing borrowing from third parties using a financial guarantee from the Council;
  - Option 3 is an income strip model where the Council grants a headlease over its land assets to a pension fund in return for capital funds, and commits to paying a predetermined rent over an agreed period (usually 30-50 years) with reversion of the asset to the Council at the end of that period;
  - Option 4a is Contractual Joint Venture where a development agreement is entered into with a development partner whereby the Council transfers its land assets in return for land payments, a contractual share of future income and potential future overage payments;
  - Corporate 4b is a Corporate Joint Venture ('JV') model whereby the Council forms a new JV entity with a developer/investor partner and transfers its land assets on phased basis on a long leasehold in return for a mix of land payment and an equity share in the JV;
  - Option 5 is a direct land sale model where the Council would sell its land assets to a third party (with or without planning consent).
- Each structure is underpinned by different commercial arrangements, will lend itself to different types of assets/development projects from BCP's capital programme and meets BCP's different objectives to various degrees. These are assessed in more detail on pages 13-29.

# Executive Summary

— A variant to Option 2a (Council ow ned SPV) w hereby the Council disposes of its assets to its w holly ow ned SPV and subsequently leases it back has been discounted as it is unlikely to provide good value for money and in our assessment it is probable that the original borrow ing undertaken by the Council (to fund its on-lending to the SPV solely to enable it to buy assets from the Council) w ould be expected to be deemed to be for an improper purpose (namely to artificially create capital receipts).

— Set out below is our indicative evaluation of the different structures assessed against the Council's evaluation criteria:

| BCP Objectives | Option 1: Build & finance yourself | Option 2a: Council ow ned SPV | Option 2b: Council ow ned SPV with guarantee | Option 3: Lease solution direct with funder | Option 4a: Contractual JV | Option 4b: Corporate JV | Option 5: Direct Sale |
|---|---|---|---|---|---|---|---|
| Delivers regenerations aims | Amber | Amber | Amber | Amber | Amber | Amber | Red |
| Delivers capital receipts by 2025 | Green | Amber | Red | Amber | Green | Green | Green |
| Value for money/ Financial Return | Amber | Amber | Amber | Red | Amber | Amber | Red |
| Control retained by the Council | Amber | Green | Green | Amber | Amber | Amber | Red |
| Risk exposure | Red | Amber | Amber | Red | Amber | Amber | Green |
| Management capacity an capability | Amber | Amber | Amber | Amber | Amber | Red | Green |

— Option 1 may not be able to fully deliver the Council's ambitious regeneration aims at the required scale and pace given the additional borrow ing, resources and expertise required particularly for the delivery of the large mixed use tow n centre redevelopments w hilst exposing the Council to significant levels of risk. How ever, the option may be suitable to the requirements and needs of specific individual projects.

— Option 2a and b w hilst offering some segregation betw een BCP's core activities and its commercial and real estate developments, do not bring in any new capital or development or operating expertise and therefore rely on the Council's borrow ing capacity and expertise for implementation as w ith Option 1. Option 2b does not offer a straight forw ard mechanism to extract capital receipts (rather than dividends) given the Council's investment in the SPV is through equity capital only and there is no direct means – such as the repayment of loans – w hich w ould enable the SPV to make cash payments to the Council on an ongoing basis w hich w ould score as capital receipts.

— Option 3 ( Income Str ip solution) is not considered to offer good value for money over Option 1 given extent of risk taken by the Council and the associated cost of finance impacting the level of returns retained by the Council. In addition, in order to achieve the des ired accounting treatment, the Council w ould need to dispose of the completed assets therefore losing the long term interest in the developments. The implementation of this option should take into account the guidance provided in MHCLG's (now DLUHC) Capital Finance Framew ork on assessing the commercial and financial risks to w hich the Council may be exposed to under such an approach and ensuring that they are appropriately mitigated.

# Executive Summary

— Options 4a ( Contractual JV) and Option 4b ( Corporate JV) offer a good balance betw een delivering the Council's regeneration vis ion at required scale and pace particularly for the more complex large scale redevelopments, securing commercial upside for the Council from redevelopment, allow ing the Council to exert an optimal degree of of control/ influenc e over the development in terms of use mix, design/development and operational activity either contractually ( Option 4a) or through a minority equity stake and governance structure w ith representation at JV Board level ( Option 4b) and dow nside ris k mitigation by procuring an Inv estment Partner/ Developer responsible for masterplanning, gaining planning consent, redevelopment and securing occupiers, w ithout compromising the accounting treatment;

— Option 5 offers a quic k solution to secure a capital receipt in a short space of time given the Counc il's minimum requirement to achieve capital receipts by 2025 how ever, it does not allow the Counc il to exert any control over the land use going forw ard to achieve its regeneration aims and the Council w ill not benefit from longer terms value gains from redevelopment.

— Our analysis also show s that there are a range of structures that are better suited to specific schemes from BCP's capital programme, specifically:

- The large mixed use regeneration schemes could be delivered through a corporate joint venture w ith an investor or delivery partner w ho could bring access to additional funding as required for the Boscombe Tow n Centre scheme, specific land ow nership interests needed for the Heart of Poole scheme w hich assumes the acquisition of Brow nsea House or specific skills, know ledge and expertise as required for the Bournemouth International Centre w here experience of operating conferencing and events facilities may be required to achieve BCP's ambitions for this project

- The housing schemes inc luding some of the larger residential redevelopments such as Turlin Moor could be facilitated by a dedicated Counc il ow ned SPV ( Option 2a), w hether by increasing the scale and remit of BCP's existing housing subsidiary, Seascape Homes and Property Limited or by creating a separate SPV to br ing forw ard these developments and potentially recruiting skills and experience not available w ithin the Council

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- The leisure facilities at Queens Park and medical science and research development at Wessex Fields w ould benefit from a guarantee SPV structure (Option 2a) w hich w ould strengthen the demand case for raising the required financing

— Further analysis is needed to refine the options evaluation, inc luding the Council's consideration of w hich criteria are most important to the delivery of its strategic objectives and applying suitable w eightings against each criterion as w ell as a more in depth understanding of the schemes and projects w ithin the Council's capital programme (including feasibility assessments).

— Whilst we have presented these as discrete options, in reality a large regeneration project could combine aspects of different options – i.e. the Counc il may direct fund some elements, sell others plots to raise capital and enter into more complex JV or guarantee arrangements for others. The detail of this needs to be considered on a project by project basis in more detail than is in the scope of this report.

— Many of the options assessed have merit and could be applied in certain situation. Rather than there being one option that fits all projects, it is likely that across the portfolio of projects that BCP is considering that different models w ill be applicable. The r ight model w ill depend on the project particulars, w hilst the Council w ill also need to consider the combined impact on financial capacity, risk profile, management capacity and financial impact across its portfolio of projects.

# Background & Scope

# Background & Scope

- Bournemouth Christchurch and Poole (BCP or ‘ the Council’) have developed an aspirational regeneration vision for the city region to become one of the best coastal places in the world in which to live, work, invest and plan.
- Underpinning this vision is BCP’s Big Plan which involves five large capital projects that will deliver significant changes across the whole area and support the creation of an estimated 13,000 jobs across all sectors of the economy as well a number of wider capital plans aimed at increasing BCP’s housing provision and leisure facilities.
- The Council wishes to explore how to best to structure the delivery of these major projects in order to realise these opportunities and ambitions.
- KPMG has been appointed by BCP to undertake an options appraisal of the different commercial and delivery models available to BCP to deliver its capital projects. Specifically this report aims to set out:
  - an overview of the sites under consideration for development opportunities;
  - the range of potential options available to the council to deliver the projects and extract capital receipts which includes simple mechanisms such straight land sales to more complex structures including JV partnerships;
  - the evaluation criteria based on BCP’s objectives and constraints used to appraise the different commercial options identified;
  - an initial qualitative assessment of the identified options against the evaluation criteria; and
  - consideration of next steps including quantitative evaluation of all the options being assessed, detailed accounting and tax treatment commentary and other commercial considerations needed for implementation of the preferred options.

# Background & Scope

## Overview of BCP's Major Capital Projects

— Alongside BCP's Big Plan, reflecting the scale of BCP's ambition, is a large and diverse capital programme, comprising approx. at least 18 investments with an estimated gross development value of Council-owned sites alone nearing £1bn over the next 5 years. Each investment within the programme varies considerably in terms of scale, complexity and the level of business planning that has been undertaken to date. These range from small, discrete schemes (approx. £2m), redevelopment opportunities in town centres to large mixed use regeneration projects on significant sites of regional interest such as the former power station at Holes Bay seeking to deliver 800+ new homes in new communities.

— Below is a summary of the different projects with more detail available at Appendix 1:

1. **Large scale mixed use regeneration projects**
   - Heart of Poole/ Town Centre North regeneration
   - Holes Bay (Former Power station site regeneration)
   - Boscombe Towns Fund Programme
   - Cotlands Road Car Park (BDC scheme)
   - Winter Gardens (BDC scheme)
2. **Housing led developments**
   - Civic Centre Poole: (300-326 units)
   - Civic Centre Christchurch (partly retained for mayoral services)
   - Oakdale redevelopment (80 units)
   - Chapel Lane (70 units)
3. **Housing schemes with transfer to HRA**
   - Turlin Moor Housing Development (350-400 units)
   - Constitution Hill (80-100 units)
4. **PRS schemes acquisition**
   - Carters Quay (161 units)
   - Richmond Gardens (211)
5. **Medical, science and research development**
   - Wessex Fields: including keyworker accommodation (500 units)
6. **Leisure/events/conferencing facilities**
   - Bournemouth International Centre
   - Queens Park Acquisition
7. **Proposed site disposals for residential schemes**
   - Broadwaters
   - Beach Road

# Overview of BCP's objectives

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# Overview of BCP's objectives

Based on initial discussions with the Council, we have developed a set of evaluation criteria to assess the suitability of each of the options under consideration, aligned to the Council's short, medium and long term objectives as follows:

| # | Criteria | Description |
|---|---|---|
| 1 | Delivers regenerations aims/speed | — This criterion assesses the scale and pace at w hich the Council's regeneration vision is delivered |
| 2 | Delivers capital receipts by 2025 | — The Council has a target to extract capital receipts from its land holdings and disposal programme in line w ith the timing constraints from its w ider transformation programme. This criterion assesses w hether the option delivers capital receipts by 2025 and the flexibility to use of those capital receipts.<br>— This criterion also assesses the accounting treatment impact of the different options on: compliance w ith Prudential Code and Borrow ing Limits, impact on BCP's revenue and capital accounts, Impact on BCP's SoFP in its ow n right as a Local Authority and Impact on BCP's consolidated group accounts |
| 3 | Value for money/ financial return | — This criterion measures the level of financial returns generated by the option for the Council both in the short and longer term, including upfront capital, or share of ongoing revenue streams through equity returns, overage pay ments or ground rent, taking into account cost of capital, transaction costs and friction costs such as tax (SDLT, CT and VAT). |
| 4 | Extent of control retained by the Council over the development | — *Control over land use:* This criterion assesses the extent of control retained by the Council over the range of uses for the sites.<br>— *Control over design and specification:* This criterion assesses the extent of control retained by the Council over the design and service specification for the new developments including massing assumptions, consideration of the volume and quality of residential and commercial units developed<br>— *Control of operational activity:* the level of Council input into the operation of the new developments on a day to day basis or at a more strategic level exerting influence over the strategic direction of the development |
| 5 | Council risk exposure | — *Construction/development risk*: This criterion assesses w hether the option w ould effectively transfer the design and construction risk to a third party<br>— *Demand risk*: The criterion assesses w hether the option w ould effectively transfer the demand/occupancy/sales risk to a third party.<br>— *Operational risk*: This criterion assesses w hether the transaction w ould effectively transfer the operational risk to a third party (maintenance of the development).<br>— *Financing risk*: This criterion assesses the extent to w hich responsibility for securing financing for the development rests w ith a third party w ithout seeking any guarantees or imposing financial obligations on the Council. |
| 6 | Management capacity and capability | — This criterion assesses the complexity of the option to deliver and implement in terms of required management capacity and skills |

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# Potential Commercial Delivery Structures

# Commercial Delivery Structures

— In this section we set out a number of structuring considerations which will determine the commercial delivery structure which best fits with BCP’s regeneration, corporate and accounting objectives.

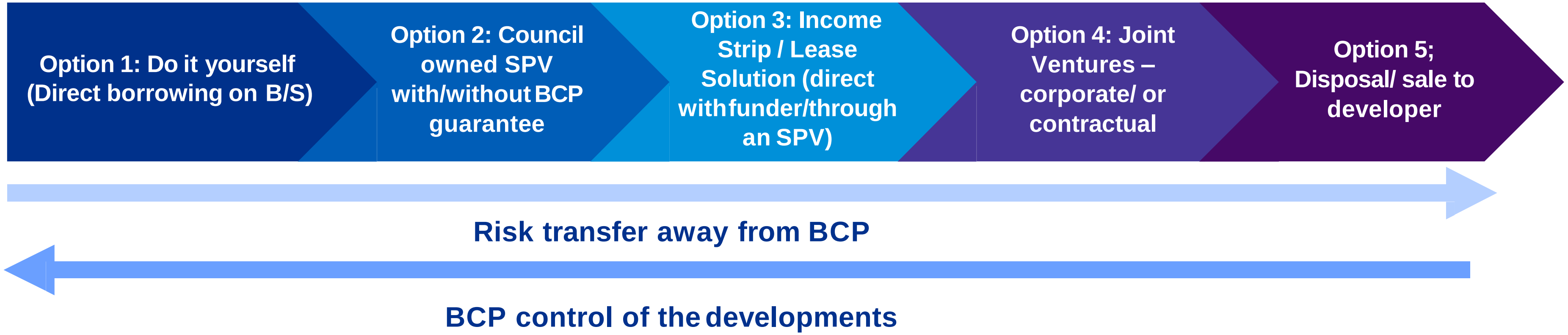
— There are a number of delivery structures for the development of capital projects observed in the sector, each underpinned by different commercial arrangements which will lend themselves to different types of finance and meet different objectives.

— At a high level these range from:

- Council owned and managed structures;
- Long term lease arrangements; and
- Partnership solutions.

— The options can broadly be placed on a spectrum with the last option being the lowest risk to the Council and the level of risk increasing as they move towards the first option with an associated increase in Council control and influence over development as well as financial returns





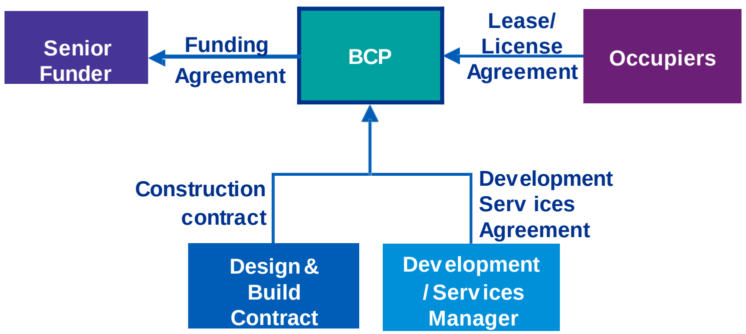

— Ulimatelythe optimal structure for BCP will be a function of its specific issues and needs, its appetite for absorbing various risks, and preferences for control and accounting treatment.

— These options are described in more detail on the following pages and will be assessed against the evaluation criteria discussed with BCP based on its objectives set out on page 12 as any selected option will need to be tailored to the specific commercial priorities of the Council.

# Option 1: Council develop and finance themselves directly

## Overview of the option

- Under this option, the Council would take direct responsibility for the development and funding of the schemes.
- This would involve either the Council acting as developer (if capability and capacity exists in-house) or the appointment of an external Development Manager (DM) for the larger development projects within the programme.
- The Council's development team (if in-house option) or the external DM would take day-to-day responsibility for creating a masterplan, gain planning consent, manage the sites and the redevelopment.
- Responsibility for funding would sit with the Council which would need to secure additional borrowing to deliver the schemes, either using PWLB or the capital markets.




| Criteria | Rating (RAG) | Commentary |
|---|---|---|
| Delivers regeneration aims | Amber | • Scale and pace of delivery of regeneration ambitions may be limited by BCP's borrowing capacity, existing management and operational capacity and expertise required to deliver the more complex large scale town centre regeneration schemes. |
| Delivers capital receipts by 2025 | Green | Under this option the Council will:<br>• Recognise available Capital Receipts on the disposal of the assets (i.e. where the assets would be required to be de-recognised from the Council's balance sheet in accordance with proper practices). Capital receipts will only be recognised when and to the extent that consideration is received in cash.<br>• Should the Council choose to use some (or all) of the capital receipts subsequently generated by disposals to reduce the CFR (and thereby reduce the MRP charge which would otherwise arise) they will not be available for use under the flexible capital receipts exemption to fund service reform.<br>• The Council may consider it prudent to use capital receipts generated by a disposal to provide for borrowing undertaken in respect of a disposed asset, to the extent that the borrowing has not already been provided for, since the asset is no longer providing continuing economic benefits to the Council. |
| Value for money/ Financial Return | Amber | • Potential to generate maximum financial returns under this option as the Council would directly benefit from any uplift in land value over the long and medium term through redevelopment of the sites and keep 100% of any development profit generated by the schemes. However, the overall size of the gain may be comparably smaller than in the partner options that follow where additional third party capital is invested, larger schemes are delivered or additional expertise is needed to maximise development potential.<br>• Level of financial return is dependent on the Council's overall cost of finance, assumed to be secured at competitive rates given the strength of BCP's covenant. |
| Control retained by the Council | Amber | • The Council retains complete control over the land use, design and specification, and operational activity of the schemes with no restrictions over future development, assuming the completed developments are retained by the Council in the long term.<br>• The Council's level of long term control is significantly reduced if the completed assets are disposed of, which will be required in order to extract capital receipts (as detailed in the second criteria above). |

# Option 1: Council develop and finance themselves directly

| Criteria | Rating (RAG) | Commentary |
|---|---|---|
| Risk exposure | Red | • BCP is responsible for servicing the debt irrespective of the underlying scheme performance.<br>• Council exposed to high levels of commercial risk including construction, demand/occupancy, operational and financing risk. High risk of delivery for more complex schemes; unless expert delivery team and strong internal governance structure.<br>• If external DM used, potential misalignment of interests betw een Council and external DM given lack of DM equity commitment. |
| Management capacity an capability | Amber | • No significant issues expected in delivering and executing this option given BCP's experience of raising funds corporately.<br>• May require upskilling/recruitment/third party DM if BCP does not have development management capability in house.<br>• If in house development capabilities exist and are used, this option may require significant ongoing resource investment to manage and deliver the developments. |

### How it relates to your projects

— This structure is mainly suited to small developments that fit the funding envelope of BCP or those that deliver wider social value and may otherwise not fit the risk bracket of typical property investors.

— It is our understanding that BCP is unlikely to take any undue commercial risk on purely speculative commercial development programs where there isn't a wider social or economic benefit or broader placemaking agenda for the city region.

— As such, this structure may suit the following projects from its portfolio:

- Residential schemes where transfer to HRA is proposed and units form part of the HE Strategic Partnership Status such as:
  - Turlin Moor Housing Development: 350-400 units required by HRA
  - Constitution Hill: 80-100 residential units required by HRA
- Smaller scale residential projects, such as:
  - Oakdale redevelopment: 80 units, £15m GDV
  - Chapel Lane residential development: 70 units, £18m GDV
- Civic centre developments such as Civic Centre Christchurch, given part of the site will be retained for Mayoral purposes limiting the potential for residential and other developments
- Larger developments such as the Bournemouth International Centre redevelopment (£350-£300m GDV) could also be achieved through this structure provided BCP is comfortable taking on significant debt and has the management and operational capacity and expertise to execute, manage and deliver the redevelopments at the required pace and scale.

### Examples of projects delivered using this structure

Examples of where this structure has been adopted in the sector include:

— Aberdeen City Council: part of their ambitious capital programme to promote economic development and regeneration, was the development of its exhibition and conference centre (The Events Complex Aberdeen), financed using a £407m index-linked bond, rated by Moody's, issued by the Council. This is the largest index-linked issuance in the capital markets by a UK local authority to date. This allowed the Council to secure terms for the finance which are not available through conventional PWLB borrowing as well as diversify its sources of finance. The Council subcontracted the delivery of the development to a Development Manager following a procurement exercise and the ongoing operation of the venue to a third party under a long term arrangement.

# Option 2a: Council owned SPV funded by the Council

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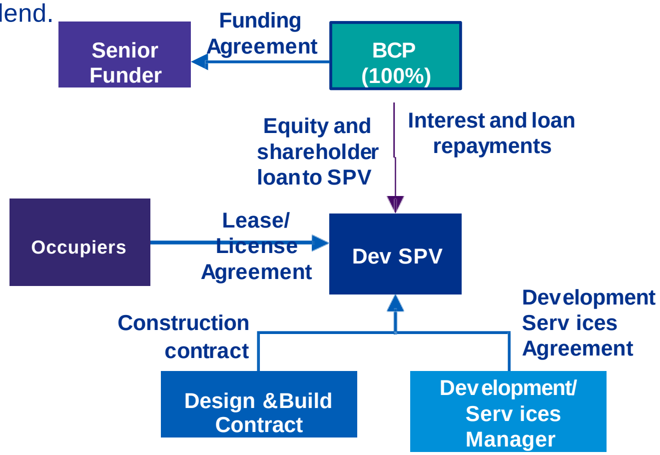
## Overview of the option

- Under this option, the Council would set up an SPV which will be wholly owned by the Council to develop and deliver the schemes.
- The SPV would have its own board / senior management team, governance and decision making arrangements and Articles of Association - such that the entity has the capacity to act in its own right, freeing up BCP to focus on its core services.
- This option assumes the financing requirement for the capital programme is provided by BCP using its own borrowing capacity in the form of long term debt from PWLB/capital markets. BCP then on-lends the loan proceeds to its whollyowned subsidiary through a mix of debt and equity (in a way that is transfer pricing and Subsidy Regime compliant). The on-lending rates and implied margins for the individual schemes mayvary by project/scheme.
- The SPV will be responsible for redeveloping the sites and entering into a service agreement with a Delivery Partner, to undertake development management and promotion activities.
- On completion of the redeveloped assets, the SPV will either sell the redeveloped plots and realise a development profit or hold longer term to extract rental income that is repatriated to BCP as interest and repayment of loans or dividend.




| Criteria | Rating (H/M/L) | Commentary |
|---|---|---|
| Delivers regeneration aims | Amber | • While a new legal entity will need to be established under this option, this is a fairly quick and straightforward process, therefore similar timescales to Option 1 apply subject to BCP's capacity to raise funds.<br>• As with Option1, the scale and pace of delivery of regeneration may be limited by BCP's borrowing capacity and access to the required expertise (development, operating, etc) as the SPV itself will not have any new capital or human resource apart from what BCP provides. |
| Delivers capital receipts by 2025 | Amber | Under this option the Council will:<br>• Incur no fresh capital expenditure on the disposal of assets by the Council to the SPV in return for share capital / loans, or in respect of that capital expenditure undertaken by the SPV directly.<br>• Recognise available Capital Receipts only when the SPV repays those loans and / or redeems share capital. |
| Value for money/ Financial Return | Amber | • BCP can retain all of the financial return generated by the SPV, noting that if set up as a company, the subsidiary would be subject to corporation tax.<br>• As with Option 1, while developer profit will not be shared with other parties, the overall size of the return may be comparably smaller than in joint venture options where access to additional funding/investment can be provided. |
| Control retained by the Council | Green | • Significant control retained by BCP as although the subsidiary Board will be responsible for setting the strategic direction of the company and have its own governance structure, it will be reliant on continued support from BCP and ultimately controlled by BCP. |

# Option 2a: Council owned SPV funded by the Council

| Criteria | Rating (H/M/L) | Commentary |
|---|---|---|
| Risk exposure | Amber | • The company structure w ould enable BCP to enter into activities w ith limited recourse to the BCP (e.g. there is a limited liability company or partnership), safeguarding the Council's core business fromcommercial and financial risks associated with the private development activity<br>• Risks associated with delivery including development management, construction, demand and operation of the redeveloped plots w ill sit w ith the SPV and passed to third parties. |
| Management capacity an capability | Amber | • Limited additional resource pressures to execute this structure given it is not a novel or particularly complex structure to deliver compared to partner options.<br>• Assuming a third party DM is used, this w ill free up BCP's in-house resources, however the SPV w ill need to invest time and resource in monitoring and overseeing the contract |

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### How it relates to yourprojects

— This structure is a typical model used by local authorities to deliver housing projects where a new housing subsidiary is set up to separate the Council's commercial and investment activities from its core services provision.

— Given BCP's ambitions to significantly increase their housing provision and build at least 1,000 new homes on BCP ow ned land this structure may suit the majority of the Council's residential developments including:

- larger mixed tenure residential developments such as the Civic Centre Poole redevelopment w ith 300-326 units (£70-80m);
- smaller scale housing projects such as Oakdale redevelopment (80 units) and Chapel Lane residential development (70 units).

— How ever, care must be taken to ensure the SPV has appropriate expertise to deliver its ambitions and appropriate oversight and governance from the Council. There have been some high profile failures in the sector, although there are a larger number of success stories.

— Depending on the credit strength of the underlying project cashflow s this structure could be suitable for BCP's larger regeneration schemes w ith strong income generating assets including the Winter Gardens mixed use development delivering high quality homes, car parking, retail and leisure space.

### Examplesof projects delivered using thisstructure

— There are numerous local authority ow ned housing subsidiaries set up to deliver housing throughout the UK.

— Some examples on w hich w e have advised include:

- London Borough of New ham have established Red Door Ventures (now Populo), a w holly ow ned subsidiary of the council set up to deliver private rented sector housing. The entity's remit is to develop significant extra housing in the Borough w hilst providing an income stream to the Council's general fund, acting as a stimulus to improve the quality of service offered by private landlords in the area.
- [redacted]
- South Holland District Council have set up a Wholly Ow ned Company, Welland Homes, to increase housing supply in the local area to meet the needs of a grow ing population, improve the quality of rented sector accommodation across the district, and to generate general fund income for the Council through returns from market and affordable housing sales and rental receipts.
- London Borough of Redbridge have established a housing subsidiary Redbridge Living to optimise its assets to create capital and revenue, as w ell as to provide additional opportunities for development of affordable housing in the borough.

# Option 2b: Council owned SPV borrows with a guarantee



## Overview of the option

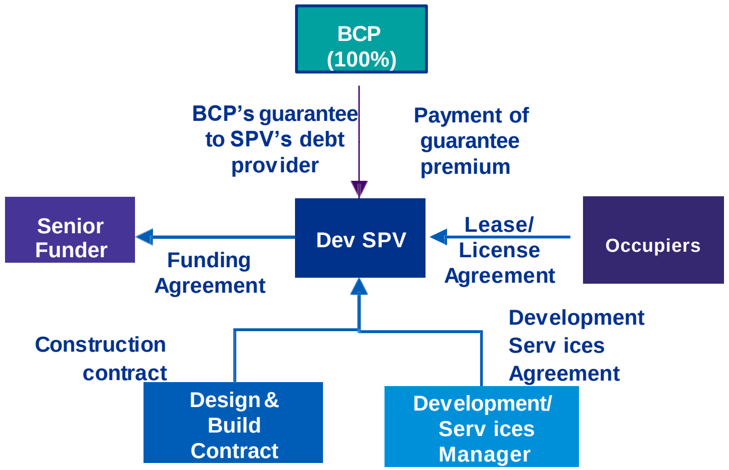
— This option is a variant of Option 2a where the Council sets up a whollyowned subsidiary.

— However, in this option, it is the SPV which will be responsible for raising the senior financing required to redevelop the sites and entering into a service agreement with a Delivery Partner, to undertake development management and promotion activities.

— A guarantee will be provided by BCP to cover the third party debt, in exchange for a guarantee fee charged by BCP to compensate for the risk taken.

— The key difference to Option 2a is that the external borrowing is now sourced directly by the whollyowned subsidiary, and BCP is primarily concerned with the implications to it of the guarantee to those external debtproviders.

— On completion of the redeveloped assets, the SPV will either sell the redeveloped plots and realise a development profit or hold the assets longer terms generating rental income.




| Criteria | Rating (H/M/L) | Commentary |
|---|---|---|
| Delivers regeneration aims | Amber | • As the SPV is responsible for securing the funding and delivering the schemes, this option gives BCP the ability to secure alternative financing, or enter into commercial deals w ith other parties safeguarding BCP borrowing capacity subject to the terms of the guarantee provided and potentially increasing the scale of the regeneration vision that can be achieved.<br>• This option w ill likely involve more lender due diligence, particularly if part/all of the lending is secured against individual schemes' cashflows, potentially increasing timescales for securing funding and delivery of regeneration aims. |
| Delivers capital receipts by 2025 | Red | • This model does not contain a straight forw ard mechanismby w hich the Council can extract capital receipts, rather than revenue (i.e. GF) dividends from the SPV. The Council has not invested in the SPV other than by w ay of initial pinpoint equity capital and there is no direct means – such as the repayment of loans – w hich would enable the SPV to make cash payments to the Council on an ongoing basis w hich would score as capital receipts.<br>• The Council w ill only be able to generate capital receipts where the SPV redeems equity at market value or the Council disposes of some or all of its equity interest to a third party. |
| Value for money/ Financial Return | Amber | • BCP w ill retain 100% control of any developer profit/capital receipt realised although the size of the gain may be comparably smaller overall than in the joint venture options w here external capital is brought in and larger more complex schemes are delivered.<br>• Similar cost of capital to the direct borrowing options w ill apply as the funder w ill ultimately rely on BCP's covenant and has full recourse to BCP in the event of default through the guarantee.<br>• Third party debt (rather than through PWLB) may allow the debt structure to be better tailored to the future income streamand optimise cash flow timing to BCP. |
| Control retained by the Council | Green | • While the subsidiary will have its ow n governance structure and management board, BCP w ill have ultimate control and influence over the strategic direction of the SPV and maintain a long term interest in its developments/assets |

# Option 2b: Council owned SPV borrows with a guarantee

| Criteria | Rating (H/M/L) | Commentary |
|---|---|---|
| Risk exposure | Amber | • Depending on the terms of the guarantee (w hether a solvency guarantee or income guarantee is required), it is likely that similar to the direct borrowing options, BCP w ill retain all financing (default) risks under this structure and potentially any underperformance risk (operational and re-letting/sales risks post construction) depending on the guarantee |
| Management capacity an capability | Amber | • Not a particularly management resource intensive structure to deliver and implement<br>• The terms of the guarantee w ill require legal review |

## How it relates to your projects

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— This structure is typically used for developments which would benefit from the Council's covenant strength in order to secure funding at competitive terms including non/low income generating developments such as leisure centres, conference facilities, research parks etc or developments where the demand case is not as strong (e.g. speculative developments).

— As such, this structure may suit the following projects from your capital programme:

- the PRS scheme potential acquisition opportunityy at Richmond Gardens (211) where the Council's SPV could raise the financing requirement from the capital markets through an index linked bond providing a natural hedge against inflation given the inflation linked revenues with a guarantee to strengthen the demand case for the project and result in lower financing costs.
- The leisure centre acquisition at Queens Park (£2m GDV) given the small size of the scheme which may prove difficult to attract the wider investor market.
- Wessexfields mixed use development (£50m GDV) given it includes medical, science and research space alongside keyworker housing, and would therefore benefit from the Council's guarantee to raise the required financing.

## Examples of projects delivered using this structure

— Examples of where this structure has been adopted in the sector include:

— [redacted]

# Option 2: SPV structures- additional variants

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### Variant to Council owned SPV structure: sale & leaseback to BCP

- A variant to this structure is where the Council sells the land assets to its whollyowned subsidiaryin return for cash considerationand subsequently leases them back from its SPV.
- As the subsidiary will not have any funds initially to pay as consideration, the Council will be required to on lend the funds to its SPV to enable it to acquire the assets for cash.
- The SPV will then undertake anydevelopment works required and once completed, the SPV will lease the assets back to the Council in return for a pre-determined rent over an agreed period.
- The Council will then occupythe completed developments or on-let to other occupiers/ sell to third parties.
- Where the SPV acquires assets for consideration from the Council the Council would be technicallyrequired to recognise capital receipts (assuming that the Council achieves a true sale to the SPV). However, where the SPV is only able to pay cash to the Council for those assets because the Council has initiallylent it the funds to do so, it is possible that the original borrowing bythe Council would be deemed to be for an improper purpose (generating capital receipts) and potentiallygive rise to anomalous accounting entries at the level of the Council's group accounts.
- Moreover, **both** (i) the initial loan bythe Council to the SPV; and (ii) the subsequent lease back of assets bythe Council (under IFRS 16); would give rise to capital expenditure bythe Council on which it would be required to charge MRP.
- As a result, this option has not been assessed infurther detail reflecting its limited opportunityto provide value for money (especiallywhen considering SDLT implications of the lease/underlease layers) and the nature of BCP's capital projects involving large mixed use regeneration projects which are not expected to be suited to this structure.

### Variant to Council owned SPV structure: Orphan SPV structure with guarantee

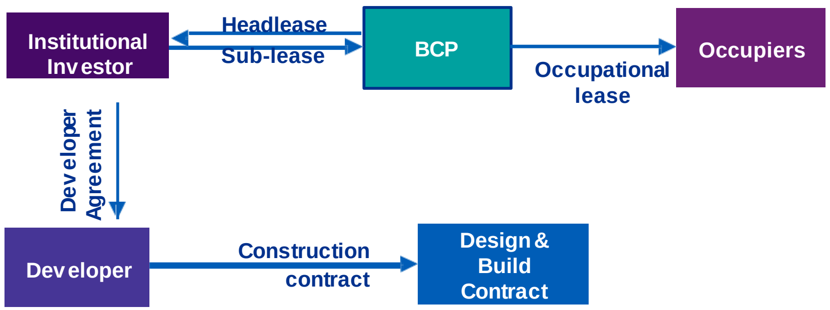
- A potential variant to this structure is where an 'orphan company' is created. An orphan company is one where the equityin the vehicle is held by a third party, usuallya trust or charitable trust, and that third party has on control over the company. It is common in structured finance and securitisationstructures, where the role of the SPV is narrow and typically limited to aggregating various contractual income streams and using them to service debt (i.e. the function of the orphan SPV is mostlyadministrative).
- This maybe appropriate where the assets are occupied bythird parties and generate income to cover, with a reasonable buffer, the cost of servicing debt associated with development.
- Like option 2b, the most likelyscenario here is that BCP would offer a guarantee over the debt service of the SPV to third parties, allowing the SPV to raise funds cheaply from the capital markets. It is likelyto therefore onlybe appropriate for developments where the income stream is relativelystable and within BCP's risk appetite.
- At the end of a pre-agreed debt term, the assets may revert to BCP depending on the arrangements agreed and the nature of the asset.
- The key difference to Option 2b is that because BCP does not hold share capital in the SPV or otherwise control it, the debt would not be consolidated in the BCP group accounts. Depending on the nature of the guarantee (whether it meets the criteria for a financial guarantee or not) BCP may need to recognise a liabilitybased on the risk of default, or a contingent liabilityin the BCP accounts.
- In all other respects, this option will have the same capital finance implications as Option 2b.
- This is a more complexstructure to implement, likelyto attract a higher level scrutiny and more complex governance arrangements.
- KPMG are currentlyadvising a UK based local authorityon a £200m+ scheme that is being delivered under this structure. Under this scheme the local authoritywill receive a material upfront cash receipt as compensation for providing a long term guarantee and for having undertaken the land assembly and planning process. It will facilitate a major regeneration project to meet the local authorities strategic objectives.

# Option 3: Income Strips/Lease Solution direct with funder



## Overview of the option

- This option represents a typical property solution for the development of the capital projects using a lease based structure.
  - The Council w ill grant a headlease to an Institutional Investor (usually a pension fund) for a long term (125 years is typical) at peppercorn rent.
- The Institutional Investor w ould in turn provide a Lease or Agreement for Lease for a 40 -50 year sublease to BCP w hich w ill require BCP to pay a pre-determined rent (subject to inflation) beginning at a specific date in the future or after practical completion of the developments. BCP w ill then either occupy the buildings directly or enter into occupational leases w ith tenants.
- In exchange for this Agreement for Lease (AfL) and subsequent lease payments due from BCP, the Pension Fund provides the capital to execute the development.
- At the end of the 40-50 year sub lease agreement, providing rent has been received by the Institutional Investor to schedule, the buildings transfer to BCP or to a separate entity nominated by BCP for a nominal value.
- The Institutional Investor w ill appoint a third party developer to manage the development and engage construction contractors to complete the construction and refurbishment w orks needed for a fixed price.
- The substance of the lease arrangement is that of a form of long term finance for the Council that is secured on the long term headlease for the developments and land.




| Criteria | Rating (H/M/L) | Commentary |
|---|---|---|
| Delivers regeneration aims | Amber | • Likely to involve more detailed due diligence compared to PWLB direct borrow ing therefore longer timescales for securing thefunding and reasonable transaction costs although lower than jointventure options.<br>• While there is significant appetite in the capital markets for stable assets with local authority backing, the scale of regeneration ambitions achieved w ill be limited by BCP's borrow ing capacity and its management and operational capacity and expertise to deliver the schemes (as w ith Options 1 & 2) |
| Delivers capital receipts by 2025 | Amber | • The Council may be able to recognise capital receipts on the grant of sub-leases on the assets it has acquired under the Af L where it concludes that it has transferred substantially of the risks & rew ards inherent in its RoU asset (under the Af L) under the sub-lease. This w ould be the case, under IFRS 16, w ere termof the sub-lease w as equal to substantially all of the term of the Af L<br>• This w ill require further consideration on a case by case basis as the Council w ould be expected to depreciate its RoU asset over the underlying asset's UEL (rather than over the length of the AfL) as the assets will revert for £Nil w hen the investor is fully repaid. As such BCP could be assessing the transfer of the risks & rew ards of ow nership on a different basis to that on w hich it treats the assets on its balance sheet. |
| Value for money/ Financial Return | Red | • Typically these structures provide little value for for money against the risk profile retained by the Council The initial lease payment to the funder is usually set as a percentage of rental revenues generated from the assets which then increases with inflation throughout the term. The resulting yield after factoring inflation is often at similar levels to the cost of capital of more structured solutions w here demand and operational risk transfer occurs.<br>• Can also be structured as fixed rate, index linked or a combination of both. The repayment profile can be structured to match the income profile of the underlying assets |

# Option 3: Income Strips/Lease Solution direct with funder

| Criteria | Rating (H/M/L) | Commentary |
|---|---|---|
| Risk exposure | Red | • Similar to direct borrowing options above, there is limited risk transfer under this option as BCP is exposed to significant demand, income (rent level/sales risk), operational risk and potentially construction risk depending on the timing of w hen the lease payments start (w hether at a fixed date or w hen Practical Completion is achieved). |
| Management capacity an capability | Amber | • Well established model in the sector for financing development projects w ith quick delivery and not therefore expected to result in significant need for management time and resources in implementing the structure. |

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## How it relates to your projects

— Given this structure relies on the covenant strength of BCP, this structure is equivalent to Option 1 Do it Yourself and would therefore suit the same type of developments from your capital programme such as: residential schemes where transfer to HRA is proposed, smaller scale residential developments and civic centre redevelopment where some of council functions/uses are retained.

— A variant of this structure is where an SPV is set up and enters into the agreement for lease with the funder supported by a solvency guarantee from the Council. This structure is similar to Option 2a discussed above suited to developments which require the Council's covenant strength to secure financing competitively.

## Examples of projects delivered using this structure

Examples of recent schemes delivered through an income strip solution include:

— Trinity Gateway: is one of five intervention areas in the £1.5bn masterplan developed by Bolton Council for regenerating the town centre. The £55m project comprises PRS accommodation, office space and a multi-storey car park. As the total development cost exceeded the estimated market value of the assets, there was a requirement for Council support to deliver the scheme, with an income strip arrangement initially proposed to bridge the gap. However, following our review, alternative financing solutions were identified which offered better value for money and risk transfer.

The implementation of this option should take into account the guidance provided in MHCLG's (now DLUHC) Capital Finance Framework on assessing the commercial and financial risks to which the Council may be exposed to under such an approach and ensuring that they are appropriately mitigated.

# Option 4a: Contractual JV with Developer/Investment Partner

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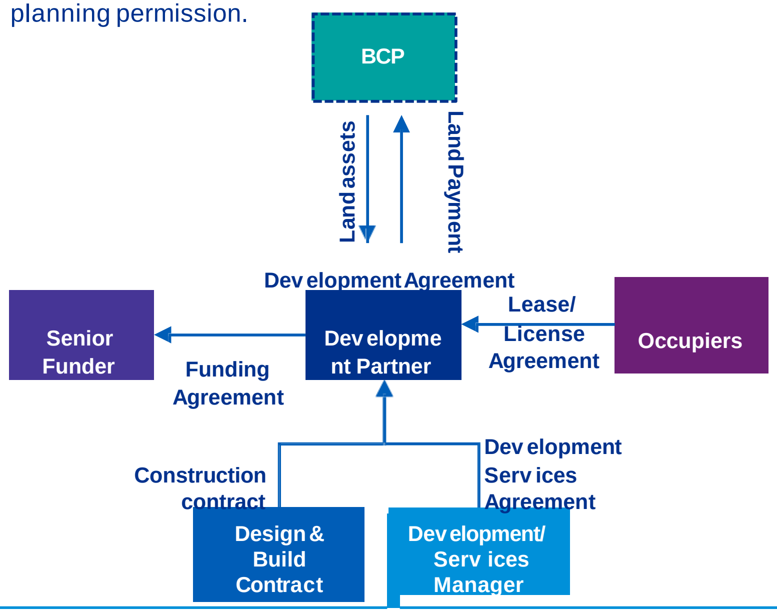
## Overview of the option

- Under this option, the Council enters into a contractual development agreement with a Development Partner to redevelop the sites and deliver the schemes.
- The Council would commit its land assets on a long leasehold basis in return for a land payment. Contractual overage mechanisms can be included in the agreement although this would be likely to impact on upfront land value payment given the requirement to share gain with the Council while the investor takes the primary development risk.
- The Development Partner would lead on securing planning, design, securing funding and delivery of the different schemes.
- The Council's land will be released to the Development Partner on a phased basis, conditional on fulfilment of a number of obligations imposed on the Development Partner within the development agreement, such as restriction on use mixfor the sites and post planning permission.




| Criteria | Rating (H/M/L) | Commentary |
|---|---|---|
| Delivers regeneration aims | Amber | • Subject to the procurement process for the investor partner/developer and alignment of objectives, the delivery of BCP's regeneration aims can be accelerated under this option as it brings in third party investment, resources and development expertise required to deliver much larger and complex schemes. |
| Delivers capital receipts by 2025 | Green | • Under this option the Council will, where sufficient of the risks and rewards inherent in the assets have been transferred to allow the Council to de-recognise themfromits balance sheet:<br>• Recognise capital receipts on the payment of the upfront land payment; and<br>• Recognise capital receipts when it receives future overage payments (as the overage arrangement provides the Council with a continuing interest in the asset disposed of, such that payments which extinguish that ownership right would be expected to be deemed to be capital receipts). |
| Value for money/ Financial Return | Amber | • BCP has potential to derive significant financial returns through its land payment which will take into account any uplift achieved through planning and redevelopment of the sites.<br>• Limited potential to realise longer term value or ongoing revenue streams (other than overage and ground rent mechanisms which would reduce the initial capital receipt). |
| Control retained by the Council | Amber | • BCP will retain a reasonable amount of controlover the land use in terms of what is being built on the site and any other obligations it wishes to impose on the Development Partner that can be contractualised at the outset, be it in relation to design/specification, operational running and delivery of the schemes. |
| Risk exposure | Amber | • Design, planning, construction, financing, demand and operating risk passed tothe Development Partner.<br>• The value of the land payment will depend on market conditions at the point of land draw down, however, mitigating factors exist such as open book valuation based on a template residual land value appraisal with fixed inputs and minimum land values. |

# Option 4a: Contractual JV with Developer/Investment Partner

| Criteria | Rating (H/M/L) | Commentary |
|---|---|---|
| Management capacity an capability | Amber | • Well established in the market and less complex to deliver given it is essentially a sale of land assets conditional upon the Development Partner meeting the obligations set out in the development agreement.<br>• May require OJEU procurement for the appointment of the Development Partner |

### How it relates to your projects

— This option is likely suited to larger scale mixed use developments where access to third party capital/investment, development and /or management expertise and capacity is required. Unlike the corporate joint venture option that follows, this structure is suitable for development projects where the Council does not require ongoing influence and control over the developments and can agree and contractualise upfront its objectives and requirements of the developer.

— Therefore, this would potentially suit any of the large mixed use regeneration projects such as Heart of Poole, Holes bay and Boscombe Town Fund Programme or the Bournemouth International Centre Development which would benefit from third party funding or access to specific expertise as long as BCP can clearly articulate in the contract its requirements of the joint venture partner and do not require influence/control of the running/operation of the developments (which would require an equity stake, voting / veto, or other decision taking powers).

### Examples of projects delivered using this structure

Examples of recent schemes delivered through a contractual joint venture include:

— Camden & Islington NHS Foundation Trust have appointed a development partner to the King's Cross Central Limited Partnership to undertake and oversee the £150m mixed use development at its prime five acre site behind St Pancras International Station and next to the ongoing regeneration at King's Cross under a contractual JV structure. Revenue from the site will allow the Trust to reinvest the money in new clinical and healthcare facilities.

— Local Space: the London Borough of Newham entered into a master agreement with a Registered Provider, Local Space Limited, that was set up to meet the temporary accommodation needs of the borough by leveraging the asset base of the Council with private finance through a contractual JV. By the Borough underwriting specific risks relating to future expansion of Local Space stock, notably demand risk and future rent level risk, Local Space was able to borrow significant extra capital at competitive rates and embark on a development programme of 700 – 1,000 new homes. These homes will be available to Newham to use to meet its temporary accommodation need at a fixed rental level that rises at less than inflation for 15 years.

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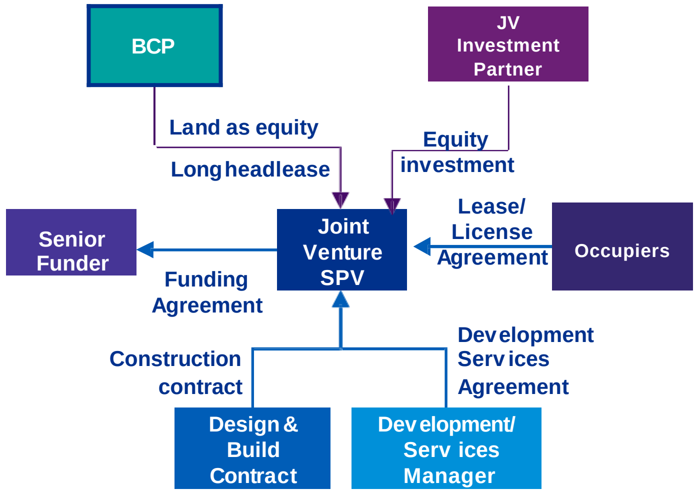
# Option 4b: Corporate Joint Venture with Developer/Investment Partner

## Overview of the option

- This is well-established landowner-investment/delivery partner joint venture model, whereby a corporate Joint Venture Vehicle (either a LLP or SPV structure) is created in which the Council takes a minority equity stake (up to 50%) in return for its land assets. A Joint Venture Investment Partner would be procured who would commit the remaining majority equity stake and bring development expertise to take forward the development.
- Day to day delivery responsibility would sit with the Joint Venture which would create a masterplan, gain planning consent, begin managing the estate and development.
- The Joint Venture (or special purpose vehicles (SPVs) wholly owned by the Joint Venture) will procure and carry out all infrastructure works, undertake direct development, secure occupiers and dispose of completed development parcels ('develop and trade' model) and/or hold developed plots within the Joint Venture in the longer term deriving an ongoing rental revenue stream ('develop & hold' model).
- Responsibility for funding would stay with the JV and require debt, equity and potentially early sale proceeds for certain plots.




| Criteria | Rating (H/M/L) | Commentary |
|---|---|---|
| Delivers regeneration aims | Amber | • The pace and scale of achieving BCP's regeneration outcomes could be significantly increased once the development/investor partner has been procured as they would provide access to additional funding, development expertise or the specific skills and knowledge required to bring forward the redevelopments otherwise not available within the Council |
| Delivers capital receipts by 2025 | Green | Under this option the Council will:<br>• Recognise capital receipts on (i) the payment of any the upfront land payments by the JV in respect of the grant of the long lease; and (ii) where the consideration for the long lease is a loan asset, when and to the extent that the JV repays that loan. |
| Value for money/ Financial Return | Amber | • This option has the potential to generate significant returns for BCP, which will receive an uplift in its land values (fromredevelopment) compared to simply selling the sites as well its share of developer profit when completed properties ae sold.<br>• In a 'develop & hold' scenario, BCP would also be entitled to a share of the net rental revenue, creating an ongoing revenue streamfor BCP as well as a share of the development profit realised at the end of the hold period (including any capital appreciation of the sites over the period). A ground rent and/or overage mechanism can alsobe overlaid. |
| Control retained by the Council | Amber | • Depending on BCP's land valuation and the resulting equity stake held by BCP, this option allows BCP to exert an appropriate degree of control/influence in key areas of the delivery of the schemes including restrictions over land use, prospective occupiers and operational activity through minority shareholder protection matters/reserved matters contained in the plot leases.<br>• A governance structure can be also developed allowing BCP equal representation on the JV Board, by divorcing the economic benefit (driven by the minority equity stake held) from the level of control/influence over the JV required, although in the event of deadlock the partner would have casting vote. |

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# Option 4b: Corporate Joint Venture with Developer/InvestmentPartner

| Criteria | Rating (H/M/L) | Commentary |
| --- | --- | --- |
| Risk exposure | Amber | • Some commercial risk exposure retained by BCP through its equity stake, how ever this can mitigated through shareholder protection matters. Expert Developer Manager appointment likely to mitigate a number of planning and development risks and add extra value. <br> • Typically BCP's land value w ill not be fixed at JV inception but at the point of land draw down (once planning and funding is in place) therefore there is a risk if the market conditions change. There are various mechanisms to mitigate this including, using a template residual development appraisal for determining BCP's land value w ith fixed input and only a handful of variables to be agreed at land draw down, setting a minimum land value w hich the JV Investment Partner commits to paying. |
| Management capacity an capability | Red | • More complex transaction structure to execute and deliver, likely to require OJEU procurement, resulting in higher transaction costs and time. <br> • Significant requirement for resource both throughout procurement and into JV operation |

## How it relates to your projects

— This option is likely suited to large scale mixed use developments due to the typically high financing requirement involved which a third party investor could provide and/or where specific expertise, knowledge or skills are required to bring forward the delivery of the projects whether this relates to development expertise (creating a masterplan, managing the planning process, developing the plots and providing the management services required), commercial and operational expertise to run the developments once completed or ownership interests for adjacent sites. Such a structure allows BCP to retain some long term influence and control over the future direction of a long term development, alongside a partner.

Therefore, this would potentially suit the following schemes from your capital programme:

— Holes Bay Regeneration Scheme (former power station development with an estimated GDV of £250): bringing forward this development combining residential, commercial and community uses maybe facilitated by this corporate joint venture structure with an investor partner/private developers or adjacent landowners which would allow BCP to access funding, development expertise or access to neighbouring sites to bring forward a holistic regeneration of the site at a larger scale.

— This could also apply to the town centre regeneration schemes in both Poole (£229m GDV) and Boscombe (£210m GDV) where an external partner could bring in ownership interests (given that the Poole redevelopment assumes acquisition of Brownsea House) or additional funding required to deliver to deliver the regeneration at the appropriate scale (given the funding constraints for the Boscombe redevelopment).

— This structure may also be appropriate for the Bournemouth International Centre redevelopment (£250-£300m) given BCP's ambition to transform the current facilities into a. 21st Century Cultural Quarter, visitor destination and events venue where specific conferencing and events expertise and operating experience from a private sector partner may be beneficial.

## Examples of projects delivered using this structure

Examples of recent schemes delivered through a corporate joint venture include:

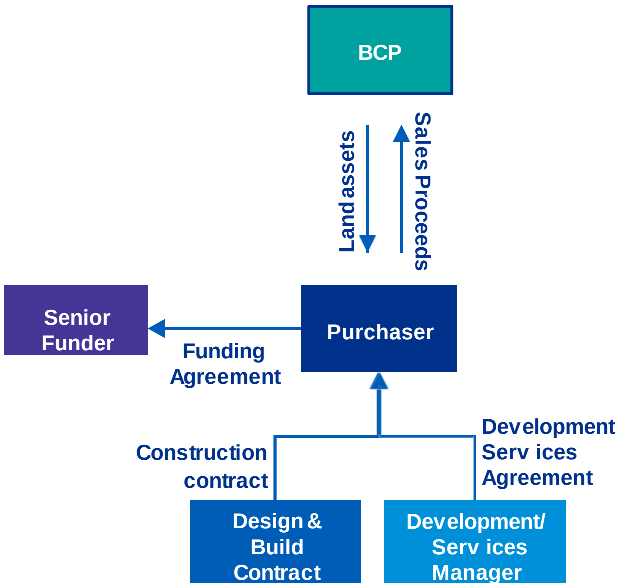
— ID Manchester scheme: The University of Manchester has recently appointed a Bruntwood Scitech consortium as its Investor Partner following an OJEU procurement to bring forward the £1.5bn, 29-acre mixed-use, innovation district at its North Campus site under a contractual joint venture structure where the University holds a minority interest but is able to exert significant influence and control over the development through carefully drafted and negotiated legal agreements.

— Other similar projects delivered under this structure include Oxford North development where Thomas White Oxford of St John's College partnered with Hill Group for the first phase of new homes at the new life sciences district for Oxford which will include new laboratories and workspaces for biomedical science, new homes, public parks, hotel, nursery, small shops, cafes, restaurants and bars.

# Option 5: Straight Land Sale

## Overview of the option

- Under this option the Council would market the sites for disposal on a subject to planning basis.
- Once a preferred purchaser has been identified, the Council can complete the sale.
- Alternatively, the Council could work with the preferred purchaser who would create a masterplan, gain planning permission and then complete the purchase. The latter would allow the Council to benefit from a value uplift realised through planning.




| Criteria | Rating (H/M/L) | Commentary |
|---|---|---|
| Delivers regeneration aims | Red | • The scale and pace of delivering regeneration outcomes will depend on the extent to which the aims of the purchaser/developer the sites have been sold to align with BCP's regeneration vision, as BCP will have little influence over what gets build on the sites it disposed of |
| Delivers capital receipts by 2025 | Green | • Provided the Council transfers sufficient of the risks and rewards of ownership in the assets to recognise a disposal (and therefore derecognise the assets) available capital receipts will be generated on receipt of the land payment from the third party.<br>• This option will provide BCP with capital receipts in a short term, therefore likely to be a quick solution to meet any immediate short term capital needs (through land proceeds), particularly for those sites with high real estate values. |
| Value for money/ Financial Return | Red | • Unlikely to achieve best value for money as BCP will not benefit from medium to long term value gains fromredevelopment of the sites/or change in use which have the potential to be significant when compared against day one land proceeds.<br>• BCP could have access to future receipts via overage agreement or ground rent, although this may reduce initial receipt payable. |
| Control retained by the Council | Red | • BCP loses contractual input into the design process of the specification of what gets built on its sites following divestment.<br>• BCP is unlikely to have any material level of control over the future developments with limited ability to benefit from operational activity going forward |
| Risk exposure | Green | • Design, planning, construction, demand and operating risk passed to another party.<br>• No requirement to raise finance as this is done by the purchaser/developer.<br>• Potential legacy/reputational risk as a result of divestment to one/multiple purchasers with potential negative impact on estate management into longer term. |
| Management capacity an capability | Green | • No requirement to increase own resources significantly to deliver the option. |

# Option 5: Straight Land Sale



### How it relates to your projects

- This option is likely suited to sites with high land values attached which are mostlyfor commercial use and provide limited opportunities for social value or wider benefits for realising the Council's regeneration agenda or sites that have been declared surplus to the Council's requirements.
- Therefore, this structure is likely suited to the following projects from your capital programme:
  - Beach Road car park residential development – given proximity to the beach and potential for the high land values from mainly commercial developments (such as PRS, premium accommodation), the Council could generate an upfront capital receipt without the implications of a lengthy procurement process. However, the lack of planning consent and restrictive covenant attached to the site will impact the value of the capital receipt generated
  - Broadwaters development (25-40 units) – given the small size of the scheme and the site being declared surplus to requirements with a preferred bidder appointed to develop a residential scheme on site
  - The PRS scheme acquisition at Richmond Gardens - depending on BCP's objectives for this acquisition (whether it is to continue to let it at market rents) or there are wider opportunities for the Council's regeneration vision for the area given the location/proximity to other sites, the private sector developer market might be better suited to take on this developments

# Options Evaluation

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# Potential Commercial & Funding Options Evaluation

| BCP Objectives | Option 1: Build & finance yourself | Option 2a: Council owned SPV | Option 2b: Council owned SPV with guarantee | Option 3: Lease solution direct with funder | Option 4a: Contractual JV | Option 4b: Corporate JV | Option 5: Direct Sale | Comments |
|---|---|---|---|---|---|---|---|---|
| Delivers regenerations aims | Amber | Amber | Amber | Amber | Amber | Amber | Red | • Options 1-3 are fairly quick to implement, however, delivery of the Council's regeneration aims in these options may be limited by availability of capital, management capacity and specific expertise (whether development, specific operating capabilities such as conferencing and events or adjacent land ownership interests) required to bring forward developments at an appropriate pace and scale. This must be balanced against a potential lengthy procurement process for an Investor/Delivery Partner required in the partner options |
| Delivers capital receipts by 2025 | Green | Amber | Red | Amber | Green | Green | Green | • While there is a mechanism whereby BCP would receive capital receipts under most structures, Options 4a (Contractual JV), 4b (Corporate JV) and Option 5 (direct land sale) would likely be the quickest option to provide any immediate short term capital receipts as they involve the Council getting an upfront land payment. |
| Value for money/ Financial Return | Amber | Amber | Amber | Red | Amber | Amber | Red | • While BCP's share of the financial returns generated from the redevelopment are maximised in Options 1-3 where the Council retains 100% of any development profits, the overall size of the gain could be comparably larger in the partner options (Options 4a & 4b) even after sharing with respective shareholders<br>• Option 5 is unlikely to to achieve best value for money as BCP will not benefit from medium to long term value gains from redevelopment of the sites |
| Control retained by the Council | Amber | Green | Green | Amber | Amber | Amber | Red | • With an in-house solution (Options 1-3) the Council would retain maximum level of control to the extent it holds completed assets, also depending on the chosen funding solution and any restrictions imposed by lenders.<br>• Options 4 where the Council has an equity stake in a JV entity would allow the Council to exert a degree of influence over the land use and operational activity through minority shareholder protections. In Option 4a the Council would be able to exert control over key matters only to the extent these can be contractualised at the outset (without an ongoing equity stake). |

# Potential Commercial & Funding Options Evaluation

| BCP Objectives | Option 1: Build & finance yourself | Option 2a: Council owned SPV | Option 2b: Council owned SPV with guarantee | Option 3: Lease solution direct with funder | Option 4a: Contractual JV | Option 4b: Corporate JV | Option 5: Direct Sale | Comments |
|---|---|---|---|---|---|---|---|---|
| Risk exposure | Red | Amber | Amber | Red | Amber | Amber | Green | • Options 2a and 2b involving new separate legal entities being established on a limited recourse basis w ould provide some separation betw een BCP's core business fromcommercial and financial risks related to property development and score comparatively higher than Options 1 and 3<br>• Option 4b provides a good balance of risk transfer to a third party in relation to development, demand and operational responsibilities, w ith some residual risk for the Council through its equity stake held. How ever, the Council's risk is limited to its share capital invested, being the value of its land assets.<br>• Option 4a w ould score slightly higher on the basis that the transaction is effectively a sale of land assets conditional upon the Development Partner meeting the obligations set out in the development agreement. |
| Management capacity an capability | Amber | Amber | Amber | Amber | Amber | Red | Green | • Options 4a & 4b are likely to be more complex to implement given they involve lengthy procurement processes for a Delivery/Investor Partner coupled w ith high transaction costs particularly around the legal documentation to ensure the transaction structuring offers sufficient protections for the Council over key matters (such as conditional land draw downs mechanism, prohibited uses, termination scenarios, distribution policies etc).<br>• While the in house option 1-3 should be quick to implement they are dependent on the Council's ability to secure additional borrowing and existing management capacity and expertise to bring forward and manage the delivery of the developments |

# Potential Commercial & Funding Options Evaluation

### Summary of initial qualitative evaluation

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— Our indicative evaluation w ould suggest that:
  - Option 1 is not considered to be able to deliver the Council's ambitious regeneration aims at the required scale and pace given the extent of risk taken by the Council, the additional borrow ing, resources/expertise required particularly for the large mixed use tow n centre redevelopments
  - Option 2a w hilst offering some segregation betw een BCP's core activities and its commercial and real estate developments, do not bring in any new capital or development or operating expertise and therefore rely on the Council's borrow ing capacity and expertise for implementation as w ith Option 1. Option 2b does not offer a straight forw ard mechanism to extract capital receipts (rather than dividends) given the Council's investment in the SPV is through equity capital only and there is no direct means – such as the repayment of loans – w hich w ould enable the SPV to make cash payments to the Council on an ongoing basis w hich w ould score as capital receipts.
  - Option 3 (Income Strip solution) is not considered to offer good value for money over Option 1 given extent of risk taken by the Council and the associated cost of finance impacting the level of returns retained by the Council. In addition, in order to achieve the desired accounting treatment, the Council w ould need to dispose of the completed assets therefore losing the long term interest in the developments.
  - Options 4a (Contractual JV) and Option 4b (Corporate JV) offer a good balance betw een delivering the Council's regeneration vision at required scale and pace particularly for the more complex large scale redevelopments, securing commercial upside for the Council from redevelopment, allow ing the Council to exert an optimal degree of of control/influence over the development in terms of use mix, design/development and operational activity either contractually (Option 4a) or through a minority equity stake and governance structure w ith representation at JV Board level (Option 4b) and dow nside risk mitigation by procuring an Investment Partner/Developer responsible for masterplanning, gaining planning consent, redevelopment and securing occupiers, w ithout compromising accounting treatment;
  - Option 5 offers a quick solution to secure a capital receipt in a short space of time given the Council's minimum capital requirement to achieve by 2025 how ever, it does not allow the Council to benefit from longer terms value gains from redevelopment w ith no material control over the land use going forw ard.

— Our analysis also show s that there are a range of structures that are better suited to specific schemes from BCP's capital programme, specifically:

  — The large mixed use regeneration schemes could be delivered through a corporate joint venture w ith an investor or delivery partner w ho could bring access to additional funding as required for the Bocombe Tow n Centre scheme, specific land ow nership interests needed for the Heart of Poole scheme w hich assumes the acquisition of Brow nsea House or specific skills, know ledge and expertise as required for the Bournemouth International Centre w here experience of operating conferencing and events facilities may be required to achieve BCP's ambitions for this project

  — The housing schemes including some of the larger residential redevelopments such as Turlin Moor could be facilitated by a dedicated council ow ned SPV (Option 2a), w hether by increasing the scale and remit of BCP's existing housing subsidiary, Seascape Homes and Property Limited or creating a separate SPV to bring forw ard these developments and potentially recruiting skills and experience not available w ithin the Council

  — The leisure facilities at Queens Park and medical science and research development at Wessex Fields w ould benefit from a guarantee SPV structure (Option 2a) w hich w ould strengthen the demand case for raising the required financing

— Further analysis is needed to refine the options evaluation, including the Council consideration of w hich criteria is most important to the delivery of its strategic objectives and applying suitable w eightings against each criterion as detailed on the follow ing page. Whilst w e have presented these as discreet options, in reality a large regeneration project could combine aspects of different options – i.e. the Council may direct fund some elements, sell others plots to raise capital and enter into more complex JV or guarantee arrangements for others. The detail of this needs to be considered on a project by project basis in more detail than is in the scope of this report.

# Next Steps

In order to complete our options appraisal review , w e describe below the follow ing next steps required:

- Further refinement of the options and evaluation criteria follow ing initial feedback from the Council;
- Further development of any chosen option for specific assets in order to provide the Council w ith a detailed understanding of the transaction, risks, implications and financial impact
- Detailed financial analysis and modelling w hich sets out the level of financial return the Council can expect to derive under the chosen options for each site;
- Detailed analysis of accounting and tax implications (including VAT) for the Council for the different options;
- Considerations of outline commercial principles to support external contracts needed for implementation and execution of the preferred option.

The intention is for these steps to be completed and documented in a more detailed KPMG assessment of options as part of the Phase 2 w ork package.

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# Accounting Considerations

# Accounting Considerations

### Scope & purpose of indicative accounting analysis

- A number of commercial structuring options have been outlined for taking forward BCP's regeneration aspirations.
- In evaluating the potential for those evaluation to meet BCP's objectives an indicative analysis has been undertaken to understand the likely accounting and budgetary impact of those options on BCP. Specifically, this indicative accounting analysis focusses on the Capital Finance implications of the options on BCP including the extent that they would (i) require the Council to recognise Capital Expenditure; and (ii) allow the Council to recognise Capital Receipts.
- This accounting analysis should only be considered to be indicative as it is based on a broad conceptual description of potential options, rather than a finalised contractual position. Where the structure and contracts differ from those assumed in the option description, the accounting and capital finance implications for the Council may also differ, potentially materially.
- Only the Council, and specifically its s.151 officer, can determine the accounting treatment appropriate for the Council to adopt in respect of any given transaction. As determining the accounting treatment likely to be appropriate to a given transaction involves judgement, the Council and/or its auditors may arrive at different conclusions to those implied by our views.

### Accounting implications of the potential commercial structures

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- The likely accounting implications of each of the commercial structuring options are now considered in turn.
- The accounting analysis seeks where appropriate to draw out the additional potential implications for the Council where it is developing assets for its own use (whether by the GF or the HRA), rather than disposing the completed assets to third parties.

# Option 1: Council develop and finance themselves directly

This option is relatively straight forw ard as it is similar to traditional capital projects w hich the Council w ould undertake on its ow n behalf.

## Capital Expenditure

- The expenditure incurred by the Council on either acquiring assets for subsequent development and / or on developing those assets w ould be expected to fall to be capital expenditure for the purposes of the Capital Finance Regulations. Accordingly, that expenditure w ould increase the Council's CFR to the extent that it did not finance the expenditure through the use of other capital resources such as available capital receipts.
- Borrow ing to fund such expenditure (i.e. on the development of assets for either its ow n use, or their subsequent disposal in the context of w ider regeneration objectives) w ould be expected to be considered to be a law ful purpose.
- There is a potential technical accounting classification issue in that w here the Council is acquiring / developing assets solely for the intent of subsequent sale (rather than its ow n use), such assets may be more appropriately classified as stock rather than PPE on the face of the Council's balance sheet. How ever, the classification of the assets on the Council's balance sheet does **not** alter the capital finance implications of the expenditure, as that expenditure w ould remain to be capital expenditure as defined for the purposes of the regulations.

## MRP / GF

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- The Council w ill be required to make an annual MRP charge based on the increase in the CFR in accordance w ith the Council's ow n MRP policy.
- If the Council has opted to capitalise (rather than expense) interest costs on the borrow ing undertaken to fund capital expenditure the GF w ill not bear interest costs on the borrow ing undertaken (as the assets w ould appear to be qualifying assets) incurred during the development period. Subsequently, or w here the Council has opted to expense all interest costs, the GF w ill bear the interest costs in addition to the MRP charge.
- The statutory guidance on MRP requires MRP to be first charged in the year after the expenditure w as incurred, or w hen the borrow ing is incurred in providing an asset, in the year after the asset has become operational. The MRP guidance does not specifically consider the asset class of assets developed for subsequent sale, but it w ould appear reasonable for the Council (w here consistent w ith its existing MRP policy) for such assets to:
    - First charge MRP in the year after the asset has been completed and is capable of sale in in its current condition (as this appears to be consistent w ith the asset becoming operational); and
    - Base the MRP on the expected life of the asset developed (subject to a maximum of 50 years). The Council may adopt a more prudent (shorter) period over w hich to base the annual MRP charge (say equal to the tenor of the borrow ing undertaken to finance the development).
- Where the borrow ing w as incurred on developing housing assets w hich should be accounted for in the HRA, no MRP arises (as the duty to make MRP does not extend to housing assets). Moreover, the interest costs of the borrow ing undertaken for such housing assets w ould be charged to the HRA, rather than the GF.

# Option 1: Council develop and finance themselves directly

## Capital Receipts

- The Council w ill recognise Capital Receipts on the disposal by it of the developed assets for consideration (i.e. w hen it has transferred the predominant majority of the risks and rew ards of ow nership inherent in the assets to a third party) w hether under a freehold disposal or a finance lease. Therefore, the timing of the receipt of proceeds w ill depend on the pace at w hich the Council can develop and then dispose of the assets. The Council w ill not generate capital receipts on assets it retains for its ow n operational use, or in respect of w hich it only grants an operating lease (as defined under IAS 17 & IFRS 16).
- The Council w ill only be able to recognise available Capital Receipts to the extent that it receives consideration for the assets. For example, w here the disposal is under a finance lease, available Capital Receipts w ill be restricted to the amount of the capital (or loan) element of the finance lease paid by the acquirer.

## Summary

- Under this option the Council w ill:
    - Incur capital expenditure, w hich in turn w ill require it to charge the GF on an ongoing basis w ith both the interest costs of any borrow ing undertaken as w ell as an annual MRP charge (w hich w ill be incurred from the year after the assets become operational)
    - Recognise available Capital Receipts on the disposal of the assets (i.e. w here the assets w ould be required to be de-recognised from the Council's balance sheet in accordance w ith proper practices). Capital receipts w ill only be recognised w hen and to the extent that consideration is received.
- Should the Council choose to use some (or all) of the capital receipts subsequently generated by disposals to reduce the CFR (and thereby reduce the MRP charge w hich w ould otherw ise arise) they w ill not be available for use under the flexible capital receipts exemption to fund service reform. The Council may choose to use capital receipts in this w ay, at least to the extent that the borrow ing associated w ith the disposed assets has not been previously provided f or (through MRP or otherw ise), as the assets w ill not be providing continuing economic benefits to the Council.

# Option 2a: Council uses a wholly owned SPV to acquire and develop and subsequently dispose of the assets

Under this option the Council borrows to on-lend (in the form of equity or shareholder loans) to the SPV, which then uses that funding to acquire & develop assets for subsequent sale. Where the Council disposes, at their fair value, of assets it owns to the SPV, it will **not** receive cash consideration. Instead the Council will be granted an equity interest in the SPV, or otherwise recognise the consideration due to it from the SPV as a form of loan / financial receivable for those existing assets sold to the SPV. No funding is provided by 3rd parties.

## Capital Expenditure

- The amounts borrowed by the Council to invest in the SPV (as either equity or shareholder loans) will be capital expenditure for the purposes of the capital finance regulations (under Regulations 25(1)(b) to (d)). It is assumed that the Council will **not** structure its financial support to the SPV in the form of loan capital to benefit from the specific exemption under Reg. 7(a) of the 2012 amendments for such investments to not fall to be capital expenditure (as such an approach would be inconsistent with the objective of the Council generating capital receipts).
- Borrowing solely to enable the development of assets for either the Council's own use, or their subsequent disposal in the context of wider regeneration objectives, by its wholly owned SPV would be expected to be considered to be a lawful purpose.
- Subsequent expenditure by the SPV on acquiring or developing assets (and any additional borrowing its undertakes to do so) will **not** fall to be capital expenditure by the Council as under the prudential regime the Council needs to take into account only that borrowing and expenditure which is reflected in its single entity (rather than group) accounts.



## MRP / GF

- The Council will be required to make an annual MRP charge based on the increase in the CFR arising on its investment in the SPV in accordance with the Council's own MRP policy.
- This MRP would be in addition to the charge borne by the GF for the interest costs on any borrowing undertaken. This reflects that shareholder loans / share capital are not qualifying assets which would permit the Council to capitalise the interest costs associated with the borrowing needed to acquire them.
- The statutory guidance on MRP requires MRP to be first charged in the year after the expenditure was incurred (i.e. the year after the investments have been made). The period over which the MRP should be calculated will reflect the nature of the investment. Where it is in the form of equity / share capital, it will need to be based on a maximum of 20 years; where in the form of shareholder loans it will be based on a maximum period of 25 years. The Council may adopt a more prudent (shorter) period over which to base the annual MRP charge.
- The GF would also benefit from the actual interest receivable from the SPV in respect of the shareholder loans. Where the interest rate on the shareholder loans was less than a commercial rate (i.e. the loans were classified as 'soft loans') the interest credited to the GF will be the actual interest receivable (rather than the imputed effective interest rate required under IFRS 9).

# Option 2a: Council uses a wholly owned SPV to acquire and develop and subsequently dispose of the assets

## Capital Receipts

- The disposal by the SPV of developed assets w ill not give rise to capital receipts for the Council. The Council w ill only be able to recognise Capital Receipts to the extent that, and w hen, the SPV repays in cash the principal on the shareholder loans or redeems / buys-back the share capital held by the Council.
- This means that w hen the Council can recognise capital receipts w ill reflect w hen the SPV can generate sufficient cash to repay loans / buy-back share capital. This in turn w ill depend on w hen the SPV can either dispose of the assets for consideration, or otherw ise generate cash (for example through rentals, or by borrow ing against the assets from a third party funder) w ith w hich to repay the Council.
- The disposal by the Council of assets to the SPV in return for another capital asset (w hether in the form of share capital of loans) w ill not create capital receipts for the Council (in effect it has simply sw apped one capital asset for another). Only w hen the SPV repays those loans / redeems the share capital w ill the Council be able to recognise capital receipts.
- Where the Council disposes of assets to the SPV in return for cash consideration - w hich is <u>not</u> assumed to be the case under this option – the Council w ould be *technically* required to recognise capital receipts since:
    - The prudential regime applies only to the Council's single entity accounts and therefore consideration arising on asset disposals, even to a w holly ow ned subsidiary, w ould score as capital receipts (as the acquisition by the Council of those assets w ould score as capital expenditure); and
    - s21(3) of the Local Government Act 2003 makes clear that, in the event of conflict betw een statutory provisions and proper practices, that the statutory provisions w ill prevail (i.e. substance is overridden in favour of the legal form of a transaction).
- How ever, w here the SPV is only able to pay cash to the Council for those assets because the Council has initially lent it the funds to do so (such lending scoring as capital expenditure by the Council), *it is probable* that the original borrow ing undertaken by the Council (to fund its on-lending to the SPV solely to enable to buy assets from the Council) w ould be deemed to be for an improper purpose (namely to artificially create capital receipts) unless the Council could clearly demonstrate that there w as a substantive purpose / rationale for it to receive cash for the assets and that it had to lend to the SPV to enable that outcome to be achieved.
- Moreover, though the Council's single entity accounts w ill show useable capital receipts under such an approach, these w ill not be show n on the group balance sheet. In the group accounts all transactions betw een the Council and its w holly ow ned SPV w ill typically be eliminated (unless s21(3) of the 2003 Act is taken to preclude this imposition of proper accounting practice). Where, the group accounts did eliminate transactions relating to the on-lending to and subsequent acquisition for cash by the SPV of Council ow ned assets, it w ould leave the group accounts show ing on its balance sheet:
    - The assets, together w ith the value of any w orks undertaken on them by the SPV:
    - The combined cash balance of the SPV and the Council: and
    - The Council's ow n external borrow ing to fund its on-lending to the SPV.
- Whilst this w ould not effect the Council's group general fund balances (as the capital transactions are neutralised in the GF in the single entity accounts), the balances show n for both the CAA and available capital receipts in the group accounts w ill be reduced by the value of the capital receipts recognised in the Council's single entity accounts on the disposal of assets to the SPV. Therefore, unless the s21(3) override of proper practices is also applied at the level of the group accounts, the Council could have the anomalous position that w here all the available capital receipts (as measured at the single entity level) w ere utilised – as flexible capital receipts or otherw ise – it w ould be required to show a negative available capital receipts reserve in its group accounts. In all cases it w ould show low er available capital receipts in its group accounts compared to its single entity accounts.

# Option 2a: Council uses a wholly owned SPV to acquire and develop and subsequently dispose of the assets

## Summary

- Under this option the Council w ill:
  - Incur capital expenditure on that provision of share capital / shareholder loans to the SPV, funded by borrow ing.
  - Be required to charge the GF on an ongoing basis w ith both the interest costs of any borrow ing undertaken as w ell as an annual MRP charge.
  - Incur no fresh capital expenditure on the disposal of assets by the Council to the SPV in return for share capital / loans, or in respect of that capital expenditure undertaken by the SPV directly
  - Recognise available Capital Receipts only w hen the SPV repays those loans and / or redeems share capital
- Where the SPV acquires assets for consideration from the Council, using funds lent to it by the Council, it is probable that the original borrow ing by the Council w ould be deemed to be for an improper purpose **and** potentially give rise to anomalous accounting entries at the level of the Council's group accounts
- Should the Council choose to use some (or all) of the capital receipts subsequently generated by disposals to reduce the CFR (and thereby reduce the MRP charge w hich w ould otherw ise arise) they w ill not be available for use under the flexible capital receipts exemption to fund service reform. The Council may choose to use capital receipts in this w ay, at least to the extent that the borrow ing associated w ith the disposed assets has not been previously provided f or (through MRP or otherw ise), as the assets w ill not be providing continuing economic benefits to the Council.

# Option 2b: Council uses a wholly owned SPV to acquire and develop and subsequently dispose of the assets - SPV borrowing.

This option is similar to Option 2a, except rather than the Council borrow ing to fund the SPV, the SPV itself borrow s directly from a third party supported by a guarantee from the Council.

## Capital Expenditure

- No capital expenditure (or borrow ing) is incurred by the Council under this option.
- Subsequent expenditure by the SPV on acquiring or developing assets, and the borrow ing its undertakes to do so, w ill **not** fall to be capital expenditure by the Council as the Council needs to take into account only that borrow ing and expenditure w hich is reflected in its single entity (rather than group) accounts.

## MRP / GF

•The Council w ill **not** be required to make an annual MRP charge, nor w ill it incur interest costs on borrow ing.



Provision of the Guarantee

- The guarantee is likely to fall to be a financial guarantee (as defined by IFRS 9) as its is assumed it w ill require the Council to reimburse the lender specified amounts if the SPV fails to meet its obligations under a debt instrument.
- The Council w ould be required to calculate a loss allow ance for the guarantee w hich w ill be a charge to the GF, net of any premium income earned by the Council from providing the guarantee (it is assumed that the Council w ould charge the SPV a 'market' premium for the guarantee).
- The loss allow ance w ill reflect the Council's risk w eighted assessment of the likelihood of it being required to make payments under the guarantee to the lender.

## Capital Receipts

- This model does not contain a straight forw ard mechanism by w hich the Council can extract capital receipts, rather than revenue (i.e. GF) dividends from the SPV.
- This reflects that as the Council has not invested in the SPV other than by w ay of initial pinpoint equity capital there is no direct means – such as the repayment of loans – w hich w ould enable the SPV to make cash payments to the Council, w hich w ould score as capital receipts, on an ongoing basis.
- The Council could receive capital receipts either (i) w here the SPV redeemed the shares at their market value; or (ii) by selling some or all its interest in the SPV to a third party. These, and similar approaches, w ould be expected to be subject to approval / agreement w ith the 3rd party lender and w ould be expected to be most likely late in the development life cycle of the projects being undertaken by the SPV.
- It w ould therefore be reasonable to assume that the generation of capital receipts w ould be later than under Option 2a.

# Option 2b: Council uses a wholly owned SPV to acquire and develop and subsequently dispose of the assets – SPV borrowing.

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## Capital Receipts (Cnt'd)

- Where the Council disposes of assets to the SPV in return for cash consideration under this option, the Council w ould again be technically required to recognise capital receipts as:
  - The prudential regime applies only to the Council's single entity accounts and therefore consideration arising on asset disposals, even to a w holly ow ned subsidiary, w ould score as capital receipts (as the acquisition by the Council of those assets w ould score as capital expenditure); and
  - s21(3) of the Local Government Act 2003 makes clear that, in the event of conflict betw een statutory provisions and proper practices, that the statutory provisions w ill prevail (i.e. substance is overridden in favour of the legal form of a transaction).
- How ever, even though the SPV's ability to pay cash to the Counc il now reflects that it has secured third party funding, there remains a reasonable r isk that the provision of a guarantee by the Council (to enable the SPV to borrow ) would be deemed to be for an improper purpose (namely to artificially create capital receipts) unless either (i) the premium for the guarantee w as at a market rate as this w ould imply that the overall arrangement w as commercial / at arms ' length; and / or (ii) the Counc il could clearly demonstrate that there w as a substantive purpose / rationale for it to receive cash for the assets **and** that it had to provide the SPV lender w ith a guarantee to enable that outcome to be achieved.
- Moreover, though the Counc il's single entity accounts w ill show useable capital receipts on the sale of these assets to the SPV , the group accounts – as discussed above under Option 2a – w ould show a low er (and potentially even negative) available capital receipts reserve as transactions betw een the Council and its w holly ow ned SPV w ould be eliminated on consolidation.

## Summary

- The Council w ill not incur capital expenditure, nor w ill it w ill be required to bear an annual MRP charge or the interest costs of borrow ing
- The Council w ill be required to charge the GF w ith the net cost / income (being the difference betw een the premium income and the estimated loss allow ance) associated with the provision of the guarantee
- The Council w ill only be able to generate capital receipts w here the SPV redeems equity at market value or the Council disposes of some or all of its equity interest in the SPV to a third party.
- Should the Council choose to use some (or all) of the capital receipts subsequently generated by disposals to reduce the CFR (and thereby reduce the MRP charge w hich w ould otherw ise arise) they w ill not be available for use under the flexible capital receipts exemption to fund service reform. The Council may choose to use capital receipts in this w ay, at least to the extent that the borrow ing associated w ith the disposed assets has not been previously provided for (through MRP or otherw ise), as the assets w ill not be providing continuing economic benefits to the Council.

# Option 3: Income Strips/Lease Solution direct with funder

This option is similar to Option 1, except rather than the Council borrow ing directly from the PWLB it now borrow s from an investor under a lease structure. They key steps, from an accounting perspective, of this Option are:

1. The Council grants a long lease (125 years) on a peppercorn to the Investor of the sites (land and buildings) to be developed. Though structured as a long lease, the lease collapses once the third party is repaid (w hich w ould be reasonably expected to be w ithin 40 to 50 years). Therefore, though it provides security to the investor, in substance the headlease is one of 40 to 50 years length;
2. The Council simultaneously enters into an Agreement for Lease (AfL) w ith the Investor, under w hich it agrees to lease back (on a 40 to 50 year term) developed assets as they are completed and made available. The rent payable under the future lease w ill reflect the cost of developing the new assets (i.e. it is not expected that the Investor takes substantive construction risk on the new assets – the future rent w ill reflect their actual cost, rather than necessarily being a fixed price agreed in advance). At the end of this lease term the assets revert to the Council for £nil (through the collapse of the headlease). Once made available to it, the Council can deploy the new assets as it sees fit.
3. The Investor (typically in consultation w ith the Council) appoints a developer to take forw ard the projects, and the Investor makes funds available to the developer as required to undertake w orks, acquire new sites etc.



**Capital Expenditure**

- When the Council w ill be required to recognise capital expenditure w ill depend on the extent to w hich it is deemed to control the assets covered by the AfL before they are completed and formally (legally) transferred to the Council.
- As the Investor / Developer w ill be taking forw ard projects w hich have been designed and specified by the Council (rather than speculative developments) and – as discussed further below in the context of capital receipts – the assets covered by the headlease are unlikely to be de-recognised from the Council's balance sheet, it w ould be prudent for the Council to assume that it controls the assets during the development phase of activity.
- Therefore (similar to PFI contracts accounted for under IFRIC 12 and consistent w ith the requirements of IFRS 16 to recognise lease c ommencement w hen the lessee controls the underly ing assets) the Council w ould recognise both assets under construction and an associated financial liability to pay for those assets during the development phase of activity. The financial liability w ould be subsequently re-classified as a lease liability w hen the completed assets are then made available for use by the Council under a lease.
- The Council w ill therefore recognise capital expenditure and associated borrow ing (w hich will increase the CFR) <u>during the development phase</u>. No further capital expenditure / borrow ing w ould need to be recognised w hen the assets are formally made available for use (provided the lease liability required under IFRS 16 is not assessed as being greater than the financial liability already recognised).

**MRP / GF**

- The Council w ill be required to charge MRP on the increase in the CFR. As the Council w ill be repaying the borrow ing under a lease, the annual MRP charge can – if the Council opts to do so – be based on the element of the rental payment w hich represents debt repayment (in effect charge MRP on a sinking fund basis).
- As the assets are not operational until they are transferred to the Council under a lease, <u>no MRP w ill be incurred during the development phase of projects</u>.
- The Council w ill also incur annual interest costs, based on the effective interest rate of the lease.

# Option 3: Income Strips/Lease Solution direct with funder



## Capital Receipts

- No capital receipts w ill arise on the grant of the long headlease to the Investor. As the ‘in substance’ term of the lease is 40 / 50 years, and the underlying assets are expected to be land & buildings it is considered unlikely that the Council (as lessor) w ould conclude that it had transferred substantially all the risks and rew ards associated w ith the assets to the Investor under the headlease. As such no sale w ill occur, and the Council w ill not derecognise the assets from its balance sheet.
- Therefore, even if the headlease w as not at a peppercorn (i.e. the Investor paid a premium to the Council) no capital receipt w ould arise and any cash receipt w ould instead be treated as borrow ing.
- As the assets covered by the AfL w ill be recognised on the Council’s balance sheet, the Council w ill be able to generate capital receipts on their disposal for consideration (i.e. w here it has transferred substantially all the risks and rew ards of ow nership inherent in the assets to a third party). Where interests in leases are disposed of (i.e. a sub-lease is granted to another party), IFRS 16 requires that the assessment of the transfer of risks and rew ards is based on the term of the underlying lease (i.e. on the Right of Use asset), rather than on the useful economic life of the underlying assets.
- How ever, as the assets w ill revert to the Council for £Nil, the useful economic life the Council w ill adopt in depreciating the assets w ill be based on that of the underlying assets, rather than on that of the Right of Use asset. It may therefore be prudent for the Council to currently assume, pending refinement of the mechanism by w hich it w ill dispose of asset it holds on a leasehold from the Investor, that it w ill assess the extent to w hich it has transferred the risks and rew ards of ow nership by reference to the useful economic life of the underlying assets, rather than to the 40 / 50 year term of the lease.
- This issue w ill require further consideration should it be the case that the Council is constrained by its lease w ith the Investor to only granting leases of not more than 40 / 50 years to third parties in respect of those assets.

## Summary

- Under this option the Council w ill:
  - Incur capital expenditure, w hich in turn w ill require it to charge the GF on an ongoing basis w ith both the interest costs of any borrow ing undertaken as w ell as an annual MRP charge (w hich w ill be incurred from the year after the assets become operational). The annual MRP charge may be based on the debt repayment element of the annual rental payable to the Investor.
  - Recognise available Capital Receipts on the disposal of the assets (i.e. w here the assets w ould be required to be de-recognised from the Council’s balance sheet in accordance w ith proper practices). Capital receipts w ill only be recognised w hen and to the extent that consideration is received.
  - Depending on w hether and how the Council can dispose of assets held under a lease, further consideration may be required of the basis on w hich the Council w ould determine if it has transferred all the risks and rew ards to a third party.
- Should the Council choose to use some (or all) of the capital receipts subsequently generated by disposals to reduce the CFR (and thereby reduce the MRP charge w hich w ould otherw ise arise) they w ill not be available for use under the flexible capital receipts exemption to fund service reform. The Council may choose to use capital receipts in this w ay, at least to the extent that the borrow ing associated w ith the disposed assets has not been previously provided f or (through MRP or otherw ise), as the assets w ill not be providing continuing economic benefits to the Council.

# Option 4a: Contractual JV with Developer/Investment Partner

Under this option the Council w ill:

1. Transfers sites / assets it already ow ns to a Developer, potentially on a rolling or phased basis, on a long leasehold for a land payment
2. The land payment w ill be made up of a initial lump sum, potentially supplemented by future overage payments
3. The Developer builds out the sites at its ow n risk and takes the benefit of any sale or other proceeds
4. The assets / sites revert to the Council only at the end of the long lease and there is **no** automatic provisions / options to collapse the lease before that time

No separate entity, or contractual risk and decision sharing mechanism, is established that w ould need to be assessed under IFRS 10 / 11.

**Capital Expenditure**

- No capital expenditure or borrow ing w ill be recognised by the Council. Construction costs are borne solely by the Developer, an entity independent of the Council, and the Council does not underw rite / underpin the Developer.

**MRP / GF**

54 • The Council w ill not be required to recognise MRP, or interest costs on borrow ing.

**Capital Receipts**

- Provided the long lease is of sufficient length (125+ years) it w ould be reasonably expected that the Council w ould conclude (under IAS 17 / IFRS 16) that it had transferred sufficient of the risks and rew ards inherent to the assets to enable the assets to be derecognised from its balance sheet. As such the grant of the long lease w ould constitute a disposal.
- The available capital receipts arising on the disposal w ill equal the lump sum land payment from the Developer.
- Where the Council also has an overage arrangement, it w ould recognise the fair value of the amounts expected to be paid under the arrangement as a financial asset w ith a corresponding credit to deferred capital receipts (reflecting that the overage arrangement provides the Council w ith a continuing interest in the assets). Only w hen the Council actually receives overage payments w ill it be able to reclassify (a proportion of) the deferred capital receipts as available capital receipts.

**Summary**

- Under this option the Council w ill:
  - Not Incur capital expenditure, or need to recognise borrow ing. Accordingly, it w ill not need to charge MRP or interest costs to the GF.
  - Recognise capital receipts on the payment of (i) the upfront land payment; and (ii) if / w hen it receives future overage payments.
- Should the Council choose to use some (or all) of the capital receipts subsequently generated by disposals to reduce the CFR (and thereby reduce the MRP charge w hich w ould otherw ise arise) they w ill not be available for use under the flexible capital receipts exemption to fund service reform. The Council may choose to use capital receipts in this w ay, at least to the extent that the borrow ing associated w ith the disposed assets has not been previously provided for (through MRP or otherw ise), as the assets w ill not be providing continuing economic benefits to the Council.

# Option 4b: Corporate Joint Venture with Developer/Investment Partner

Under this option the Council w ill:

1. Form a JV entity w ith a Developer in w hich it does not, or have the right to, exercise control.
2. It then transfers sites / assets it already ow ns to the JV, potentially on a rolling or phased basis, on a long leasehold in return for a mix of land payment and loan assets
3. The JV builds out the sites at its ow n risk using future sale proceeds and other income to (i) repay debt including to the Council; and (ii) distribute profits
4. The assets / sites revert to the Council only at the end of the long lease and there is **no** automatic provisions / options to collapse the lease before that time

## Capital Expenditure

- it is assumed that the JV w ill be deliberately structured to avoid it being deemed to be controlled by the Council (e.g. the Council w ill have a minority of the equity voting rights, appoint a minority of the directors, not have veto rights etc.). Moreover, it is further assumed that the JV w ill not be established on the basis that the Council and the Developer share control of the JV entity. The JV is therefore likely to be accounted for by the Council as an Associate, rather than as a Subsidiary (under IFRS 10) or as a JV (though the manner in w hich Associates and JV are reflected in the group accounts is materially the same).
- No capital expenditure or borrow ing w ill be recognised by the Council. Construction costs (and borrow ing) are borne solely by the JV, an entity separate from the Council, acting in its ow n interests (rather than as an Agent of the Council). Therefore, the Council w ill **not** be required to record the activities undertaken by the JV in its single entity accounts.

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## MRP / GF

- The Council w ill not be required to recognise MRP, or interest costs on borrow ing.
- Dividends from the JV w ill be credited as income in the Council's single entity accounts.

## Capital Receipts

- Provided the long lease is of sufficient length (125+ years) it w ould be reasonably expected that the Council w ould conclude (under IAS 17 / IFRS 16) that it had transferred sufficient of the risks and rew ards inherent to the assets to the JV to enable the assets to be derecognised from the Council's balance sheet. As such the grant of the long lease w ould constitute a disposal.
- The available capital receipts arising on the disposal w ill equal the cash sum (if any) paid by the JV on the grant of the long lease. Where the JV instead accepts a loan obligation in consideration for the grant of the long lease, the Council w ill only be able to recognise capital receipts w hen the JV repays the principal of the loan.
- Surpluses generated by the JV w hich are distributed as profits (dividends) w ill **not** score as capital receipts (instead being credited to the GF as revenue income).
- As the Council w ill treat the JV as an associate, rather than a subsidiary, capital receipts recognised in its single entity accounts on the grant of the long leasehold w ill be recognised, at least in part, in the group accounts. The JV w ill be accounted for on the equity method, w hich does not require the elimination of the transactions betw een the Council and the JV in full. It only requires that profits / losses on transactions betw een the Council and the JV are eliminated. Therefore, to the extent that the capital receipt equals the book value of the asset as originally recognised by the Council, it w ill continue to be recognised in the group accounts.

# Option 4b: Corporate Joint Venture with Developer/Investment Partner

**Summary**

- Under this option the Council w ill:
  - Not Incur capital expenditure, or need to recognise borrow ing. Accordingly, it w ill not need to charge MRP or interest costs to the GF.
  - Recognise capital receipts on (i) the payment of any the upfront land payments by the JV in respect of the grant of the long lease; and (ii) w here the consideration for the long lease is a loan asset, w hen and to the extent that the JV repays that loan.
- Should the Council choose to use some (or all) of the capital receipts subsequently generated by disposals to reduce the CFR (and thereby reduce the MRP charge w hich w ould otherw ise arise) they w ill not be available for use under the flexible capital receipts exemption to fund service reform. The Council may choose to use capital receipts in this w ay, at least to the extent that the borrow ing associated w ith the disposed assets has not been previously provided for (through MRP or otherw ise), as the assets w ill not be providing continuing economic benefits to the Council.

# Option 5: Straight Land Sale

| Capital Expenditure |
| --- |
| • No capital expenditure or borrow ing arises under this option. |
| **MRP / GF** |
| • The Council w ill not be required to recognise MRP, or interest costs on borrow ing, as no capital expenditure / borrow ing occurs. |
| **Capital Receipts** |
| • Provided the Council transfers sufficient of the risks and rew ards of ow nership in the assets to recognise a disposal (and therefore derecognise the assets) available capital receipts w ill be generated on receipt of the land payment from the third party. |
| **Summary** |
| • Under this option the Council w ill:<br>• Not Incur capital expenditure, or need to recognise borrow ing. Accordingly, it w ill not need to charge MRP or interest costs to the GF.<br>• Recognise capital receipts on the receipt of cash consideration from the 3rd party.<br>• Should the Council choose to use some (or all) of the capital receipts subsequently generated by disposals to reduce the CFR (and thereby reduce the MRP charge w hich w ould otherw ise arise) they w ill not be available for use under the flexible capital receipts exemption to fund service reform. The Council may choose to use capital receipts in this w ay, at least to the extent that the borrow ing associated w ith the disposed assets has not been previously provided for (through MRP or otherw ise), as the assets w ill not be providing continuing economic benefits to the Council. |

# Appendix 1: Overview of BCOP's capital plans

## Appendix 1

# Overview of BCP's major capital projects

- Alongside BCP's Big Plan, reflecting the scale of BCP's ambition, is a large and diverse capital programme, comprising approx. at least 18 investments with an estimated gross development value of Council-owned sites alone nearing £1bn over the next 5 years. Each investment within the programme varies considerably in terms of scale, complexity and the level of business planning that has been undertaken to date. These range from small, discrete schemes (approx. £2m), redevelopment opportunities in town centres to large mixed use regeneration projects on significant sites of regional interest such as the former power station at Holes Bay seeking to deliver 800+ new homes in new communities (approx. £250m).
- BCP's major capital projects are summarised below:

| Name | Description | Location | Mix of uses | GDV | Area | Key Risks |
|---|---|---|---|---|---|---|
| **Large scale mixed use regeneration projects** | | | | | | |
| Heart of Poole | Town Centre North regeneration including new leisure centre, residential units, commercial, hotel, and de-trafficking of Kingland Road, surface car parks (Dolphin Swimming Poole and Seldown Coach Park) | Poole Town Ward | — Residential: 500 units, including affordable provision 200-277 units<br>— Dolphin Swimming Poole surface car park and leisure centre £60- 70m<br>— Seldown surface Coach Park £38m (150 residential) | £229m | TBC | — Significant works needed to existing assets on site (c.£34m)<br>— assumes acquisition of Brownsea House and relocation of bus depot with Go South Coast<br>— Licence to use Seldown surface car park by National Express as a coach park |
| Holes Bay | Former Power station site aims to deliver a new housing including affordable provision and Community/Commercial space. | Hamworthy Ward | — Residential: minimum of 830 homes (inc. at least 10% affordable housing)<br>— 1,000sqm Community / Commercial use | £250m | 16 (ha gross) 12.79 (developable ha) | — Significant potential remediation. |
| Boscombe Towns Fund Programme | Mixed use town centre project incorporating residential, leisure and retail. | Boscombe West (Boscombe Sovereign Centre and surroundings) | — 560 new homes<br>— 6,700sqm of retail and leisure floor space<br>— 4,800 sqm of commercial, community and health floor space (1) | £210 (2) | | — Funding constraints (£22m of funding secured from Towns Fund Programme) |

Source: (1) https://www.bournemouthecho.co.uk/news/18658400.future-boscombe-plans-unveiled/
(2): https://democracy.bcpcouncil.gov.uk/documents/s24037/The%20Future%20of%20Regeneration%20in%20Bournemouth%20Christchurch%20and%20Poole.pdf

# Overview of BCP's major capital projects

| Name | Description | Location | Mix of uses | GDV | Area | Key Risks |
|---|---|---|---|---|---|---|
| **Large scale mixed use regeneration projects** | | | | | | |
| Wessex Fields | Mixed use development focused on the Meditech sector, capitalising on the close proximity to the hospital and creating a community driven place w hile enabling high quality jobs & key w orker housing. | Littledow n & Iford Ward | — Key w orker accommodation: 500 units<br>— Medical, science and research space | £120m (hospital)<br>£50 m Wessex Fields development | 3.56 (ha) BCP land; 2.29ha (UHD land) | — Ageas road access dispute<br>— Agreement on master planning/through road access to Deansleigh Road. Subject to planning. |
| Cotlands Road Car Park | An employment led mixed use scheme comprising commercial, office, retail, car parking and residential uses in order to attract investment into Lansdow ne (BDC scheme) | Bournemouth Central | — Five blocks, including tw o office buildings of around 8,400sqm and 4,000sqm. Other blocks w ould contain residential accommodation and all would feature retail and café space on the ground floor. A new multi-storey car park w ith 420 spaces is proposed on the site of the York Road surface car parks | £208 | TBC | — Subject to scheme viability assessments and planning |
| Winter Gardens | A mixed use residential, commercial and leisure regeneration scheme in Bournemouth Tow n Centre aimed to rejuvenate an underutilised tow n centre since since the demolition of an existing concern hall (BDC Scheme) | Bournemouth Central | — Residential: 378/379 high quality homes consisting of one, tw o and three-bed apartments as w ell as luxury penthouses;<br>— Car Park: 308 public spaces<br>— Leisure units: 4,000 square meters of dedicated leisure space<br>— Convenience store: 1000sqm<br>— 1500sqm of restaurants | £150 | 1.98 ha | — Scheme viability w ith increasing construction costs.<br>— Planning deadline and scheme amendments.<br>— Market Assessments/S123 Valuations required<br>— Completion of Legals and seeking of Cabinet/Council approvals |

Source: (1) https://www.bournemouthecho.co. uk/news/18658400.future-boscombe-plans-unveiled/
https://democracy.bcpcouncil.gov.uk/documents/s24037/T he%20F uture%20of%20Regenerati on%20in%20Bournem outh%20Christchurch%20and% 20Pool e.pdf
https://www.brightspacearchitects.com/ all-architecture-proj ects/case-study-winter-gardens/

# Overview of BCP's major capital projects

| Name | Description | Location | Mix of uses | GDV | Area | Key Risks |
|---|---|---|---|---|---|---|
| **Housing led developments** | | | | | | |
| Turlin Moor Housing Development | Infrastructure 'enabled' greenfield site, purely residential development not regeneration scheme. Units are required by HRA to form part of HE Strategic Partnership Status | Hamworthy Ward | — Residential: 350-400 units | £100m (average value of £250k/ unit | 7.8 (ha) | — No planning consent, pre app lodged but cannot proceed as all essential surveys incomplete. Significant sensitivity around local engagement methods<br>— Loss of public open space, mitigated by creation of new open space and proximity to Upton Country Park<br>— Home England grant £3.8m has been cancelled. |
| Civic Centre Poole | Residential mixed tenure development on existing civic campus. | Poole Town Ward | — Residential 300- 326 units | £70m-80m | 2 ha | — Main civic centre is Grade 2 listed, annexe is locally listed.<br>— Part of Poole Park Conservation Area. Mature trees on periphery.<br>— Utilities -legal status<br>— Flooding risk to be confirmed. |
| Civic Centre Christchurch | Residential development on existing civic campus. Adjacent Gas works site now exchanged, subject to imminent completion - Churchill Retirement Living. Part of the Civic Centre likely to be retained for Coroners service and Mayoral purposes | Christchurch Town Ward | — Residential: [tbc]<br>— Office: [tbc]<br>— Leisure<br>— Commercial | £30 | 0.45 ha including front/rear car parks | — Flood issues.<br>— Public footpaths/cycle path alongside Civic Centre.<br>— Rights of Way to public slipway, loss of public car parking. |
| Constitution Hill | Residential development on site formerly occupied by Bournemouth & Poole, College. Transfer to HRA proposed, development and feasibility studies being undertaken, units form part of HE Strategic Partnership Status. | Parkstone Ward | — 80-100<br>— Residential units | £29m | 2.1 ha | — Lady Russell Cotes House is locally listed<br>— Some topographical challenges but reasonable degree of built form already<br>— Area TPO covers the site which will have to be considered. |

Source: (1) https://www.bournemouthecho.co.uk/news/18658400.future-boscombe-plans-unveiled/
https://democracy.bcpcouncil.gov.uk/documents/s24037/The%20Future%20of%20Regeneration%20in%20Bournemouth%20Christchurch%20and%20Poole.pdf
https://www.brightspacearchitects.com/all-architecture-projects/case-study-winter-gardens/

**Appendix 1**

# Overview of BCP's major capital projects

| Name | Description | Location | Mix of uses | GDV | Area | Key Risks |
|---|---|---|---|---|---|---|
| **Smaller scale housing schemes** | | | | | | |
| Oakdale redevelopment | Relocation of Adults Skills and Learning Centre from Oakdale to Dolphin Shopping Centre resulting in site being available for residential development. | Oakdal e Ward | — 60( site 1)-20 (site 2) residential units | £15m | 0.78(ha) | — Road junctions |
| Chapel Lane | Residential scheme on current surface car park (BDC produced concept and site development plan and feasibility appraisal) | Poole Tow n Ward | — 70 residential units | £18m | 0.16 (ha) | — Loss of public surface car park. |
| Broadw aters | Disposal of the site at Boradw aters, a former vacant care home, declared surplus and w as marketed for sale in Spring 2019. A preferred bidder w ith a residential offer w as selected, undertaking due diligence and flood assessment but not in contract yet | East Southbourne & Tuckton | — 25-40 residential units. | | 0.46 ha | — No planning consent<br>— Bounded by Listed Wick Farm on eastern boundary, listed 2 storey cottage on opposite side of Wick Lane.<br>— Conservation Area, Flood zone level 3 |
| Beach Road | Surface car park. Potential disposal pending review by URC. | Canford Cliffs Ward | — 50-70 residential units | | 1.27 (ha) | — No planning consent.<br>— Restrictive Covenant |

Source: (1) https://www.bournemouthecho.co. uk/news/18658400.future-boscombe-plans-unveiled/
https://democracy.bcpcouncil.gov.uk/documents/s24037/T he%20F uture%20of%20Regenerati on%20in%20Bournem outh%20Christchurch%20and% 20Pool e.pdf
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# Overview of BCP's major capital projects

| Name | Description | Location | Mix of uses | GDV | Area | Key Risks |
|---|---|---|---|---|---|---|
| **Leisure/events facilities** | | | | | | |
| Bournemouth International Centre | An inter-connected series of projects to transform the mixed-use leisure and conference/events facility at the heart of Bournemouth's Destination offer aiming to create a 21st Century Cultural Quarter, visitor destination and events venue. | Bournemouth Central Ward | — Refurbished & redeveloped convention and exhibition centre. | £250-£300m | | |
| Queens Park Acquisition | Potential acquisition of the freehold of Queens Park Leisure Centre. of Leisure Centre to support Leisure service provision across BCP. | Queens Park | — Leisure centre facilities | £2m (land only) £3m (going concern) | | — Acquisition is subject to surveys and valuations<br>— Negotiations w ith current ow ners and tenants BH Live |
| **Other Housing Projects** | | | | | | |
| Carters Quay PRS | Residential acquisition opportunity of turnkey PRS scheme from a private sector developer (Inland Homes) | Hamw orthy | — 161 private market rent homes | TBC | TBC | — Subject to price and viability |
| Richmond Gardens PRS | Residential acquisition opportunity of turnkey PRS scheme from a private sector developer (Summix Developments Ltd) | Bournemouth Central | — 211 private market rent homes | TBC | TBC | — N/A |

Source: (1) https://www.bournemouthecho.co. uk/news/18658400.future-boscombe-plans-unveiled/
https://democracy.bcpcouncil.gov.uk/documents/s24037/T he%20F uture%20of%20Regenerati on%20in%20Bournem outh%20Christchurch%20and%20Pool e.pdf
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# Commercialisation of assets

## Bournemouth Christchurch and Poole Council



**February 2022**

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**Important Notice: About this Report**

This report has been prepared on the basis set out in our engagement letter addressed to Bournemouth Christchurch and Poole Council ("the Client") dated 28th of October 2021 (the "Engagement Letter") and should be read in conjunction with the Engagement Letter.

Please note that the Engagement Letter makes this report confidential between the Client and us. It has been released to the Client on the basis that it shall not be copied, referred to or disclosed, in whole or in part, without our prior written consent (except as specifically permitted in our Engagement Letter). Any disclosure of this report beyond what is permitted under the Engagement Letter will prejudice substantially this firm's commercial interests. A request for our consent to any such wider disclosure may result in our agreement to these disclosure restrictions being lifted in part. If the Client receives a request for disclosure of the product of our work or this report under the Freedom of Information Act 2000 or the Freedom of Information (Scotland) Act 2002, having regard to these actionable disclosure restrictions the Client should let us know and should not make a disclosure in response to any such request without first consulting KPMG LLP and taking into account any representations that KPMG LLP might make.

This engagement is not an assurance engagement conducted in accordance with any generally accepted assurance standards and consequently no assurance opinion is expressed. Nothing in this report constitutes legal advice or a valuation.

This report has not been designed to be of benefit to anyone except the Client. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the Client, even though we may have been aware that others might read this report

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In particular, and without limiting the general statement above, since we have prepared this report for the benefit of the Client alone, this report has not been prepared for the benefit of any other local authority nor for any other person or organisation who might have an interest in the matters discussed in this report.

Our work commenced on the 8th of November 2021 and the report was completed on 22nd of November 2021. We updated the report on 16th February 2022 at the request of the Council for various information including but not limited to sensitivities and interest rate. We have not undertaken to update our presentation for events or circumstances arising after that date

In preparing our report, our primary source has been information received by the Client and representations made to us by management of the Client. We do not accept responsibility for such information which remains the responsibility of management. Details of our principal information sources are set out in page 5 and we have satisfied ourselves, so far as possible, that the information presented in our report is consistent with other information which was made available to us in the course of our work in accordance with the terms of our Engagement Letter. We have not, however, sought to establish the reliability of the sources by reference to other evidence.

# Glossary of key terms

| | |
|---|---|
| **BCP** | Bournemouth, Christchurch and Poole Council |
| **CPI** | Consumer Price Index |
| **CFADS** | Cashflow Available for Debt Service |
| **DSCR** | Debt Service Coverage Ratio |
| **DSRA** | Debt Service Reserve Account |
| **GBP** | Great British Pound |
| **GF** | General Fund |
| **ICMA** | International Capital Markets Association |
| **KPMG** | KPMG LLP |
| **NPC** | Net Present Cost |
| **NPV** | Net Present Value |
| **PWLB** | Public Works Loan Board |
| **SDLT** | Stamp Duty Land Tax |
| **SPV** | Special Purpose Vehicle |
| **VAT** | Value-added Tax |
| **WALL** | Weight Average Loan Life |
| **SDLT** | Stamp Duty Land Tax |

# 1 - Background

## Background

- This report is a follow up to the KPMG report dated September 2021, Commercial and Financial Options Structuring. That report sets out a range of potential commercial options for delivering capital projects, commercialising existing assets or disposing of Council assets.
- Bournemouth Christchurch and Poole Council ("the Council" or "BCP") wishes to further examine one of the options set out in the previous report, namely establishing a wholly owned subsidiary to purchase income generating assets from BCP using third party finance secured against those assets.
- We understand that BCP would like to improve the commercial performance of the Council's asset base.
- BCP has identified their current portfolio of Beach Hut assets as a suitable example to explore this further.

## Scope of work

- KPMG has been engaged by BCP to consider the potential structure and financing of the potential transaction. The scope of work covers:
    - Outlining BCP's preferred model, including details of fund flows and accounting treatment;
    - Reviewing materials provided by BCP in relation to their Beach Hut proposition;
    - Assisting BCP to undertake indicative financial analysis of the proposed financing of the Beach Huts; and
    - Suggesting ways to potentially enhance the business potential of the SPV.
- We note our commentary is limited due to the early stage of the considerations taking place by BCP.
- This report explores the potential deliverability of a structure, which may enable BCP to achieve its required service, operational and financial outcomes. The structure and concept will require additional work to develop further.
- We note that it is part of the Council's process to develop the business cases and the value for money cases which will guide its decision making. This report is not a business case or a value for money assessment.

## Information provided

- To assist KPMG in delivering the scope of work. BCP has provided the following primary sources of information:
    - Beach Huts Income and Expenditure – Historical (2015-2016) and forecast (2021 - 2025)
    - Beach Huts – Product type summary
    - Beach Huts – Book value

# 2 - Headlines

## Council owned SPV structure

- BCP are currently exploring various avenues to seek to improve the commercial performance of their assets. This entails seeking to maximise the efficiency of the assets, cost savings and increasing the potential income. We understand that the Council would like to explore a wholly or majority owned SPV structure to seek to deliver this agenda.
- The proposed structure that BCP wishes to explore entails BCP setting up an autonomous SPV that it will wholly or majority own. This SPV will then purchase BCP's assets at market value, based on independent valuation.
- The SPV will raise senior debt from a third-party to the extent the SPV can comfortably afford to repay that debt from cash flows generated by the assets in the future.
- The value of the senior debt raised less any amount used to fund transaction costs and cash reserves in the SPV will be paid to the Council as part payment of the purchase price.
- BCP could potentially recognise a Capital Receipt to the extent that the purchase price is paid in cash.
- To the extent that the value of the senior debt raised is insufficient to pay the purchase price in full, this will be recorded as a deferred capital receipt and the SPV will grant a subordinated shareholder loan to BCP, representing the amount owed to BCP but not yet paid.
- The SPV will then apply income generated from the assets towards operating and maintenance costs, corporation tax and debt service.
- Surplus cash after meeting senior debt service obligations will be returned to BCP as a combination of subordinated debt service (i.e., paying BCP the deferred capital receipt recognised on the initial disposal of the assets and the interest on that deferred capital receipt) and dividend or retained by the SPV for growth consistent with the Council's broader transformation and asset commercialisation agenda. Where there is third party minority interest, this party will be entitled to a share of distributions proportionate to their share.
- BCP may provide a partial guarantee of the income stream to the SPV. Where BCP provides a guarantee, BCP will charge a guarantee fee at a market rate to compensate for the limited risk taken.
- The chances of the guarantee being called will need to be sufficiently remote to conclude that there has been a 'true sale' of the underlying assets to the SPV. Ultimately this is a decision for the s151 officer and will need to be agreed with BCP's auditors.
- Once the senior debt has been repaid BCP will own share capital in an entity that owns the assets and is unencumbered by external debt. The Council can continue to trade the assets through the SPV or dissolve the SPV and take back the assets at this point.
- Our understanding is that BCP's proposed structure is in line with the updated CIPFA prudential code and the current capital finance framework and that BCP has discussed this with CIPFA. BCP is exploring this structure and financing arrangement as part of their commercialisation and local regeneration agenda and is identifying and quantifying the financial risks to the Council of the structure before deciding whether to implement it. Additionally, we understand that BCP has started to consider the governance processes it will need to implement to effectively manage and mitigate the risks associated with both the initial implementation of the structure (should BCP proceed with it) and the subsequent ongoing operations of the SPV.

## Beach Hut proposition

- BCP has identified its portfolio of Beach Hut assets as one which provides opportunity for commercialisation given the strong demand for the assets and positive market drivers. This report uses this portfolio as an example to set out potential cash flow and accounting impacts of BCP selling its Beach Hut assets into a subsidiary structure.
- We understand from the Council that there are important stakeholders and beneficiaries to the Beach Hut assets including BCP Futureplaces Ltd (Council owned), site owners such as the Meyrick Family and Cooper Dean and charities relevant to the foreshore. As such, BCP could explore a Limited Liability Partnership (“LLP”) structure to incorporate the other stakeholders. This may bring additional commercial benefits such as access to additional assets, greater co-operation with relevant stakeholders and access to expertise in commercialising assets.
- Based on the high-level analysis of the Council’s assumptions, we consider that the Beach Hut cash flow could be sufficient for BCP to benefit through a capital receipt of:
    - **£50.0m** based on a **wholly owned limited company** that is wholly owned by the Council, with a financial guarantee provided by the Council up to 67% of income.
    - **£56.9m** with an **LLP structure** that is 80% Council owned and 20% by other stakeholders to the transaction. This assumes that the third party is a Council owned entity and as such the distributions would remain within the Council group. This analysis would need to be updated to reflect the assets and investment an external third party could bring to the LLP when more information is available.
- The increased capital receipt from using an LLP structure is largely driven by the increased debt capacity of the SPV due to tax being paid by the partners in that SPV rather than the entity itself (and therefore excluded from debt coverage calculations).
- The limited company option introduces additional transaction costs and corporation tax into the structure with an NPC of **£24.4m** (using the PWLB rate as a discount rate). The main driver of this is corporation tax payable by the SPV.
- Under the LLP option this NPC of additional costs reduces to **£7.1m**, primarily due to less corporation tax being payable. Only high-level tax assumptions have been made at this time and specialist tax advice will be needed to understand any tax risk associated with this option. There would need to be a robust commercial rationale for the structure other than saving tax.
- There may be opportunity to further enhance the income or drive financial efficiency from the assets either through increased provision, better management, or better pricing strategies. It is possible that implementing the commercial structure set out improves the ability to do this and offsets the additional cost. Further consideration of this is needed for BCP to make the value for money case for the transaction.
- We note that the output from BCP’s proposed scenarios for interest rate and inflation sensitivity can be found in Appendix 3.
- We estimate the potential transaction could take roughly six months to implement.

# 3 - Commercialisation and Council owned SPV structure

## Introduction

– In this section of the document, we provide an outline of the commercialisation rationale of the Council and an overview of the proposed SPV structure. The proposed SPV structure is a wholly owned SPV with 100% share capital held by BCP.

## Commercialisation

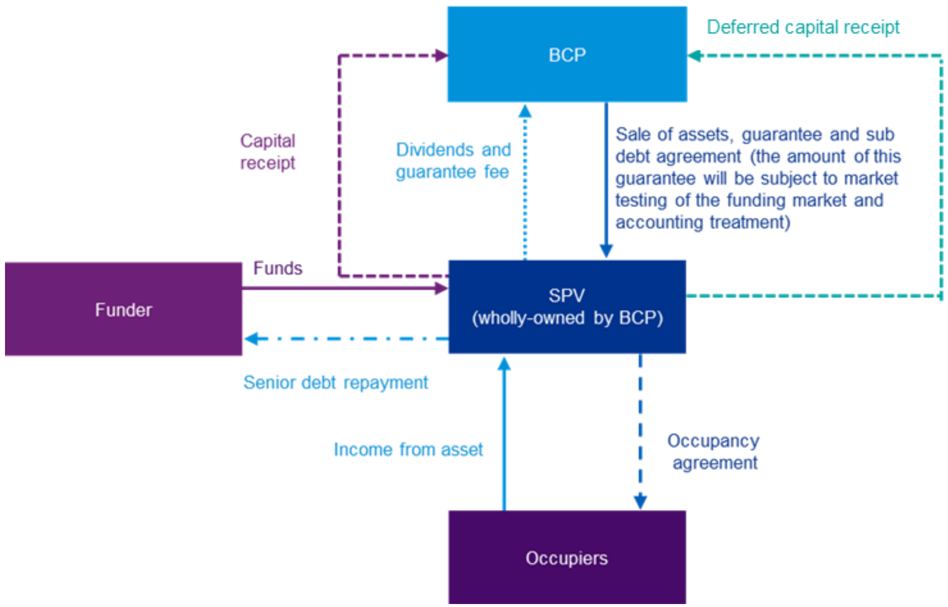
– BCP has income-generating assets that it currently manages. BCP wishes to explore commercialisation opportunities for these assets to seek to maximise their efficiency, cost savings and income potential. This commercialisation opportunity could involve setting up wholly or majority owned entities that will trade with a degree of autonomy within agreed parameters set by its Board. As such, it could create more time for BCP senior management to focus on core activities and a more nimble commercial organisation to exploit asset potential.

– As part of the commercialisation agenda, we understand from BCP that it is exploring various options including:

  - Increasing the rent of some of its assets to increase income;
  - Increasing the number of assets on some of its sites for example sites with Beach Huts; and
  - Exploring various projects with third parties to increase income.

## Structure diagram

*Figure 1 - Structure diagram*




## Overview

– BCP will set up an SPV that it will wholly or majority own.

– The SPV will have its own management team and governance arrangements, which will include decision-making arrangements. As such, the SPV will be autonomous of BCP's day to day operations but remain subject to BCP strategic oversight.

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- The SPV will purchase BCP assets at market value to demonstrate value for money.
- The SPV will fund its purchase through:
  - raising long term senior debt from a third-party funder; and
  - a subordinated shareholder loan (deferred capital receipt) to BCP for the difference between purchase price and the amount of senior funding.
- When the sale takes place, BCP will recognise a Capital Receipt to the extent that the purchase price is paid in cash, i.e. for the value of senior debt raised less any transaction costs paid for by the SPV less any proceeds used to create cash reserves in the SPV.
- The SPV will apply income generated from the assets to:
  - Pay the operating and maintenance costs of the assets, including any costs of running the SPV and management overhead;
  - Making interest and repayments of the senior debt;
  - Making interest payments on, and funding the repayment of, the subordinated shareholder loans (deferred capital receipt) from BCP;
  - Distributing any surpluses to BCP as dividends (where they would score as revenue income) or retaining them in the SPV to fund the future business plan.
- To give further security to the senior external funder, BCP may be able to provide a partial guarantee of the income stream to the SPV. The extent of this guarantee is likely to be limited (e.g. a last loss guarantee mechanism) so as not to impair the incentives and external market discipline imposed on the SPV to optimise income generation. Where a guarantee is provided by BCP it is envisaged that BCP will charge a guarantee fee at a market rate to compensate for the limited risk taken.
- We expect senior funders will require the SPV to maintain a Debt Service Reserve Account (cash collateral held by the SPV to provide a buffer if there is any shortage of income in a period).
- Any repayments on the subordinated loan, payment of guarantee fees and distribution of dividends will be subject to financial covenant agreements with the funder, which are likely to include Debt Service Cover Ratios ('DSCR') and potentially an asset cover ratio. The DSCR is the ratio of a Project's cash flows available for debt service ('CFADS') to its senior debt service obligations.
- The SPV and funders to it (which include both third party senior debt and subordinated shareholder loans (deferred capital receipt) provided by BCP) will be subject to the risks related to the operation and income generation of the asset.
- On repayment of the third-party debt in 20 years BCP will have ownership of the SPV with no debt secured against it. Should it wish to at this point it could dissolve the SPV and take back ownership of the assets or continue to operate them through the SPV.

# 4 - Accounting considerations

## Introduction

– Only the Council and specifically its s151 officer can, in consultation with its external auditors as required, determine the accounting treatment appropriate to a specific transaction based on the facts and circumstances of that transaction at the time is it entered into.

– We set out below, for consideration by the Council, our views on the potential accounting treatment of the transaction described on pages 7 & 8. This is the potential accounting treatment by BCP in its single entity accounts under ACOP and the Capital Finance Regulations as they are currently understood to apply.

## Capital expenditure and borrowing



– As the SPV (even though a wholly owned subsidiary of the Council) would be a separate entity, under the prudential regime – which applies only to the transactions which the Council is required to record in its own single entity accounts – there is likely to be no capital expenditure or borrowing incurred by BCP (as the external borrowing and acquisition of assets is instead undertaken by the SPV, rather than the Council).

– Therefore, capital expenditure by the SPV on acquiring assets, and the external borrowing it undertakes to do so, will potentially not fall to be capital expenditure by the Council.

## Minimum Revenue Provision (MRP) / General Fund impacts

– If the Council is not deemed to be undertaking capital expenditure or borrowing in its own right, it will not be required to make an annual MRP charge, nor will it incur interest costs on borrowing in its, General Fund ("GF").

## Capital receipts considerations

– Three objectives need to be met if the Council were to record capital receipts:

- The Council must demonstrate that it has actually disposed of the underlying assets such that it is, under proper practices, required to derecognise the assets from its own single entity balance sheet (i.e., achieve a "true sale" to the SPV);
- That were the Council to acquire the assets disposed of itself, that such an acquisition would fall to be capital expenditure; and
- The consideration on the disposal of the assets must be in the form of cash. Under the Capital Finance Regulations only when cash is received, on the disposal of capital assets, can the Council recognise available capital receipts.

## Achieving a "true sale"

– To achieve a "true sale" of the assets to the SPV the Council must demonstrate both that (i) it has transferred substantially all the risks and rewards incidental to the ownership of the assets to the SPV (i.e., that it is the SPV which benefits from the economic flows associated with those assets and can control them); and (ii) that the Council has not reabsorbed those risks and rewards through other means.

– The key risks and sources of reward associated with the assets to be transferred to the SPV is likely to be around (i) rental income; (ii)

- maintenance and lifecycle costs; (iii) residual value of the assets and the income arising on the disposal of some of the assets.
- Under the proposed transaction it will be the SPV, rather than the Council, which will be substantially exposed to these risks and rewards in that it will be the SPV (and through it, its external funders) that will take the risk:
  - On variations in both gross income and net income after deducting the costs incurred by the SPV on maintaining the assets and meeting its obligations to users of the assets; and
  - On the residual / market value of the underlying assets. This reflects that the Council, as a single entity, will not have the right to re-acquire the assets at a nominal or undervalue at a future point. Instead, it is intended that the disposal will not contain any rights for the Council to reacquire the assets from the SPV (but should such rights be granted to the Council they will only be exercisable at an independently established market valuation).
- In this context the potential provision by the Council of a limited guarantee to the SPV is not considered to dilute the extent to which the risks and rewards inherent in the underlying assets are transferred on their disposal to the SPV. This reflects that the guarantee – which as considered further below would be to reimburse the SPV's external funders where net income fell below a certain threshold (the threshold at which the Council's guarantee might be triggered is unknown, However, it has been assumed to be in the order of 50% to 70% of expected net income depending on the amount raised) – will operate on a "last loss" basis. This means that it is the SPV (and its external funders) which bears any losses which might occur from all reasonably expected fluctuations in net income; and the Council's guarantee can only be called after all cash reserves and other income sources the SPV are exhausted or otherwise or otherwise inadequate to meet the debt service requirements of the SPV's external funders.
- Whilst subject to more detailed modelling of the variability of the net income streams over time of the assets to be transferred to the SPV, the "last loss" basis of the potential guarantee mechanism and the high threshold at which it is expected to apply would imply that the guarantee is only likely to be triggered in remote (or at least highly unlikely) circumstances. Accordingly, it would be reasonable to conclude that the guarantee (if offered) would not substantively dilute the transfer to the SPV of the risks and rewards of ownership of the underlying assets.
- In light of the above, we consider it likely that the proposed structure would achieve a "true sale" of the underlying assets to the SPV.

### Would the acquisition score as Capital if undertaken by the Council?

- As described by the Council the assets to be disposed of to the SPV, could be treated as capital expenditure by the Council if it is acquired by the Council.
- This reflects that they would be (i) expected to be treated as a resource from which future economic benefits are expected to flow; and (ii) held by the Council for either the purposes of their service potential or income generating ability for a period of more than 1 year. As such they would be expected to be treated as either Property, Plant & Equipment, or Investment Properties under proper practices, and thereby fall to be capital expenditure for the purposes of the Capital Finance regulations.
- In light of the above, we consider that the acquisition of the assets by the Council could be treated as capital outlay.

### Is cash received?

- As currently proposed by the Council, the consideration received by the Council will likely consist of both cash and a deferred capital receipt in the form of the acceptance by the SPV of the obligation to repay a loan (and associated interest) to the Council. The proposed transaction assumes that the deferred capital receipt, in the form of a loan payable to the Council, will rank lower than the borrowing undertaken externally by the SPV to fund its payment of the cash component of the consideration payable to the Council on the transfer of the assets.

– Only that element of the consideration received in cash by the Council will score as available capital receipts. The Council would only need to recognise capital receipts in respect of its loan to the SPV, when and to the extent that the SPV repays the principal of that loan. The extent to which the consideration is in the form of a long-term loan repayable to the Council will be treated as Deferred Capital Receipts (which will not be an available resource to the Council to fund capital expenditure).

**Overall conclusion: Capital Receipts considerations**

– If the Council will dispose of assets to the SPV under a "true sale" in return for both cash consideration and a deferred capital receipt in the form of the acceptance of a loan obligation, the Council would be required to recognise capital receipts to the extent it has received cash consideration. This reflects that the prudential regime applies only to the Council's single entity (rather than group) accounts and that therefore cash consideration arising on asset disposals, even to a wholly owned subsidiary, would score as capital receipts (as the acquisition by the Council of those assets would score as capital expenditure). The extent to which the consideration is in the form of a loan repayable by the SPV to the Council would be treated as Deferred Capital Receipts.

– Moreover, s21(3) of the Local Government Act 2003 requires that, in the event of conflict between statutory provisions and proper practices, that the statutory provisions (namely that capital receipts are recognised in respect of the cash consideration) will prevail.

It is noted for completeness that whilst the Council's single entity accounts will show available capital receipts (and deferred capital receipts) on the sale of these assets to the SPV, the group accounts, if s21(3) of the LGA 2003 is deemed not to apply to that disclosure note, would show a different level of available capital receipts reserve as transactions between the Council and its wholly owned SPV are required to be eliminated on consolidation.

## Proper purpose considerations

– It is assumed that the Council is recognising available capital receipts on the disposal of assets to its wholly owned SPV to the extent that the SPV pays cash consideration for those assets, which the SPV would fund by way of external borrowing. This requires the Council to consider whether the transaction is for a proper purpose (i.e., that it is not solely a device to generate available capital receipts funded by way of external debt).

– Whilst this is a matter on which the Council will need to satisfy itself, our current understanding is that the motivations for undertaking the transaction is for commercial and strategic reasons. The generation of available capital receipts is incidental to that core purpose. This reflects that:

- The primary driver of BCP's proposed structure is the Council's strategic desire, as part of its wider transformation programme, to introduce significantly greater commerciality to its utilisation of assets and thereby increase the level of income and service benefits generated by its extensive asset base;
- The SPV is a mechanism by which to collate those assets with scope for income and service benefit optimisation. BCP expect the SPV to grow and complement the Council's wider place making agenda over time; and to this end
- The SPV is likely to, within a robust overall governance and oversight framework which the Council will design and implement, have meaningful autonomy of action and greater flexibility to take rapid and market focussed decisions. This autonomy will be reflected in the SPV's Board of Directors and the management team which over time run it on a day-to-day basis; and
- The use of external funders to support the SPV is seen by the Council as not only a mechanism by which to introduce sharpened commercial disciplines but also to financially insulate the Council's other activities from the SPV (as well

as reinforcing the SPV's autonomy) as substantially all the reasonably foreseeable risks and rewards associated with the assets are borne by the external funders.

- Whilst a matter for the Council to conclude on, the current understanding of basis of BCP's proposed structure would suggest that it is driven by a proper purpose and that the generation of available capital receipts is incidental to that purpose.

## Other accounting considerations

### Treatment of the guarantee (if provided)

– The guarantee is likely to fall to be a financial guarantee (as defined by IFRS 9) as it is assumed it will require the Council to reimburse the lender specified amounts if the SPV fails to meet its obligations under a debt instrument.

– The Council would be required to calculate a loss allowance for the guarantee which will be a charge to the GF, net of any premium income earned by the Council from providing the guarantee (it is assumed that the Council would charge the SPV a 'market' premium for the guarantee).

– The loss allowance would reflect the Council's risk weighted assessment of the likelihood of it being required to make payments under the guarantee to the lender (which as noted above is currently considered to be very low on the basis of the current understanding that the guarantee will operate on a "last loss" basis).

### Treatment of loan between Council and the SPV

– A portion of the consideration provided by the SPV on the disposal of assets is in the form of the acceptance by the SPV of a loan obligation to the Council which will give rise to a financial asset and deferred capital receipt on the Council's balance sheet.

– The Council will need to account for its financial asset (loan to the SPV) under IFRS 9, on the amortised cost basis. This will require the Council to review the loan (and any balance for unpaid interest at the year-end) for impairment and make an appropriate Expected Credit Loss (ECL) provision. In this context it should be noted that:

  - Any increase in the ECL arising on the principal would not be expected to be a charge to the GF as the loan balance represents a deferred capital receipt (and the original asset disposed of was fully funded through capital resources). Any provision required in respect of unpaid interest would however be a charge to the I&E account; and

  - Interest income on the loan (measured on the effective interest rate method which we would be expect to be the same as the nominal interest rate of the loan – as the loan is expected to be at a commercial rate consistent with the wider purpose for establishing the SPV and disposing of certain assets to it) will be credited to the I&E when earned. To the extent that the SPV has not paid interest due by the year-end, the Council will recognise a financial receivable for the amount due.

# 5 - Beach Hut proposition

## Introduction

- This section of the report discusses our findings on the indicative amount of third-party debt that the SPV could raise based on the estimated income generated (the "Project" and the "Transaction") by BCP's Beach Huts and related land interest (the "Assets") and the associated capital and revenue flows to the Council if implemented.
- To inform our analysis, we have reviewed the following information sent by BCP:
  - Beach Huts Income and Expenditure – Historical (2015-2016) and forecast (2021 -2025)
  - Beach Huts – Product type summary
  - Beach Huts – Book value



## Key assumptions

This sub section states the key assumptions which were provided by or agreed with the Council. We have extrapolated the figures over a likely debt term to get an indication on how much capital the SPV could raise.

- Purchase price of assets: BCP has provided the book value of the assets. We note that to achieve the desired accounting treatment and meet the Council's best value requirements, the assets will need to be transferred at fair value. In the absence of a formal valuation of the assets, we have used a capitalisation method agreed by the Council to estimate the value of the assets. This will need to be replaced by a formal valuation if the Project is progressed. To provide a high-level estimate of the fair value we applied a net initial yield of 8% to the 2021 annual income of £5.4m. This results in a proxy for fair value of £67m which we have used in this report. The net initial yield of 8% reflects the non-prime purpose-built student accommodation in regional locations according to CBRE in Residential Investments Q3' 2021. We have used this yield since there are limited large scale transactions similar to the Beach Hut asset class. Additionally, the assets have similarities to student accommodation, such as a stable income stream, low operating cost base and a waiting list in most cases.
- Inflation: We considered various methodologies and sources for the inflation rate. Below we list some of these approaches
  - Difference between the index-linked gilt and fixed gilt: This suggests the market is forecasting inflation of between 3.8% and 4.0% over a 10-to-20-year duration.
  - Office for Budget Responsibility ("OBR") RPI forecast: The OBR provides forecasts for inflation. In the forecast as of 16th of February 2022, which covers the period until Q1 2027, RPI has a maximum rate of 5.43% and then stabilises in the latter years to around 2.8%. We calculated a compound average rate using the OBR forecasts for RPI. This results in a rate of approximately 3.47%.
- Since the assumption for revenue in this analysis is linked to inflation and the debt is fixed, high inflation is beneficial once debt is raised. We have therefore taken a conservative approach by using a rate of 2.9%. This is the CPI rate from the Office of National Statistics for the month ending September 2021, when we started the analysis. This is also close to the rate of the OBR forecast when inflation stabilises in the latter years of the appraisal period. We note that inflation movements can be volatile. As such, adverse movement of inflation could impact the output from the extrapolation of the Council's assumptions.
- Revenue forecast: BCP has provided a revenue forecast for 5 years which we understand assumes an increase in assets. For our

analysis, we increased the revenue for the year ending 2021 by an inflation rate of 2.9% for each year over 20 years.

– Operating and maintenance cost: We take a conservative approach by using the highest operating and maintenance cost as a % of income for the last three years. This results in an allowance of 7.4% of income for operating costs and 5.0% for maintenance costs. We have then applied an inflation rate of 2.9% for each year over 20 years.

– SPV cost: We have assumed an annual SPV cost of £100k and increased this amount by the inflation rate of 2.9%. This is a high-level allowance for the incremental cost of having an additional entity, to cover costs such as additional management time, audit fees, Directors fees, insurances.

– Tax: For corporation tax, a tax rate of 20% was applied simply to any annual surplus. Senior debt interest is deemed to be deductible but interest on subordinated debt payable to the Council is not. The tax rate increases to 25% from year 2 which is in line with the government's corporation tax increase to 25% from April 2023. Further detailed work on the tax computation will be needed ahead of implementation and this is a high-level allowance only at this stage.

– Lease: we have assumed the leasehold is of at least 99 years (and more likely 125 year+) and therefore represents a true disposal of land interest.

– Discount rate: We have used a discount rate of 2.62%, which is the PWLB 20-year annuity rate as of 16/02/22, instead of the HMT Green Book rate of 6.09% (nominal). The PWLB rate reflects BCP's cost of capital, and this rate is adjusted daily. The HMT Green Book rate is based on the economic concept of a Social Time Preference Rate. Given this analysis is a financial one and not an economic analysis, KPMG has agreed with BCP that the PWLB is a better measure for this purpose. The HMT Green Book rate has not changed in several years despite a reducing interest rate environment. We do note that using the HMT Green Book rate, the NPC analysis for the proposals would be more favourable.

## Debt assumptions

– This sub section states the key debt assumptions based on transactions in the market with some similarities.

– There are various debt instruments that are available to the SPV to raise the funding. For this report, we have assumed that the debt will be raised through a Private Placement ("PP") from the capital markets.

– Private placements are unlisted corporate securities including debt, offered directly to a limited group of institutional investors rather than via public markets. It is a form of raising debt from the capital markets. These instruments offer a few advantages over bank debt and some other capital markets instruments such as income strips. The advantages include the ability to structure the repayment to match the income profile of the asset and the option to hedge against inflation or not through index-linked or fixed rate debt.

– For the high-level review, we have assumed that the debt will have a fixed rate.

To consider the debt capacity of the structures at a high level, the debt assumptions are based on transactions with similar characteristics in the market and initial discussions with BCP include:

*Table 1 - Debt assumptions*

| | Definition | BCP guarantee |
|---|---|---|
| Tenor | Number of years to pay the senior debt back | 20 years |
| Repayment profile | The profile under which debt is repaid and whether it is repaid in full over the tenor of the debt or will need to be refinanced in the future. | Repaid in full over the debt term with an amortisation profile to hit the Debt Service Cover Ratio. |
| Transaction cost | Transaction costs are cost related with executing the financing transaction. This includes legal fees, financial advice, etc. These costs will be reimbursed by the funder at financial close. | 800k |
| Inflation hedging | Private placements be structured as fixed rate, index linked or combination of both. | Fixed |
| Debt Service Cover Ratio | This is the ratio of a Project's CFADS to its debt service obligations. | 1.5x |
| Debt Service Reserve Account ('DSRA') | DSRA provides for some cash (enough to meet the next debt service payment, generally 6-12 months) to be set aside to provide liquidity and secured in favour of lenders | 6 months |
| Guarantee fee | A guarantee fee is the amount charged for BCP providing a guarantee to the SPV. We have assumed that this is the difference in margin between the guarantee and no guarantee debt option equivalent. In this case 1.25%. | 1.25% |

- <u>Pricing</u>: The all-in rate for a private placement transaction typically consists of:
  - <u>Reference rate</u>: Long term debt transactions (over 10 years) such as private placements are typically priced with reference to the underlying gilt rate. We have used the relevant gilt rate for the corresponding Weighted Average Loan Life ("WALL") period. This in line with common practice.
  - <u>Credit margin / spread</u>: This reflects the additional project risk over risk-free rates. Since there are limited transactions comparable to this one in the market, we have used the spreads for recent Local Government private placement transactions to determine the guaranteed debt margin. We have used social housing, tourism and student accommodation bond yields to inform the spread for the non-guaranteed option.
- We note that the pricing offered by private placement providers could vary depending on their risk appetite for the transaction. A soft market testing will be required for the deliverability of the structure and the pricing. The indicative debt pricing is as follows. These figures are expressed as a percentage over gilts.

*Table 2 - Pricing*

| | BCP guarantee | No guarantee |
|---|---|---|
| Market comparable range | Gilt + 0.95% -1.40% | Gilt + 2.10% -2.90% |
| All in price | Gilt + 1.25 % | Gilt + 2.50 % |

- <u>Subordinated debt (</u>deferred capital receipt<u>)</u>: Sub-ordinated debt is debt that ranks after senior debt for interest and repayment. For the proposed structure, the SPV will have to purchase the assets from the BCP at a purchase price which represents its fair value. As such, a sub-debt from BCP to the SPV will be required to make



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up for the difference between purchase price and the amount of senior funding. In our analysis, we have priced the sub-debt at 3.00% above the all-in rate of the senior debt although this is indicative only and not material to the overall analysis at this stage.

Dividend: Based on the DSCR levels for the proposed transaction, taking into account the other assumptions, there will be a surplus after servicing the senior debt. This amount will be returned to BCP as a combination of the sub-debt repayment, sub-debt interest, guarantee fee and dividend.

## Financial Summary

- In this section of the report, we provide the outcome from our initial high-level analysis.
- This analysis assumes **no change in the income or operating cost assumptions** associated with the assets as a result of the structure and wider commercialisation activities – it considers the amount of debt that could reasonably be raised and estimates the additional costs that result from implementing the structure. This will need to be overlaid with the estimate financial benefits from better asset performance when available as part of a value for money assessment by BCP.
- We note that the provision of a BCP guarantee will have pricing benefits for the transaction. With a lower price, the SPV can raise more senior debt upfront.
- Table 3 shows the indicative pricing, upfront capital receipt to BCP and the maximum amount that the SPV could raise from the private placement market based on our assumptions.

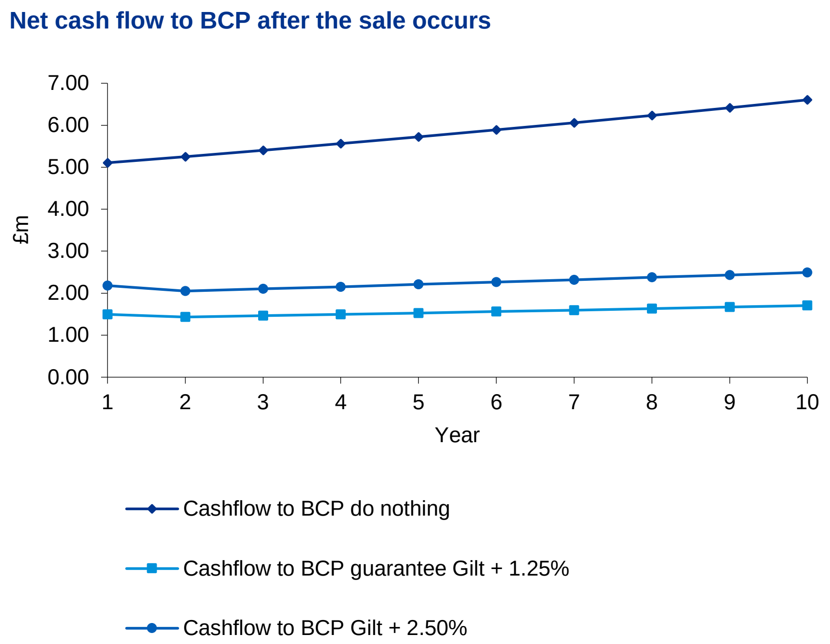
*Table 3 – Debt raise summary*

| | BCP guarantee | No guarantee |
|---|---|---|
| Pricing | Gilt + 1.25% | Gilt + 2.50% |
| DSRA prefund | £1.5m | £2.1m |
| Transaction cost | £0.8m | £0.8m |
| **Upfront capital receipt to BCP** | **£50.0m** | **£31.1m** |
| **Senior debt amount** | **£52.3m** | **£34.1m** |

*Source: KPMG analysis based on Council assumptions*

- Indicatively, a capital receipt up to £50.0m could be achievable if BCP provides a guarantee.
- Under this scenario, it is assumed that the Council would provide a guarantee equivalent to 67% of income and reach the view (and that view be agreed by the Council's external auditors) that a drop in income below 67% is sufficiently remote as not to cause the guarantee to be recognised as a liability.
- Comprehensive market testing will be required to test the deliverability of the guarantee.
- In Figure 2, we present the net cash flow to BCP after the sale occurs. This is cash distribution from the SPV to the Council (whether through guarantee fee, repayment and interest on subordinated debt or subordinated debt interest).
- Figure 2 shows that the do-nothing option of retaining the asset will generate the most annual net cash flow for BCP over the life of the transaction. However, this is due to not receiving an upfront receipt in time 0 from the sale of the assets and therefore not incurring transaction and interest costs.
- Once debt is repaid after 20 years the Council receive all net income through dividend in the standard BCP guarantee option.

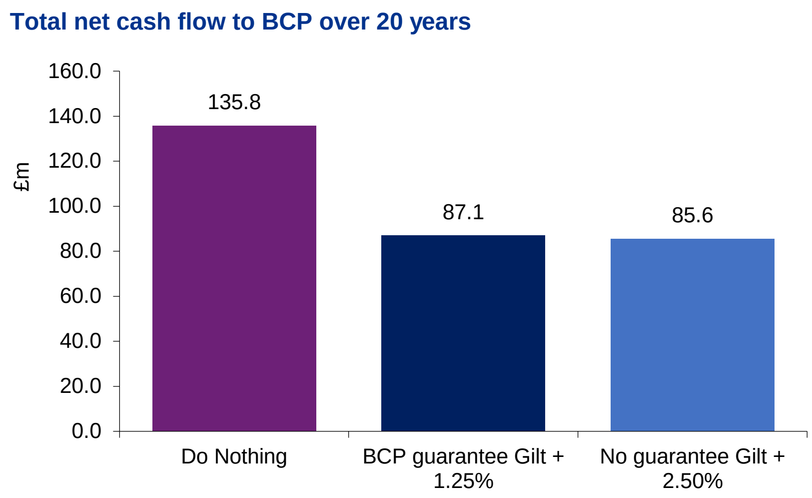
*Figure 2 - Net cashflows to BCP*




*Source: KPMG analysis based on Council assumptions*

- In figure 3, we provide the total net cash flow to BCP over the 20-year period. The chart shows that the BCP guarantee structure could potentially generate the most cash. This is mainly driven by the upfront capital receipt.

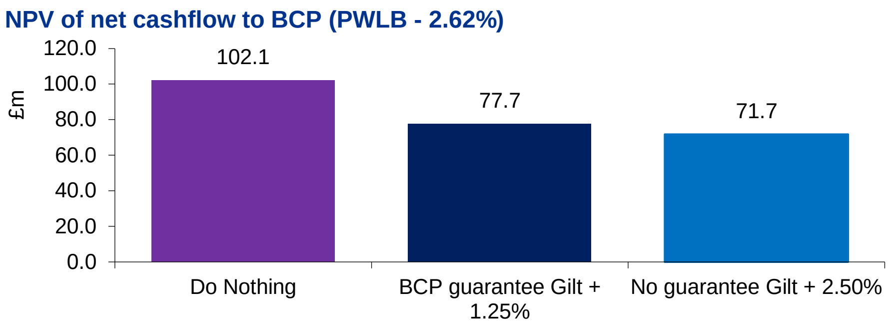
*Figure 3 - Net cashflows to BCP*




*Source: KPMG analysis based on Council assumptions*

- Assuming a base case scenario where BCP did not sell the assets to the SPV, we have calculated the NPV and compared it to the NPV of the net cash flows to BCP for all three scenarios. To derive the NPV, we have used a discount rate of 2.62% (PWLB 20-year annuity rate – 16/02/22). Figure 4 shows the NPV for the various scenarios.

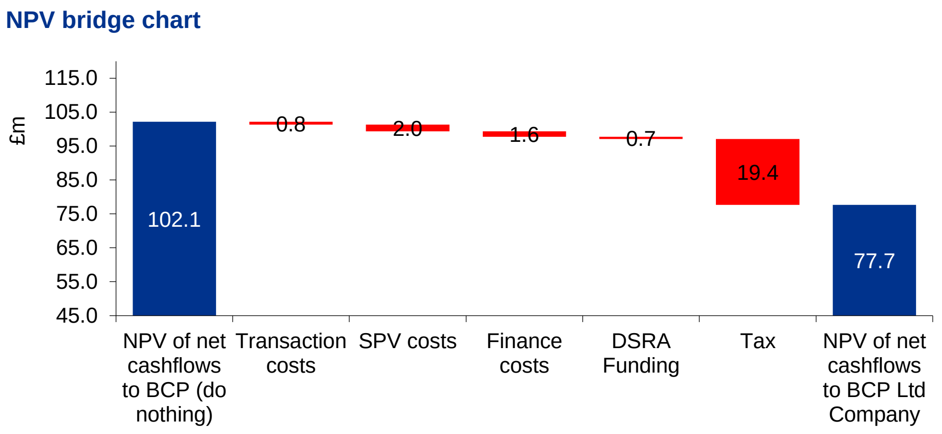
*Figure 4 - NPV of net cashflow to BCP*




*Source: KPMG analysis based on Council assumptions*

– In Figure 5, we present a bridge chart showing the NPV of the Do-nothing option to the NPV of the BCP guarantee.

*Figure 5 - NPV bridge chart for BCP guarantee (SPV - limited company)*




*Source: KPMG analysis based on Council assumptions*

## Alternative Beach Hut proposition structure

– While reviewing the Beach Hut proposition, we came to understand that there are important stakeholders and beneficiaries to the project some of which include BCP Futureplaces Ltd (Council owned), site owners such as the Meyrick Family and Cooper Dean and charities relevant to the foreshore.

– We note that there are additional structural options which could enable BCP incorporate the relevant stakeholders. This could involve the SPV's legal form being a Limited Liability Partnership ("LLP") or a structure including a charity vehicle.

### LLP structure

– The assets could be owned by an SPV whose legal form is an LLP. The LLP will consist of the Council and a third party or parties. Each party's holding could be determined by their equity or contribution of assets to the partnership e.g., 80% Council / 20% third party.

– This structure may enable BCP to spread the transaction risk and leverage the skills and expertise of its partners to commercialise the assets.

### Structural analysis assumption

– To inform BCP's decision on the structure, we extrapolated BCP's key assumptions for the Beach Huts with an LLP SPV. In this sub-section, we present the additional assumptions that we agreed with BCP for the LLP structure:

– LLP split: We have assumed an LLP structure of 80% Council / 20% Council owned entity which is a limited company. As such the distributions would remain within the Council group. Further analysis will be needed to consider the impact of bringing an external third partner into the LLP, including analysis of what assets they are willing to invest and the additional return generated from those assets.

– Tax: In addition to the corporate tax assumptions, we have included SDLT in the LLP option. A rate of 5% on the purchase of the assets is liable assuming a partner will have to pay this amount on their share

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of the LLP. Further detailed work on the tax computation will be needed ahead of implementation and this is a high-level allowance only at this stage. Where the partner is a Council owned company it may be able to get group relief for the SDLT.

– Debt capacity: The SPV will have an increased debt capacity due to tax being paid by the partners rather than the SPV itself (and therefore excluded from debt coverage calculations). We have assumed a cap of senior debt to 85% of the asset value to retain a loan to value ratio below 1.

## Financial summary

– We provide the outcome from our initial high-level analysis. For comparative purposes, we have also included the results from the limited company guarantee option in the previous section.

– Table 4 shows the indicative pricing, upfront capital receipt to BCP and the maximum amount that the SPV can raise.

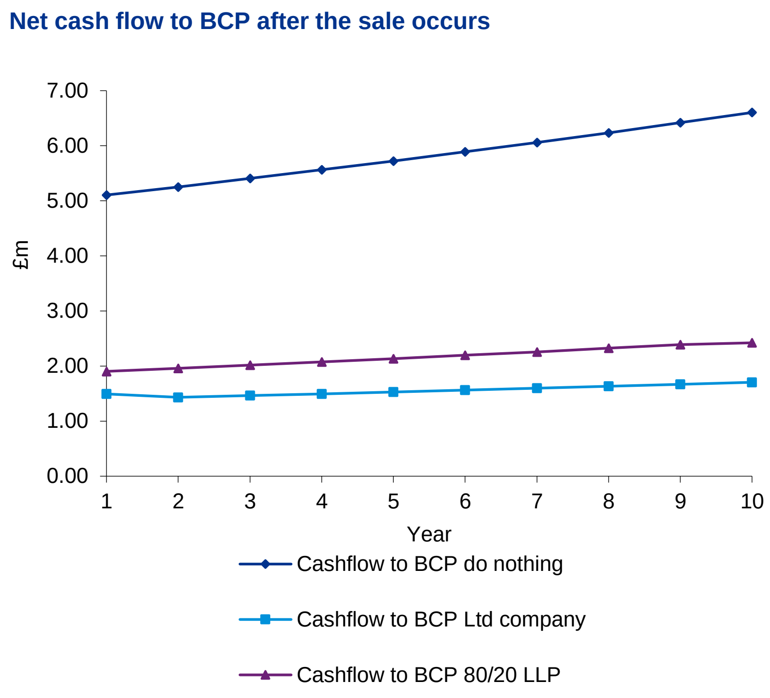
*Table 4 – LLP debt raise summary*

| | BCP guarantee (Ltd company) | BCP guarantee LLP structure (80% Council / 20% Council owned entity) |
|---|---|---|
| Pricing | Gilt + 1.25% | Gilt + 1.25% |
| DSRA prefund | £1.5m | £1.5m |
| Transaction cost | £0.8m | £0.8m |
| **Upfront capital receipt to BCP** | **£50.0m** | **£56.9m** |
| **Senior debt amount** | **£52.3m** | **£59.2m** |

*Source: KPMG analysis based on Council assumptions*

– In Figure 6, we present the net cash flow to BCP after the sale occurs. The do-nothing option of retaining the asset generates the most annual net cash flow for BCP. However, the LLP option generates more annual cash for BCP when compared to the Ltd company option. This is due to the other partner being a Council owned entity and the Council's tax exemption in the LLP structure.

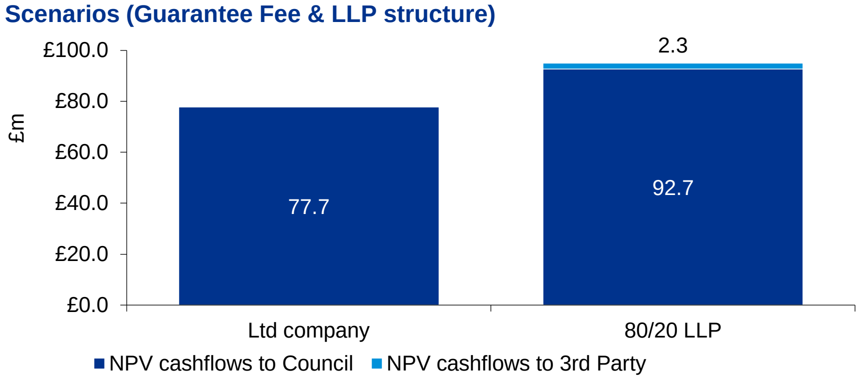
*Figure 6 - Net cashflows to BCP showing the LLP option*




*Source: KPMG analysis based on Council assumptions*

– Figure 7 shows the NPV of the net cash flow to BCP using a discount rate of 2.62% (PWLB 20-year annuity rate – 16/02/22). The LLP option will generate the most cashflow for BCP (£95.0m) due to the upfront receipt, the third party being a Council owned entity and the Council's tax exemption status.

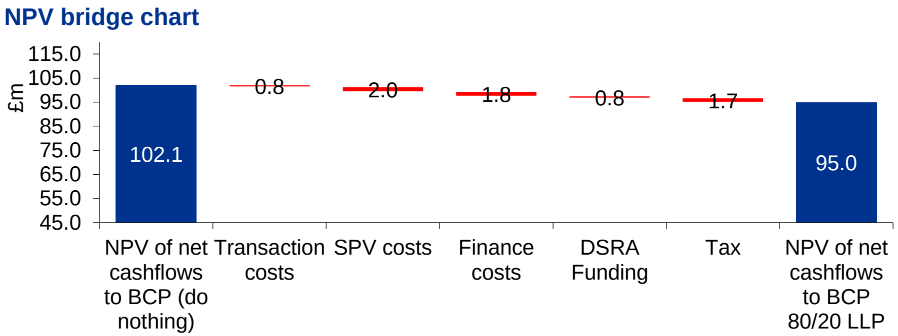
*Figure 7 - NPV of net cashflow to BCP including the LLP option*




*Source: KPMG analysis based on Council assumptions*

- Lastly, in figure 8, we present a bridge chart showing the NPV of the Do-nothing option to the NPV of the BCP guarantee LLP option.

*Figure 8 - NPV bridge chart for BCP guarantee LLP structure*




*Source: KPMG analysis based on Council assumptions*

## Sensitivities:

- Interest rate and inflation sensitivity outputs for both SPV options can be found in Appendix 3.

## Conclusion

- As a result of the above, we consider that the use of an SPV structure could enable the commercialisation of assets which may ultimately provide various benefits to BCP including a capital receipt. Further analysis of the potential for additional revenue or operating cost efficiency from commercialisation is needed to determine whether this offsets the increased cost driven by the structure, most notably tax and transaction cost.
- This is subject to BCP being able to provide evidence to it's auditors that the chances of a guarantee being called (which relies on income being less than 67% of forecast) is remote. The case for this required detailed development at the next stage.
- The net impact on BCP revenue surpluses of the limited company option is £3.6m rising to £6.5m in the 20-year period. This is driven by the interest on debt, transaction costs and tax of the SPV.
- In NPV terms (using the PWLB rate as a discount rate) for the limited company option, there is a net cost to the Council over 20 years of £24.4m. The largest part of this is due to corporation tax payable by the SPV. However, other commercial structures such as the LLP reduce this amount materially and allows the other stakeholders to be involved in the transaction. Detailed tax advice is required if the Project is progressed.
- The analysis in this report also assumes that total income from the Beach Huts is unchanged under the SPV structure. The Council may wish to further explore opportunities to enhance the income generated from the assets, through strategies such as increasing deployment or changing pricing strategy. It is possible this may mitigate or exceed the transaction costs and corporate tax leakage

and this will be important to be able to reach a conclusion on the value for money of the proposals.

- Under an 80/20 LLP structure the capital receipt will increase to £56.9m. We note that BCP will require detailed tax advice for the use of an LLP structure and there may be some tax risk associated with the structure.
- The initial funding analysis demonstrates that there is potential for the SPV to raise debt from a senior lender. However, there are a few broader considerations for the transaction. Below we list some of them:
    - Tenor: the initial analysis is based on a 20-year tenor. We note that PP funders can provide debt for up to around 45 years if there is a guarantee in place. The longer tenor will enable the debt repayment to be spread over an extended period, increasing the annual amount of cash to BCP after senior debt repayments. However, a longer guarantee may weaken the argument that it is unlikely to ever be called as cashflows become less certain the longer into the future they are predicted.
    - Fixed rate vs inflation-linked: the analysis assumes fixed rate debt. However, since the rental profile is expected to rise in line with inflation, there could be merit in exploring index-linked debt. The main advantage of index-linked debt is that it can help to hedge against inflation risk. However, a disadvantage is that funders sometimes charge a premium in the margin for the inflation hedge.
    - Funding placement: The analysis is based on a private placement funding from the capital markets. However, we note that a private placement and other forms of debt will have punitive breakage costs for early repayment if ever needed. There are other funding mechanisms that are available such as banks and debt funds that may have lower break costs and more flexibility to repay early, however, may charge a higher initial rate.
- Additional considerations for BCP regarding the SPV include:
    - Staffing: The SPV will require staff for various purposes. This could include BCP transferring or seconding a few staff to the SPV. The SPV could also purchase support from the Council via a service-level agreement.
    - Governance: effective governance measures will have to be implemented for the SPV i.e. board composition, constitution, reporting requirements.

## Implementation

- In the paragraphs below we set out the key steps to implementing the transaction.
- Step 1, detailed design: The following areas need further exploration as part of the detailed design of the transaction:
    - Governance arrangements of the SPV
    - Resourcing of the SPV, i.e. whether the SPV functions through a management agreement with BCP, BCP seconds staff into the SPV or it independently employs staff an management
    - Formal valuation of the assets
    - Consideration of the optimal method of getting cash surpluses generated by the assets after third party debt service back to BCP, i.e. whether through guarantee fee, subordinated loan interest and principle repayment or dividend
    - Further analysis of the tax implications, including corporation tax, VAT and SDLT
    - Analysis of the optimal term length for the third-party debt
    - Consideration of the optimal debt structure, such as whether index linked or not, repayment profile and tenor.

- Further consideration of optimal debt placement strategy and structure.
- Detailed accounting treatment and tax advice based on final deal design.

– Step 2, preparation for transaction:
  - Market sounding of potential investors to confirm investor appetite.
  - Detailed credit analysis on the Project and BCP (as guarantor) to inform future funder engagement
  - Development of funding heads of terms.
  - Additional tax and accounting advice (if required).

– Step 3, transact:
  - Setting up of the SPV and bank accounts.
  - Preparation of an information memorandum for funders.
  - Funding competition.
  - Detailed legal documentation.
  - Funds flow.

Indicatively we would expect Step 1 to be 2-3 months (including allowing for Easter); Step 2 to take 6 weeks to 2 months; Step 3 to take 2 months. This suggests end to end the transaction is likely to take around 6 months to execute.

# Appendix 1- Cashflows BCP Ltd company (guarantee gilt + 1.25%)

## SPV cash flow – nominal £m

| | Total | Year | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 15 | 20 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Cashflow statement** | | | | | | | | | | | | | | | |
| Revenue | **155.0** | | - | 5.8 | 6.0 | 6.2 | 6.3 | 6.5 | 6.7 | 6.9 | 7.1 | 7.3 | 7.5 | 8.7 | 10.0 |
| Operating Costs & Maintenance Costs | **(19.2)** | | - | (0.7) | (0.7) | (0.8) | (0.8) | (0.8) | (0.8) | (0.9) | (0.9) | (0.9) | (0.9) | (1.1) | (1.2) |
| SPV costs | **(2.7)** | | - | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.2) |
| Tax | **(26.4)** | | - | (0.6) | (0.8) | (0.8) | (0.9) | (0.9) | (1.0) | (1.0) | (1.1) | (1.2) | (1.2) | (1.6) | (2.1) |
| Cashflows from operations | **106.7** | | - | 4.4 | 4.4 | 4.5 | 4.6 | 4.7 | 4.8 | 4.9 | 5.0 | 5.1 | 5.2 | 5.8 | 6.5 |
| | | | | | | | | | | | | | | | |
| **CFADS** | **106.7** | | - | 4.4 | 4.4 | 4.5 | 4.6 | 4.7 | 4.8 | 4.9 | 5.0 | 5.1 | 5.2 | 5.8 | 6.5 |
| | | | | | | | | | | | | | | | |
| **Debt service reserve cash flow** | - | | 1.5 | (0.0) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | (2.2) |
| | | | | | | | | | | | | | | | |
| **Senior Debt service** | | | | | | | | | | | | | | | |
| Opening balance | **647.9** | | - | 52.3 | 50.9 | 49.4 | 47.9 | 46.2 | 44.4 | 42.5 | 40.5 | 38.3 | 36.0 | 22.3 | 4.2 |
| Drawdown | **52.3** | | 52.3 | - | - | - | - | - | - | - | - | - | - | - | - |
| Repayment | **52.3** | | - | 1.4 | 1.4 | 1.6 | 1.7 | 1.8 | 1.9 | 2.0 | 2.2 | 2.3 | 2.4 | 3.2 | 4.2 |
| Interest | **18.9** | | - | 1.5 | 1.5 | 1.4 | 1.4 | 1.3 | 1.3 | 1.2 | 1.2 | 1.1 | 1.0 | 0.6 | 0.1 |
| Closing balance | **647.9** | | 52.3 | 50.9 | 49.4 | 47.9 | 46.2 | 44.4 | 42.5 | 40.5 | 38.3 | 36.0 | 33.6 | 19.0 | - |
| | **-** | | | | | | | | | | | | | | |
| Cashflows after Senior Debt service | **79.8** | | 50.8 | 0.8 | 0.8 | 0.8 | 0.9 | 1.0 | 1.0 | 1.1 | 1.1 | 1.2 | 1.3 | 1.6 | 4.3 |
| | | | | | | | | | | | | | | | |
| Guarantee Fee | **(8.1)** | | - | (0.7) | (0.6) | (0.6) | (0.6) | (0.6) | (0.6) | (0.5) | (0.5) | (0.5) | (0.5) | (0.3) | (0.1) |
| | | | | | | | | | | | | | | | |
| **Subordinated Debt service** | | | | | | | | | | | | | | | |
| Opening balance | **339.4** | | - | 17.0 | 17.2 | 17.5 | 17.7 | 17.9 | 18.1 | 18.2 | 18.2 | 18.2 | 18.2 | 16.8 | 12.8 |
| Drawdown/ (Repayment) | **9.5** | | 17.0 | 0.2 | 0.3 | 0.2 | 0.2 | 0.2 | 0.1 | 0.1 | 0.0 | (0.1) | (0.1) | (0.6) | (3.3) |
| Closing balance | **348.9** | | 17.0 | 17.2 | 17.5 | 17.7 | 17.9 | 18.1 | 18.2 | 18.2 | 18.2 | 18.2 | 18.1 | 16.3 | 9.5 |
| | | | | | | | | | | | | | | | |
| Cashflows after Subordinated Debt service | **69.2** | | 67.8 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 |
| | | | | | | | | | | | | | | | |
| Dividend | **1.4** | | - | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 |

*Source: KPMG analysis based on Council assumptions*

# Appendix 1- Cashflows BCP Ltd company (guarantee gilt + 1.25%)

## Council cash flow – nominal £m

| | Total | Year | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 15 | 20 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Council cashflows** | | | | | | | | | | | | | | | |
| Purchase price | **67.1** | | 67.1 | - | - | - | - | - | - | - | - | - | - | - | - |
| Guarantee Fee | **8.1** | | - | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.5 | 0.5 | 0.5 | 0.5 | 0.3 | 0.1 |
| Subordinated debt drawdown | **(17.0)** | | (17.0) | - | - | - | - | - | - | - | - | - | - | - | - |
| Subordinated debt interest | **20.1** | | - | 1.0 | 1.0 | 1.0 | 1.0 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.0 | 0.8 |
| Subordinated repayment | **7.5** | | - | (0.2) | (0.3) | (0.2) | (0.2) | (0.2) | (0.1) | (0.1) | (0.0) | 0.1 | 0.1 | 0.6 | 3.3 |
| Equity contribution | **(0.0)** | | (0.0) | - | - | - | - | - | - | - | - | - | - | - | - |
| Dividends | **1.4** | | - | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 |
| Total net cashflows to the Council | **87.1** | | 50.0 | 1.5 | 1.4 | 1.5 | 1.5 | 1.5 | 1.6 | 1.6 | 1.6 | 1.7 | 1.7 | 1.9 | 4.3 |

*Source: KPMG analysis based on Council assumptions*

# Appendix 2- Cashflows BCP 80/20 LLP (guarantee gilt + 1.25%)

## SPV cash flow – nominal £m

| Year | Total | Year | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 20 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Cashflow statement** | | | | | | | | | | | | | | | | | | | |
| Revenue | **155.0** | | - | 5.8 | 6.0 | 6.2 | 6.3 | 6.5 | 6.7 | 6.9 | 7.1 | 7.3 | 7.5 | 7.8 | 8.0 | 8.2 | 8.4 | 8.7 | 10.0 |
| Operating Costs & Maintenance Costs | **(19.2)** | | - | (0.7) | (0.7) | (0.8) | (0.8) | (0.8) | (0.8) | (0.9) | (0.9) | (0.9) | (0.9) | (1.0) | (1.0) | (1.0) | (1.0) | (1.1) | (1.2) |
| SPV costs | **(2.7)** | | - | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.2) |
| Tax | **-** | | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Cashflows from operations | **133.1** | | - | 5.0 | 5.2 | 5.3 | 5.5 | 5.6 | 5.8 | 5.9 | 6.1 | 6.3 | 6.5 | 6.7 | 6.9 | 7.1 | 7.3 | 7.5 | 8.6 |
| **CFADS** | **133.1** | | - | 5.0 | 5.2 | 5.3 | 5.5 | 5.6 | 5.8 | 5.9 | 6.1 | 6.3 | 6.5 | 6.7 | 6.9 | 7.1 | 7.3 | 7.5 | 8.6 |
| **Debt service reserve cash flow** | **-** | | 1.5 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | (2.6) |
| **Senior Debt service** | | | | | | | | | | | | | | | | | | | |
| Opening balance | **754.1** | | - | 59.3 | 58.0 | 56.5 | 54.9 | 53.2 | 51.3 | 49.3 | 47.1 | 44.8 | 42.2 | 39.5 | 36.6 | 33.5 | 30.1 | 26.6 | 5.1 |
| Drawdown | **59.3** | | 59.3 | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Repayment | **59.3** | | - | 1.3 | 1.5 | 1.6 | 1.7 | 1.9 | 2.0 | 2.2 | 2.4 | 2.5 | 2.7 | 2.9 | 3.1 | 3.3 | 3.6 | 3.8 | 5.1 |
| Interest | **22.0** | | - | 1.7 | 1.7 | 1.6 | 1.6 | 1.6 | 1.5 | 1.4 | 1.4 | 1.3 | 1.2 | 1.2 | 1.1 | 1.0 | 0.9 | 0.8 | 0.1 |
| Closing balance | **754.1** | | 59.3 | 58.0 | 56.5 | 54.9 | 53.2 | 51.3 | 49.3 | 47.1 | 44.8 | 42.2 | 39.5 | 36.6 | 33.5 | 30.1 | 26.6 | 22.8 | 0.0 |
| Cashflows after Senior Debt service | **101.8** | | 57.8 | 1.2 | 1.2 | 1.3 | 1.4 | 1.5 | 1.6 | 1.6 | 1.7 | 1.8 | 1.9 | 2.0 | 2.2 | 2.3 | 2.4 | 2.5 | 5.9 |
| Guarantee Fee | **(9.4)** | | - | (0.7) | (0.7) | (0.7) | (0.7) | (0.7) | (0.6) | (0.6) | (0.6) | (0.6) | (0.5) | (0.5) | (0.5) | (0.4) | (0.4) | (0.3) | (0.1) |
| **Subordinated Debt service** | | | | | | | | | | | | | | | | | | | |
| Opening balance | **63.4** | | - | 10.0 | 9.5 | 8.9 | 8.2 | 7.4 | 6.4 | 5.3 | 4.0 | 2.6 | 1.0 | - | - | - | - | - | - |
| Drawdown/ (Repayment) | **-** | | 10.0 | (0.5) | (0.6) | (0.7) | (0.8) | (1.0) | (1.1) | (1.3) | (1.4) | (1.6) | (1.0) | - | - | - | - | - | - |
| Closing balance | **63.4** | | 10.0 | 9.5 | 8.9 | 8.2 | 7.4 | 6.4 | 5.3 | 4.0 | 2.6 | 1.0 | - | - | - | - | - | - | - |
| Cashflows after Subordinated Debt service | **98.0** | | 67.8 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.8 | 2.0 | 2.2 | 2.3 | 2.4 | 2.5 | 5.9 |
| Dividend | **30.2** | | - | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.8 | 2.0 | 2.2 | 2.3 | 2.4 | 2.5 | 5.9 |

*Source: KPMG analysis based on Council assumptions*

# Appendix 2- Cashflows BCP 80/20 LLP (guarantee gilt + 1.25%)

## Council cash flow (BCP and Council owned company) – nominal £m

| Year | Total | Year | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 20 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Total cashflows** | | | | | | | | | | | | | | | | | | | |
| Purchase price | **67.1** | | 67.1 | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Guarantee Fee | **9.4** | | - | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 | 0.5 | 0.5 | 0.5 | 0.4 | 0.4 | 0.3 | 0.1 |
| Subordinated debt drawdown | **(10.0)** | | (10.0) | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Subordinated debt interest | **3.8** | | - | 0.6 | 0.6 | 0.5 | 0.5 | 0.4 | 0.4 | 0.3 | 0.2 | 0.2 | 0.1 | - | - | - | - | - | - |
| Subordinated repayment | **10.0** | | - | 0.5 | 0.6 | 0.7 | 0.8 | 1.0 | 1.1 | 1.3 | 1.4 | 1.6 | 1.0 | - | - | - | - | - | - |
| Equity contribution | **(0.0)** | | (0.0) | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Dividends | **30.2** | | - | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.8 | 2.0 | 2.2 | 2.3 | 2.4 | 2.5 | 5.9 |
| **Net total cashflows** | **110.4** | | 57.0 | 1.9 | 2.0 | 2.0 | 2.1 | 2.1 | 2.2 | 2.3 | 2.3 | 2.4 | 2.5 | 2.5 | 2.6 | 2.7 | 2.8 | 2.8 | 6.0 |
| | | | | | | | | | | | | | | | | | | | |
| **Total cashflows pre-tax to Council Group Companies** | **110.4** | | 57.0 | 1.9 | 2.0 | 2.0 | 2.1 | 2.1 | 2.2 | 2.3 | 2.3 | 2.4 | 2.5 | 2.5 | 2.6 | 2.7 | 2.8 | 2.8 | 6.0 |
| **Council cashflows** | | | | | | | | | | | | | | | | | | | |
| Purchase price | **67.1** | | 67.1 | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Guarantee Fee | **9.4** | | - | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 | 0.5 | 0.5 | 0.5 | 0.4 | 0.4 | 0.3 | 0.1 |
| Subordinated debt drawdown | **(10.0)** | | (10.0) | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Subordinated debt interest | **3.8** | | - | 0.6 | 0.6 | 0.5 | 0.5 | 0.4 | 0.4 | 0.3 | 0.2 | 0.2 | 0.1 | - | - | - | - | - | - |
| Subordinated repayment | **10.0** | | - | 0.5 | 0.6 | 0.7 | 0.8 | 1.0 | 1.1 | 1.3 | 1.4 | 1.6 | 1.0 | - | - | - | - | - | - |
| Equity contribution | **(0.0)** | | (0.0) | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Dividends | **24.1** | | - | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.7 | 1.6 | 1.7 | 1.8 | 1.9 | 2.0 | 4.7 |
| **Pre-tax cashflows** | **104.3** | | 57.0 | 1.9 | 1.9 | 2.0 | 2.1 | 2.1 | 2.2 | 2.2 | 2.3 | 2.4 | 2.3 | 2.1 | 2.2 | 2.2 | 2.3 | 2.3 | 4.8 |
| Tax Payable | **-** | | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| **Post-tax cashflows to the Council** | **104.3** | | 57.0 | 1.9 | 1.9 | 2.0 | 2.1 | 2.1 | 2.2 | 2.2 | 2.3 | 2.4 | 2.3 | 2.1 | 2.2 | 2.2 | 2.3 | 2.3 | 4.8 |
| **Limited company cashflows** | | | | | | | | | | | | | | | | | | | |
| Purchase price | **-** | | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Guarantee Fee | **-** | | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Subordinated debt drawdown | **-** | | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Subordinated debt interest | **-** | | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Subordinated repayment | **-** | | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Equity contribution | **(0.0)** | | (0.0) | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Dividends | **6.0** | | - | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.2 | 0.4 | 0.4 | 0.5 | 0.5 | 0.5 | 1.2 |
| **Pre-tax cashflows** | **6.0** | | (0.0) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.2 | 0.4 | 0.4 | 0.5 | 0.5 | 0.5 | 1.2 |
| Tax Payable | **(2.2)** | | (0.7) | (0.0) | (0.0) | (0.0) | (0.0) | (0.0) | (0.0) | (0.0) | (0.0) | (0.0) | (0.0) | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) | (0.3) |
| **Post-tax cashflows to the Limited Company** | **3.9** | | (0.7) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 | 0.9 |
| | | | | | | | | | | | | | | | | | | | |
| **Total cashflows post-tax to Council Group Companies** | **108.2** | | 56.3 | 1.9 | 2.0 | 2.0 | 2.1 | 2.1 | 2.2 | 2.3 | 2.3 | 2.4 | 2.4 | 2.4 | 2.5 | 2.6 | 2.6 | 2.7 | 5.7 |

*Source: KPMG analysis based on Council assumptions*



KPMG

# Appendix 3 - Sensitivity analysis

The tables in this section display the outcome of interest rate and inflation sensitivity analysis:

**Interest rate sensitivity**

The interest rate sensitivity below, assumes movements of +25bps, +50bps and +75bps in the gilt rates before financial close. As displayed in the table, as interest rates increase before financial close, the borrowing capacity decreases and the upfront capital receipt.

In the LLP option, the SPV's debt capacity will increase due to tax being paid by the partners rather than the SPV itself (and therefore excluded from debt coverage calculations). For the sensitivities, similar to the base case, we have assumed a cap of senior debt to 85% of the asset value to retain a loan to value ratio below 1. In addition, the DSCR ratio has been adjusted (1.64x) to ensure the debt is repaid in full over 20 years.

| | Interest rate sensitivity | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | BCP guarantee | | | | | BCP guarantee LLP structure (80% Council / 20% Council owned entity) | | | |
| Interest rate | Gilt + 1.25% | Gilt +125 bps | Gilt +125 bps | Gilt +125 bps | | Gilt + 1.25% | Gilt +125 bps | Gilt +125 bps | Gilt +125 bps |
| Movement in gilt | | +25bps | +50bps | +75bps | | | +25bps | +50bps | +75bps |
| DSRA prefund | £1.5m | £1.5m | £1.5m | £1.5m | | £1.5m | £1.5m | £1.5m | £1.5m |
| Transaction cost | £0.8m | £0.8m | £0.8m | £0.8m | | £0.8m | £0.8m | £0.8m | £0.8m |
| **Upfront capital receipt to BCP** | **£50.0m** | **£48.9m** | **£47.8m** | **£46.7m** | | **£56.6m** | **£55.1m** | **£53.7m** | **£52.3m** |
| **Senior debt amount** | **£52.3m** | **£51.2m** | **£50.1m** | **£49.0m** | | **£58.9m** | **£57.4m** | **£56.0m** | **£54.6m** |
| **NPV of payment to BCP** | **£77.1m** | **£76.7m** | **£75.6m** | **£74.7m** | | **£95.1m** | **£93.7m** | **£92.4m** | **£91.1m** |

*Source: KPMG analysis based on Council assumptions*

**Inflation rates**

The inflation sensitivity table assumes movements in inflation after financial close. The inflation rates used include 0.90%, 1.90%, 3.90%, 4.90%, 3.90% with a decrease to 2.90% from year 6 and 4.90% with a decrease to 2.90% from year 6.

In line with the base case, the revenues, operating cost and maintenance cost increase by inflation. As such, in a high inflation environment, the SPV will meet its senior debt obligations with greater headroom than a low inflation environment. Based on BCP's assumptions, for the Ltd company option, in a low inflation environment of 0.90%, the minimum DSCR is 1.04x over 20 years; however, the minimum debt cover is 1.50x in 20 years in a high inflation environment (4.90%). For the LLP option, in a low inflation environment of 0.90%, the minimum DSCR is 1.13x over 20 years; however, the minimum debt cover is 1.64x in 20 years in a high inflation environment (4.90%).

If the Beach Huts rent were linked to inflation, the Council should consider inflation-linked debt to hedge against inflation and ensure the rental income stream matches the debt repayment. These are among the considerations that will be discussed in the next step.

**Inflation sensitivity**
BCP guarantee Ltd Company

| Inflation | 2.90% | | 0.90% | | 1.90% | | 3.90% | | 4.90% | | 3.90% for 5 years then reduction by 1% | | 4.90% for 5 years then reduction by 2% | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Maximum | Mininum | Maximum | Minimum | Maximum | Minimum | Maximum | Minimum | Maximum | Minimum | Maximum | Minimum | Maximum | Minimum |
| Senior Debt Service Cover | 1.50x | 1.50x | 1.50x | 1.04x | 1.50x | 1.25x | 1.80x | 1.50x | 2.16x | 1.50x | 1.56x | 1.50x | 1.62x | 1.50x |
| NPV of payment to BCP | £77.7m | | **£65.3m** | | **£71.2m** | | **£85.1m** | | **£93.4m** | | **£80.3m** | | **£82.9m** | |

**Inflation sensitivity**
BCP guarantee LLP structure
(80% Council / 20% Council owned entity)

| Inflation | 2.90% | | 0.90% | | 1.90% | | 3.90% | | 4.90% | | 3.90% for 5 years then reduction by 1% | | 4.90% for 5 years then reduction by 2% | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Maximum | Mininum | Maximum | Minimum | Maximum | Minimum | Maximum | Minimum | Maximum | Minimum | Maximum | Minimum | Maximum | Minimum |
| Senior Debt Service Cover | 1.64x | 1.64x | 1.64x | 1.13x | 1.64x | 1.36x | 1.97x | 1.64x | 2.36x | 1.64x | 1.70x | 1.64x | 1.80x | 1.64x |
| NPV of payment to BCP | £95.0m | | **£80.2m** | | **£88.0m** | | **£106.5m** | | **£117.6m** | | **£100.2m** | | **£103.2m** | |

**Inflation sensitivity**
(Do nothing)

| Inflation | 2.90% | 0.90% | 1.90% | 3.90% | 4.90% | 3.90% for 5 years then reduction by 1% | 4.90% for 5 years then reduction by 2% |
|---|---|---|---|---|---|---|---|
| NPV of payment to BCP | £102.1m | **£85.1m** | **£93.1m** | **£112.2m** | **£123.6m** | **£105.7m** | **£109.3m** |

*Source: KPMG analysis based on Council assumptions*

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# Commercialisation of Council-owned Beach Huts

## Bournemouth Christchurch and Poole Council

## July 2022

**This report is provided in confidence and its circulation and use are limited – see Notice on page 1. Some parts of this Report may be published but other parts are exempt from disclosure under the Freedom of Information Acts.**

# Glossary

| | |
|---|---|
| **BCP** | Bournemouth, Christchurch and Poole Council |
| **CPI** | Consumer Price Index |
| **CFADS** | Cashflow Available for Debt Service |
| **DSCR** | Debt Service Coverage Ratio |
| **DSRA** | Debt Service Reserve Account |
| **GBP** | Great British Pound |
| **GEPOC** | General Power of Competence |
| **GF** | General Fund |
| **HMT Green Book** | Her Majesty's Treasury Green Book |
| **ICMA** | International Capital Markets Association |
| **KPMG** | KPMG LLP |
| **LBH** | London Borough of Haringey |
| **NPC** | Net Present Cost |
| **NPV** | Net Present Value |
| **OBR** | Office for Budgetary Responsibility |
| **PWLB** | Public Works Loan Board |
| **RPI** | Retail Price Index |
| **SDLT** | Stamp Duty Land Tax |
| **SPV** | Special Purpose Vehicle |
| **Subsidiary** | New council-owned subsidiary for the Beach Huts |
| **VAT** | Value-added Tax |
| **WALL** | Weighted Average Loan Life |

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**Important Notice: About this Report**

This report has been prepared on the basis set out in our engagement letter addressed to Bournemouth Christchurch and Poole Council ("the Client") dated 14th of April 2022 (the "Engagement Letter") and should be read in conjunction with the Engagement Letter.

Please note that the Engagement Letter makes this report confidential between the Client and us. It has been released to the Client on the basis that it shall not be copied, referred to or disclosed, in whole or in part, without our prior written consent (except as specifically permitted in our Engagement Letter). Any disclosure of this report beyond what is permitted under the Engagement Letter will prejudice substantially this firm's commercial interests. A request for our consent to any such wider disclosure may result in our agreement to these disclosure restrictions being lifted in part. If the Client receives a request for disclosure of the product of our work or this report under the Freedom of Information Act 2000 or the Freedom of Information (Scotland) Act 2002, having regard to these actionable disclosure restrictions the Client should let us know and should not make a disclosure in response to any such request without first consulting KPMG LLP and taking into account any representations that KPMG LLP might make.

This engagement is not an assurance engagement conducted in accordance with any generally accepted assurance standards and consequently no assurance opinion is expressed. Nothing in this report constitutes legal advice or a valuation.

This report has not been designed to be of benefit to anyone except the Client. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the Client, even though we may have been aware that others might read this report

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In particular, and without limiting the general statement above, since we have prepared this report for the benefit of the Client alone, this report has not been prepared for the benefit of any other local authority nor for any other person or organisation who might have an interest in the matters discussed in this report.

Our work commenced on the 14 of April 2022 and the report was completed 23 of June 2022. This report is a follow on from our previous report dated February 2022.

In preparing our report, our primary source has been information received by the Client and representations made to us by management of the Client. We do not accept responsibility for such information which remains the responsibility of management. Details of our principal information sources are set out in page 24 and we have satisfied ourselves, so far as possible, that the information presented in our report is consistent with other information which was made available to us in the course of our work in accordance with the terms of our Engagement Letter. We have not, however, sought to establish the reliability of the sources by reference to other evidence.

# 1 Executive Summary

## 1.1 Background

To support the delivery of Bournemouth, Christchurch and Poole Council's ("BCP" or "the Council") Seafront Strategy, as well as its wider regeneration and transformation programmes, the Council has identified significant opportunities to improve the value generated by its Beach Hut assets.

This includes opportunities to increase revenues, diversify the product offering, improve the management and operational performance of the Beach Huts, and facilitate wider improvements to seafront facilities and infrastructure.

It will require investment to deliver these benefits and improve the quality of provision.

A commercial structure has been developed based on establishing a new wholly owned subsidiary specifically set up to purchase and manage the Beach Hut assets. Transferring the Beach Hut assets into a wholly owned subsidiary is expected by the Council to provide benefits compared to operating the assets within the Council, including:

- Enabling the raising of investment capital to further invest in Beach Hut assets over time to improve their quality and amenity, without this capital using up Council capital budgets.
- Allowing a streamlined decision making and governance structure, creating a more agile organisation able to respond more efficiently to changing market conditions.
- Streamlining the use of Council management and Councillor time.
- Ring-fencing of risk within a subsidiary with limited recourse to the Council for non-core commercial activity.
- Increasing potential to generate additional revenue, in part through price harmonisation across BCP beach front assets.
- Generating capital for the Council through the sale of the assets to the subsidiary, to allow the Council to invest in core capital projects or other transformation activities.

## 1.2 Scope of Report

KPMG financial and accounting analysis provided in a February 2022 report indicated that there is the potential to generate additional revenue from the Beach Hut assets that could benefit the Council and residents.

The February report set out that circa £50m of third-party debt could be raised against the income generated from the Beach Hut assets and that this, less an allowance for transaction costs, could be paid to the Council as a Capital Receipt to contribute to the wider need for Council capital budget. Based on an estimated value of the Beach Hut Assets of £67m, the purchase would therefore be funded through a combination of £51.6m of third-party debt plus £17m of shareholder loans (deferred capital receipt) provided to the subsidiary by the Council on commercial terms, after allowing for transaction costs and establishing cash reserves within the subsidiary.

Since the February 2022 report BCP has undertaken further research into the additional revenue potential and investment needed in the Beach Hut assets and has been developing a business plan for the subsidiary.

KPMG has been engaged by BCP to provide further commentary on BCP's identified structure and financing of the potential transaction. This report sets out:

- An update on the corporate form of the proposed subsidiary, i.e. the choice between a limited company structure and a limited liability partnership (LLP), following legal advice.
- Updated indicative financial forecasts for the subsidiary considering:

- Updated revenue, operating and investment projections provided by BCP
- Updated financing terms and an optimised debt structure reflecting the changes in BCP assumptions and market movements in debt terms.

- Updated net present value calculations of the forecast returns to the Council if the Transaction proceeds, to assist BCP with value for money deliberations.
- Further detail on the likely tax impact for the subsidiary and the Council.
- Further detail on the accounting treatment of the subsidiary, in particular the treatment of the sales proceeds as a Capital Receipt

## 1.3 Headlines

| | |
|---|---|
| **Corporate form** | Following legal advice, the option of a limited liability partnership has been ruled out as the Localism Act requires commercialisation activity to be carried out through a company. |
| **Council scenarios** | The Council has provided KPMG with two scenarios that forecast the expected revenues, operating costs and investment associated with the Beach Hut assets:<br>- a "Base Case" scenario that assumes harmonisation of pricing/fees across the Beach Hut portfolio within the first five years of the subsidiary being established, with an increased rolling annual capital investment spend to improve and maintain the assets, financed by debt and shareholder loans over a 25-year debt term; and<br>- a "Base Case Plus" scenario that assumes an acceleration of the revenue increases within the first two years and capital investment programme from year 1, with quicker repayment of debt over a 22.5 year debt term.<br>The debt term is shorter under the Base Case Plus scenario because the increased financial performance allows the debt to be repaid quicker. The Council has stated that it wants to prioritise repaying the debt quickly rather than borrowing more money over a longer term. Both scenarios forecast an upfront capital receipt to BCP of £50m. |
| **Quantitative value for money using HMT Green Book Method** | The HMT Green Book provides guidance to public sector organisations on conducting investment appraisal. For asset sales, the HMT Green Book provides three tests to indicate value for money, which are helpfully summarised in a National Audit Office report[1] into the sale of the Government student loans portfolio:<br>- the [Council] should satisfy itself that an efficient market exists for this asset and that this market appears to be functioning efficiently at the time of sale;<br>- the [Council] should ensure that sales are structured and executed in such a way as to promote efficient pricing; and<br>- the sale price needs to exceed or be broadly neutral when compared with the retention value to [the Council].<br>Applying this logic to BCP's proposed Beach Hut transaction, the first two tests are broadly satisfied because:<br>- The sale will be at a market value with that valuation being subject to independent valuation by the Council. The independent valuation will help to determine the sale price to ensure it is in line with the market and that the price is not deflated or risk adjusted due to the market not functioning efficiently.<br>- Any deferred proceeds for the sale (amounts not paid by the subsidiary at the point of sale) will be on market terms with an arm's length interest rate applied.<br>The combination of these points indicated that the Council will receive a purchase price that represents fair value for the assets. |

[1] The sale of student loans (nao.org.uk), The Sale of Student Loans, National Audit Office 20 July 2018

| | |
|---|---|
| | In assessing whether the sale price exceeds or is broadly neutral with the retention value (the "Do Nothing" option), the HMT Green Book suggests a discounted cash flow approach is used as follows:<br>- A real discount rate of 3.50%, or 6.09% nominal. This represents the Social Time Preference Rate estimated by HMT, being the general preference of society to consume today rather than tomorrow. It does not represent the cost of capital to the public sector.<br>- That the tax differential between options is not considered, as this is an intra-government cash flow.<br>In the table below, the NPV benefit or deficit compared to the Do Nothing option using a 6.09% nominal discount rate is presented: |

| Case | Do Nothing NPV (£m) | Transaction NPV (£m) | Benefit/(deficit) £m |
|---|---|---|---|
| Base Case | 74.7 | 92.4 | 17.7 |
| Base Case Plus | 67.9 | 93.3 | 25.5 |

Using HMT guidance methodology for investment appraisal the transaction therefore shows significant potential to generate positive value for money.

The Council also intends to require the subsidiary to invest an additional £450k per annum into the Beach Front Hut assets compared to the Do Nothing option, increasing amenity.

Note that the NPV of the Do Nothing scenario differs under the Base Case and Base Case Plus as the NPV is assessed over the debt term and the debt term differs under each case. This is because the Council has stated their preference to repay outstanding debt as quickly as possible rather than increase the level of debt raised (which would be possible under the Base Case Plus). The period for the full repayment of debt represents an appropriate period to assess value for money over as at the point of full repayment the Council will own unencumbered assets in a wholly owned subsidiary and has flexibility to reassess the ownership structure at that point.

**Net Present Value using Council cost of capital**

The Council's actual cost of capital is lower than a nominal rate of 6.09%. The rate of PWLB borrowing over an equivalent term, perhaps the best proxy to the actual cost of Council borrowing, is approximately 3.50% (at the time of the analysis).

Whilst tax is an intra-government cash flow, it is a real cash flow for the subsidiary and would therefore reduce the direct financial returns to BCP.

Using the PWLB rate as a discount rate and including the cost of tax under the subsidiary option, the net present value benefit or deficit in the latest forecast cash flows is as follows:

| Case | Do Nothing NPV (£m) | Transaction NPV (£m) | Benefit/(deficit) £m |
|---|---|---|---|
| Base Case | 101.4 | 91.1 | (10.3) |
| Base Case Plus | 89.4 | 90.6 | 1.2 |

Using a PWLB discount rate and including tax, the Base Case is not expected to provide a Net Present Value benefit over the initial debt term. Under the Base Case Plus there is expected to be a Net Present Value benefit.

Under this discounting methodology, significant levels of corporation tax are forecast to be paid by the subsidiary – with an NPV of £17.1m and £17.7m in the Base Case and Base Case Plus respectively.

**Using gift aid to mitigate tax cost**

The subsidiary company will be liable for corporation tax on profits. The Council have asked KPMG to consider the possibility for this tax cost to be mitigated by the subsidiary. This involves using gift aid to donate profits to local charitable organisations and the tax cost reduced to zero. Indicative calculations suggest that to reduce the corporation tax to zero, the subsidiary would need to donate roughly £4m on average each year. To save £25 of corporation tax the Council would need to donate £100 of profits, post the change to corporation tax rates to 25% in 2023.

The Council has suggested it may be possible to make donations to organisations linked to the Seafront Strategy, and that these donations would benefit residents. Donations are a gift and once made the ability to control how they are spent is challenging. The subsidiary board, acting independently of the Council, would need to take a view each year that donating profits was a suitable use of funds. Nonetheless, gift aid may be part of the toolkit deployed by the subsidiary to improve seafront assets that complement the Beach Hut assets in a tax efficient way.

**Capital receipt**

As the transaction will involve the Council relinquishing ownership & control of the assets to its subsidiary for a 'true sale' to occur, the £50m cash payment received by the Council will be treated as a capital receipt and contribute towards the capital budgets of the Council. No such capital receipt is received under the Do Nothing option.

**Impact on Council revenue budgets**

Revenue budget

In the table below, we present the total revenue budget to the Council in the first ten years of the Transaction. A detailed breakdown can be found in section 5.6.

| Revenue (£m) | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | Total |
| Do Nothing | 0.00 | 4.32 | 4.44 | 4.57 | 4.69 | 4.82 | 4.98 | 5.15 | 5.32 | 5.50 | 5.68 | **49.47** |
| Base case | 0.00 | 1.84 | 1.83 | 1.90 | 1.90 | 1.91 | 1.90 | 1.89 | 1.88 | 1.87 | 1.86 | **18.78** |
| Base Case Plus | 0.00 | 1.85 | 1.88 | 1.88 | 1.87 | 1.87 | 1.87 | 1.86 | 1.84 | 1.83 | 1.81 | **18.56** |

Capital budget

In the subsequent table, we present the capital receipts to the Council in the first ten years of the various scenarios. The capital receipts consist of the £50m cash payment to the Council once the Transaction closes and the shareholder loan principal repayment to the Council over the life of the Transaction. We provide a detailed breakdown in section 5.6.

| Capital Receipt (£m) | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | Total |
| Do Nothing | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | **0.00** |
| Base case | 50.00 | 0.00 | 0.00 | 0.01 | 0.07 | 0.13 | 0.16 | 0.20 | 0.24 | 0.28 | 0.32 | **51.40** |
| Base Case Plus | 50.00 | 0.00 | 0.02 | 0.08 | 0.12 | 0.18 | 0.22 | 0.27 | 0.32 | 0.37 | 0.42 | **52.01** |

| | |
|---|---|
| **Governance** | The nature of the commercial and governance arrangements between the Council and its subsidiary is crucial to achieving an optimal balance of segregation of activities and control. This will allow the Council to continue to focus on delivering its core services and allow the subsidiary to operate within a more commercially driven governance structure.<br><br>The optimal model needs to demonstrate a sufficient transfer of risk, responsibility and accountability to the subsidiary with appropriate protections, Council step-in arrangements and governance framework in the event of changes/issues. We set out the key governance considerations in section 6 of the report |

# 2 Background

## 2.1 Background

This report is a follow up to the KPMG report dated February 2022, Commercialisation of Assets. That report explores potential commercial structures that BCP considered to improve the commerciality of Council owned income-generating assets.

Bournemouth Christchurch and Poole Council ("the Council" or "BCP") has identified its current portfolio of Beach Huts as a portfolio of assets where opportunity exists to generate further financial return, whilst also improving the quality and amenity of the assets for residents and visitors.

The February 2022 report provided commentary on an option being explored by the Council to sell 3,461 Beach Huts (1472 Council owned Beach Huts and 1989 privately owned Beach Huts (site licenses)) to a wholly owned subsidiary of BCP, with that subsidiary borrowing third party finance secured against those assets to fund the purchase ("the Transaction"). We understand from the Council that these Beach Huts are mostly on Council freehold land but with some leasehold title interest, owned and/or managed by the Council.

KPMG financial and accounting analysis provided in the February 2022 report indicated that circa £51.6m of third-party debt could be raised against the income generated from the Beach Hut assets and that this, less an allowance for transaction costs, could be paid to the Council as a Capital Receipt to contribute to the wider need for capital budget within the Council. Based on an estimated value of the Beach Hut Assets of £67m, the purchase would therefore be funded through a combination of £51.6m of third-party debt plus £17m of shareholder loans (deferred capital receipt) provided to the subsidiary by the Council on commercial terms, after allowing for transaction costs and establishing cash reserves within the subsidiary.

The February 2022 report provided indicative financial analysis based on assumptions provided by the Council of the subsidiary being a wholly owned limited company and of setting up a limited liability partnership ("LLP"), potentially with other organisations owning Beach Huts in the area. The LLP option showed a marginal financial benefit because of the tax efficient nature of the entity. BCP has since sought legal advice on the deliverability of the LLP structure.

## 2.2 Scope of work

Since the February 2022 report BCP has been undertaking further research into the additional revenue potential and investment need in the Beach Hut assets and has been developing a business plan for the subsidiary.

KPMG has been engaged by BCP to provide further commentary on the BCP preferred structure and financing of the potential transaction. This report sets out:

- An update on the corporate form of the proposed subsidiary, i.e. the choice between a limited company structure and a limited liability partnership (LLP), following legal advice.
- Updated indicative financial forecasts for the subsidiary taking into account:
  - Updated revenue, operating and investment projections provided by BCP
  - Updated financing terms and optimised debt structure reflecting the changes in BCP assumptions and market movements in debt terms.
- Updated net present value calculations of the forecast returns to the Council if the Transaction proceeds, to assist BCP with value for money deliberations.
- Further detail on the likely tax impact for the subsidiary.
- Further detail on the accounting treatment of the subsidiary, in particular the treatment of the sales proceeds as a Capital Receipt

It is part of the Council's process to develop the business case and the value for money assessment that will guide its decision making. Please note, this report is not a business case nor a value for money assessment but provides analysis that will contribute towards those considerations.

## 2.3 Information provided

To assist KPMG in delivering the scope of work. BCP has provided the following primary sources of information:

- Beach Huts Income and Expenditure – Historical (2015-2016) and forecast (2021 - 2025)
- Beach Hut database v7 MASTER (including Harmonisation Data)
- Beach Hut database v9 MASTER (including Harmonisation Data)(Base Case Plus v1.0) (Sent to KPMG 160622)
- Commercialisation of Beach Hut Assets through Special Purpose Vehicle V1 (Sent to KPMG 190522)
- SSL TORs DRAFT V02
- Seafront Budget 2122
- BCP's Commercial companies structure chart.
- BCBL Incorporation Articles 15 12 14
- Seascape Shareholder Agreement Signed 1.4.2015; and
- Seascape South Resource Agreement - 1 Apr 2015

Previous KPMG reports on the commercialisation of income generating assets prior to this report include:

- Commercialising and Financing Options Structuring; September 2021.
- Commercialisation of Assets; February 2022.

# 3 Corporate Form

## 3.1 Limited company or LLP option

The KPMG February 2022 report provided analysis on both a wholly owned limited company structure and a limited liability partnership, with the partnership likely being with other Beach Hut owning operators in the area or other organisations linked to the protection and amenity of the seafront.

Legal advice subsequently obtained by the Council suggests the LLP option is not possible because the underlying objective of the transaction is a commercial one. The Localism Act 2011[2] states that when a Local Authority uses its General Power of Competence (GEPOC) for a commercial purpose, it must do so through a company.

Exceptions to this have been successful, with the most quoted example being the London Borough of Haringey (LBH) who won the case brought against them by a resident for using an LLP structure. However, that case relied on the commercial objective being secondary to the primary objectives of the partnership. In BCP's case, it is felt that commercialisation is a primary objective of the proposed entity and hence the LLP option is not permissible.

As such, the Council has concluded that the corporate form of the new entity will be a limited company guaranteed by shares, which is wholly owned by the Council. All subsequent financial analysis in this report assumes this structure.

An illustration of the structure can be found in Appendix 1.

It is understood that the Council has also considered the use of a Teckal company. A Teckal company is a company where a local authority controls all of the shares, exercises effective day-to-day controls over the company's affairs and at least 80% of the turnover of the Teckal company comes from its public sector owners. We note that BCP Council has formed the view that the subsidiary would not be a Teckal company primarily due to the amount of non-BCP income exceeding the allowable threshold (20%) plus the need for a Teckal company to be independent and not under significant control from the Council.

[2] Localism Act 2011; https://www.legislation.gov.uk/ukpga/2011/20/contents/enacted

# 4 Commercial Rationale

## 4.1 BCP's commercial rationale for exploring the Transaction

The Council has explained that, like most UK local authorities, it is facing financial challenges. This is due to various factors including the recovery from the global pandemic, high costs of social care and the current cost of living crisis. As such, the Council is seeking to maximise the income generation from Council owned assets and, where appropriate, realise capital receipts through asset sales to fund further investment. The sale of assets to a wholly owned subsidiary recognises a capital receipt whilst the Council, through its ownership of the subsidiary, retains ultimate control of the assets.

Furthermore, the BCP Seafront Strategy aims to establish a world-class seafront fully aligned with the Council's Big Plan for the conurbation and supports a wide range of Corporate Strategy priorities. As part of the Seafront Strategy, the Council has outlined a 5-year investment plan to improve infrastructure and essential amenities to enable the seafront to become "world-class" in quality. It is understood that the Beach Huts subsidiary is part of this strategy.

## 4.2 Benefits of commercialisation

The Council considers the key benefits of the commercialisation of the Beach Huts to include:

- **Increased revenue and harmonisation:** The Council has stated that harmonising the policies of the Beach Huts across the BCP area is still outstanding, and there are opportunities to enhance the financial return through more investment in the assets, ongoing maintenance and a dedicated team focussed on maximising revenue potential from the assets. The subsidiary will act on a commercial basis and adjust prices to align with market demand. It is felt that a subsidiary operating on an arms' length basis will have greater ability to implement investment and price reviews more swiftly than if undertaken directly by the Council.
- **Capital investment**: The Council is not currently allocating any funds for capital expenditure to improve the Beach Huts within constrained Council capital budgets, other than those already approved. After the Beach Huts are sold to the subsidiary, the subsidiary business plan assumes it will reinvest at least £450k annually from its income for capital improvements to the Beach Huts. This will not require ongoing capital budget from the Council.
- **Ringfencing of risk**: The use of the ringfenced subsidiary will enable the Council to insulate itself from some of the financial and operational risks associated with owning the Beach Huts and any borrowing secured against them. In the event of default or insolvency, creditors can only claim against the assets of subsidiary as it is a legal entity separate from the Council. The use of limited recourse entities for commercial activity to provide a degree of insulation to parent company balance sheets from non-core activity is a common commercial practice. This benefit is tempered by the intended financial guarantee that the Council will have to provide to senior debt providers of the subsidiary whilst the credit worthiness of the entity in its own right is established through trading history.
- **Decision making**: The Council's decision-making processes, whilst thorough and democratic, do not lend themselves to managing assets such as Beach Huts on a day to day basis in a commercial way, particularly where swift action may be required. Understandably, the optimal management of Beach Hut assets is not top of Council management team or Member priorities. A subsidiary will have a separate management team (either directly appointed or purchased under a management agreement from the Council) that can make decisions on managing the Beach Huts with this being its core purpose, through delegated authority within certain limits set by the Council. This will enable the subsidiary to respond quickly to market conditions with the Council retaining input on key matters through pre-agreed reserved matters.
- **Time saving**: Currently, it is understood that there is a dedicated team of four individuals who currently administer the Beach Hut business across the conurbation, with the support of ancillary teams. The Council forecasts that moving the Beach Huts into the subsidiary (within reasonable

delegated authority limits) will save the Council's management team time, freeing them up to focus on other core Council activities.

- **Procurement advantages**: At present, the Council has to run open competition for items such as works undertaken as part of capital projects. In some cases, this can take a few months. The Council has considered that the subsidiary could be structured such that there is savings in the procurement process through various methods such as call-off frameworks. This would be particularly advantageous if there was a wider investment need/capital programme.

# 5 Quantitative Analysis

## 5.1 Introduction

This section provides an update to the indicative financial forecasts of the subsidiary using the updated revenue, operating cost and investment assumptions provided by the Council following its further work into the Beach Hut commercialisation opportunity. These assumptions can be found in Appendix 2. While the key debt assumptions are in Appendix 3.

The financial analysis assesses how much third-party debt can comfortably be raised by the subsidiary secured against Beach Hut net income and the impact of the transaction on the Council cash flows and financial statements.

For the purpose of this analysis, it has been assumed that the Beach Huts will attract a sale price of £67m and revenues from the Beach Huts can service a debt amount that will result in a £50m capital receipt for the Council, in line with the report of February 2022 and the target figure for the Council given other capital commitments. BCP is seeking a formal valuation of the assets to verify the £67m assumption. In this financial analysis the debt term is flexed to maximise the speed at which debt is repaid whilst maintaining the initial £50m capital receipt, i.e. all else being equal, if revenue projections improve the model repays the debt earlier rather than allowing an increase in the amount borrowed.

The Council has provided two revenue and cost scenarios:

- **Base Case**: price harmonisation (similar price for Beach Huts assets with similar characteristics) in five years and capital investment programme from year 1; and
- **Base Case Plus**: involves acceleration of the price harmonisation to two years and capital investment programme from year 1.

Both key scenarios are compared to the financial outcome if the Council chose to “Do Nothing”. The “Do Nothing” scenario assumes the Beach Huts remain with the Council under existing management and ownership arrangements.

## 5.2 Debt capacity

Table 1 shows the amount the subsidiary could raise in the Base Case and Base Case Plus. The £51.6m debt amount includes £50m which will be paid to Council as a capital receipt under both scenarios. The additional £1.6m is sufficient to cover expected transaction costs and create a cash reserve to support certain potential downside scenarios should they arise.

The Base Case results in a required debt term of 25.25 years while the Base Case Plus allows for debt to be repaid over a shorter 22.5 year term:

Table 1: Debt raise summary

| | Base Case | Base Case Plus |
|---|---|---|
| **Pricing** | Gilts + 1.05% (105 bps) | Gilts + 1.05% (105 bps) |
| **Debt term (tenor)** | 25.25 years | 22.5 years |
| **Allowances for cash reserves** | £0.8m | £0.9m |
| **Transaction cost** | £0.8m | £0.8m |
| **Upfront capital receipt to BCP** | £50.0m | £50.0m |
| Senior debt amount | **£51.6m** | **£51.7m** |

## 5.3 Application of HMT Green Book in assessing quantitative value for money

As part of the Council's consideration of the value for money of the Transaction, the principles set out in the HMT Green Book (which provides guidance for public sector investment appraisal) have been applied.

For asset sales, the HMT Green Book provides three tests to indicate value for money, which are helpfully summarised in a National Audit Office report[3] into the sale of the Government student loans portfolio:

- the [Council] should satisfy itself that an efficient market exists for this asset and that this market appears to be functioning efficiently at the time of sale;
- the [Council] should ensure that sales are structured and executed in such a way as to promote efficient pricing; and
- the sale price needs to exceed or be broadly neutral when compared with the retention value to [the Council].

The logic behind the HM Treasury suggested approach can be summarised as if there is a well-functioning and liquid market for the asset class and there is otherwise no administrative or public policy reason to suggest that the assets will perform better in public ownership then the obtaining of a true market value for the assets is the overriding indicator of value for money.

Applying this logic to BCP's proposed Beach Hut transaction, the first two tests are broadly satisfied because:

- The sale will be at a market value with that valuation being subject to independent valuation by the Council. The independent valuation will help to determine the sale price to ensure it is in line with the market and that the price is not deflated or risk adjusted due to the market not functioning efficiently. There is a risk that as a relatively novel asset class that a premium will be applied to required return on capital by an investor, reducing its value from equivalent more established assets. Any reduction in value due to an inefficient market would need to be ignored when establishing a purchase price (i.e. a higher price paid) in order to indicate value for money.
- Any deferred proceeds for the sale (amounts not paid by the subsidiary at the point of sale) will be on market terms with a market determined interest rate applied.

The third of the NAO tests considers whether the value of the cash flows to the Council exceed or are broadly neutral following sale compared to the status quo, referred to as the "Do Nothing" scenario.

The HMT Green Book suggests a discounted cash flow approach to determining this and provides guidance on the discount rate to apply, suggesting a real discount rate of 3.5%, or 6.09% nominal. This represents a Treasury estimate of the Social Time Preference Rate, being the general preference to consume benefits now rather than later. Further detail is provided in appendix A6 of the HMT Green Book[4]. Importantly, it does not represent as estimate of the cost of capital for government or the public sector more broadly but an economic assessment of the time value of consumption.

In the analysis below, the HMT Green Book discount rate of 6.09%has been applied to the cashflows in the "Do Nothing" scenario and the Base Case. Following the HMT Green Book, the tax differential between options is ignored as this is an intragovernmental cash flow (as set out in paragraph A4.8 of the HMT Green Book). This is sometimes referred to as competitive neutrality, in that public sector organisations should not use their advantage from being non corporation tax paying entities in considering public versus private delivery options.

The net present value analysis includes an increase in asset value at the end of the period arising as a result of further investment in the Beach Huts. The value of the Beach Huts in a few years is inherently uncertain and no attempt has been made by KPMG to forecast a valuation in line with any formal

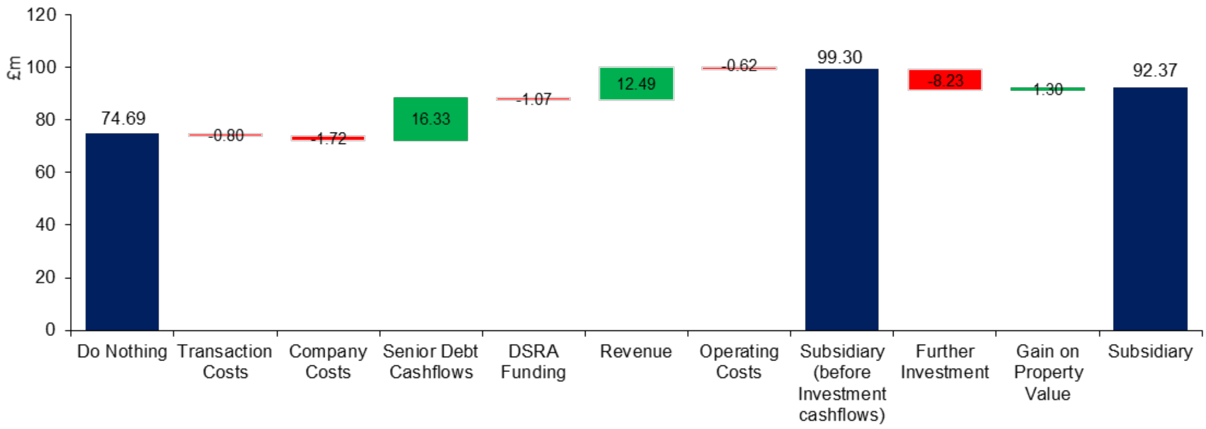
[3] The sale of student loans (nao.org.uk), The Sale of Student Loans, National Audit Office 20 July 2018

[4] The Green Book (publishing.service.gov.uk)

property valuation standards. A yield of 8% to net income of the Beach Huts has been applied at the end of the appraisal period to estimate the residual value of the assets. BCP may wish to seek further valuation advice on this although it is not material to the overall outcome. It is understood that the Council is in the process of securing a valuation.

We present the outcome in Figure 1.

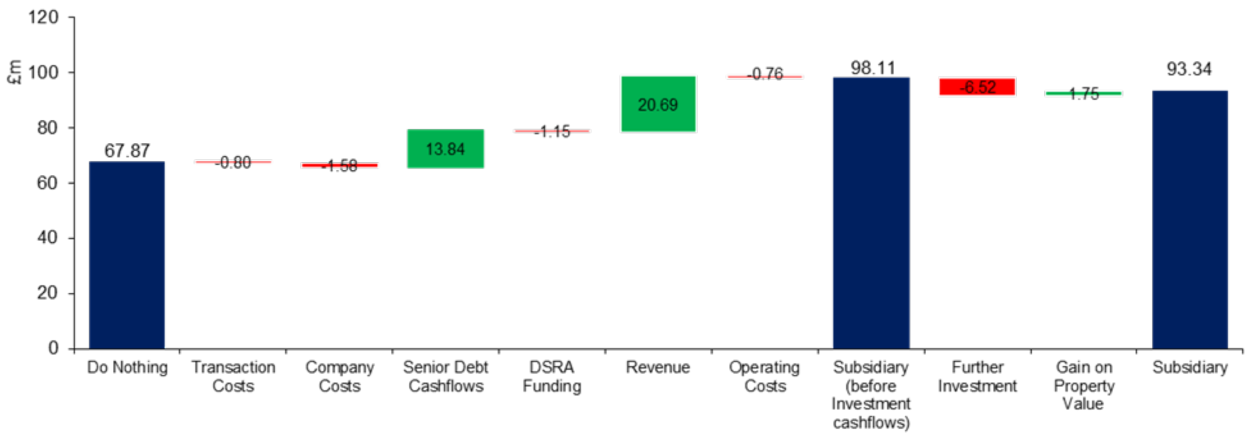
**Figure 1 - Base Case 25 years (HMT Green Book)**




The Base Case generates a NPV of Council cash flows of £92.4m vs £74.7m of the Do Nothing. This is primarily driven by enhanced revenue from commercialisation generating £12.5m of additional revenue and the added benefit of raising external debt financing at a lower cost of finance than the 6.09% discount rate.

In Figure 2, we present the outcome of the analysis for the Base Case Plus.

**Figure 2 – Base Case Plus 22.5 years (HMT Green Book)**




*We note that the NPV in the Base Case Plus scenario is slightly higher than the Base Case due to the lower tenor for the NPV analysis as a result of the debt being paid off quicker. However, if the tenor is the same as the Base Case (no debt for last 2.5 years) the NPV will be £99.7 vs £92.4 in the Base Case.

The Base Case Plus generates a NPV of £93.3m vs £67.9m. This is driven by lower debt rates generating positive returns for senior debt of £13.8m and enhanced revenue from commercialisation, generating £20.7m of additional revenue.

Using the HMT Green Book discount rate and suggested approach of neutralising the impact of tax, both the Base Case and Base Case Plus assumptions result in a material NPV advantage over Do Nothing.

Note that the NPV of the Do Nothing scenario differs under the Base Case and Base Case Plus as the NPV is assessed over the debt term and the debt term differs under each case. This is because the Council has stated their preference to repay outstanding debt as quickly as possible rather than increase the level of debt raised (which would be possible under the Base Case Plus). The period for the full repayment of debt represents an appropriate period to assess value for money over as at the point of full repayment the Council will own unencumbered assets in a wholly owned subsidiary and has flexibility to reassess the ownership structure at that point.

## 5.4 Alternative discounting approach

Whilst the HMT Green Book suggests a discount rate in calculating NPV of 6.09% nominal, this does not represent the actual cost of capital to the Council. The Council considers a more appropriate representation of its internal cost of capital is the cost of borrowing from the Public Works Loan Board (PWLB) for an equivalent duration.

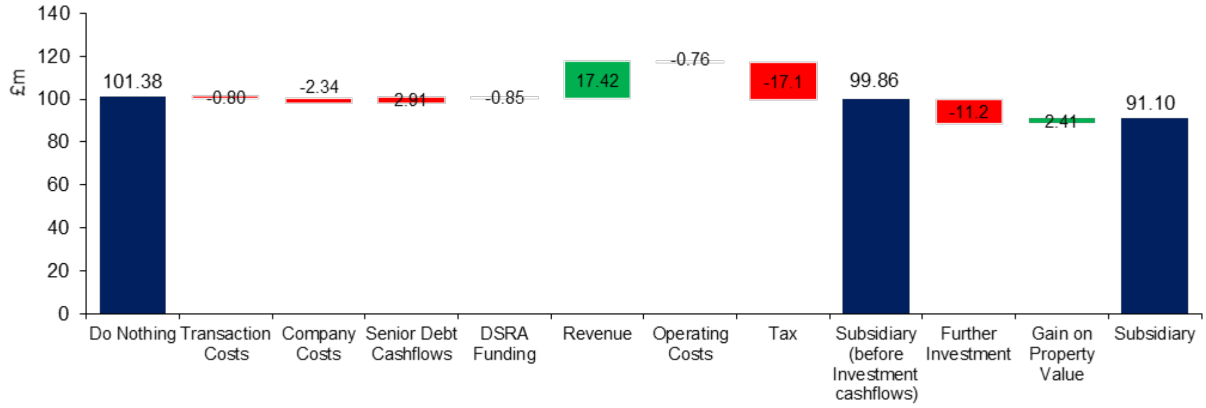
Whilst the HMT Green Book also neutralises the impact of tax, any tax paid by the subsidiary is a real cost to the subsidiary and therefore reduces return to the Council as its shareholder – regardless of whether this is ultimately payable to another public sector institution.

To assess the impact of the Transaction at the Council level KPMG has also provided an NPV analysis including the cost of tax within the subsidiary and using PWLB rates as the discount rate. This analysis benefits over the HMT Green Book assessment from being based on a better proxy for the actual financial costs and benefits to the Council. However, the use of the PWLB rate as a discount rate also has disadvantages:

- It is not necessarily a true cost of capital for the Council, in that it is not a market driven rate but a notional rate set by the Debt Management Office.
- Using a discount rate that is based on the cost of capital for the owner of the asset rather than the risk profile of the asset itself (i.e. the estimated return an investor would require for investing in the assets, after adjusting for any market illiquidity or inefficiency) can lead to unintended consequences. This is particularly acute for UK local authorities who have a very low cost of capital because of their large asset base and essentiality of service provision. Discounting assets held primarily for commercial reasons at a local authority cost of capital has the unintended consequence of resulting in a higher NPV for riskier assets which typically offer higher returns to compensate investors for higher risk. In other words, just because a local authority can borrow cheaply and invest in assets expected to generate higher returns doesn't mean it should. This has been a well-discussed issue in recent years following an increase in local authorities borrowing cheaply and purchasing commercial assets for income generation purposes.

The cashflows from the Do Nothing scenario and the Transaction are discounted to present value at the PWLB rate of 3.50%.

**Figure 3 – Base Case 25 years (PWLB)**

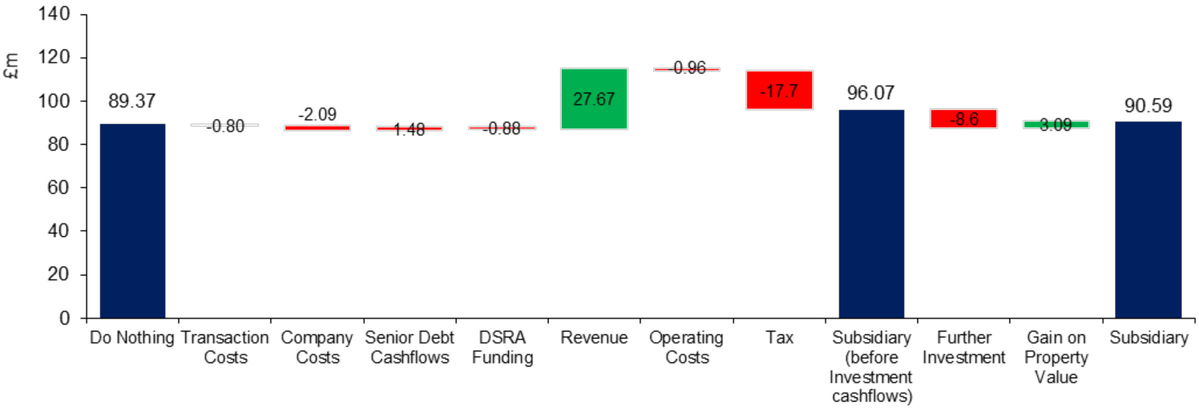



The above chart illustrates that the Council's returns generated in the Base Case result in an overall NPV deficit of £1.5m compared to the Do Nothing case before additional capital investment is made into the assets, and £10.3m once this further investment and gain on property value is taken into account.

The difference is mainly driven by a tax charge of £17.1m which offsets the additional revenue benefit.

Figure 4 shows the outcome of the Base Case Plus case using the PWLB borrowing rate as the discount rate.

**Figure 4 - Base Case Plus 22.5 years (PWLB)**




*We note that the NPV in the Base Case Plus scenario is lower than the Base Case as the debt is paid off quicker and hence assessed over a shorter period. However, if the tenor is the same as the Base Case (no debt for last 2.5 years) the NPV will be £99.4 vs £91.1 in the Base Case.

The Base Case Plus results in an overall NPV surplus of £6.7m in the Council's returns compared to the Do Nothing option before further investment into the Beach Hut assets is taken into account and £1.2m after this investment and the gain in property value.

## 5.5 In- House Harmonisation

The Council has also considered retaining the Beach Huts within the Council i.e., assuming they were not sold to the subsidiary, but attempting to better commercialise the running of the Beach Huts harmonise policies and prices.

This option would not generate a capital receipt to contribute towards Council capital budgets.

The Council considers that it would face more challenge to the increase in pricing as compared to an independent subsidiary.

## 5.6 Tax mitigation

Both the Base Case and the Base Case Plus result in a considerable level of corporation tax being payable by the subsidiary. The figures below show the projected tax charge incurred by the subsidiary. Further detailed tax analysis is found in section 8.

**Figure 5 - Base Case tax charge**

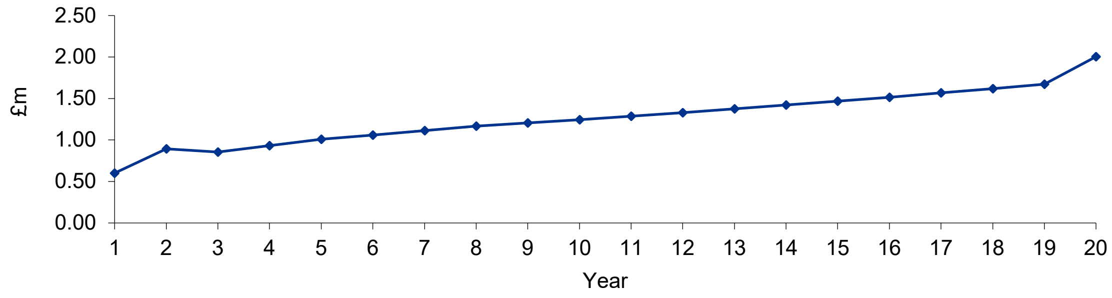
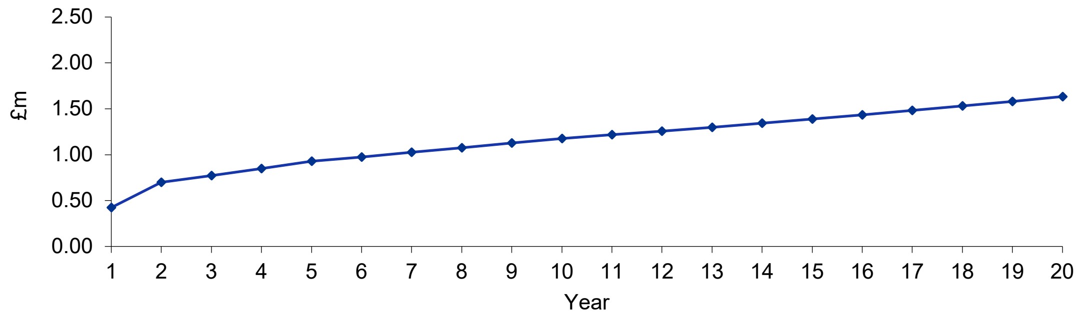



**Figure 6 – Base Case Plus tax charge**




The Council is considering the potential to reduce this tax obligation by means of the subsidiary using the Gift Aid scheme to donate to a local charity or charities rather than distribute cash as profit. Donations (via Gift Aid) to charities linked to the delivery of the Seafront Strategy should mean in theory that any such donations would be used in ways that would align with the charitable objectives of the charity concerned and thereby align with the Council objectives and benefit local residents and the Beach Hut amenities.

The structure involves making Gift Aid donations from taxable profits, hence reducing the tax liability. For every £1 donation, £0.20 (£0.25 from FY2023) is deducted from the subsidiary's tax liability.

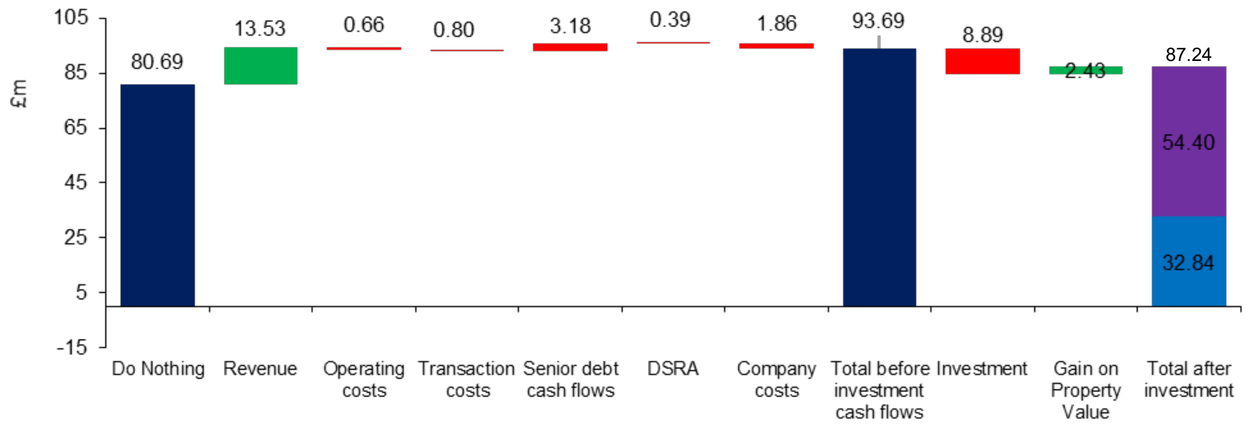
The Council has asked KPMG to present the outcome of a "Gift Aid" scenario which involves donation of profits to a local charity and hence a Gift Aid tax exemption.

In this scenario, it is assumed that a charitable donation of taxable profits is made sized such that the corporate tax charge reduces to zero. Taxable profits are derived from profit before tax figures adjusted for non-deductible interest.

For the Council to benefit from any Gift Aid distributions to a charity it would need to spend its receipts in a way that would otherwise save the Council spend. The Council is separately investigating whether such spend opportunities exist. Any charity would need to be outside of BCP control.

The decision, whether to make charitable donation or not, would ultimately be for the subsidiary Board to make at the relevant time each year. The Directors of the SPV have a duty to the SPV and its shareholders but despite being the shareholder the Council would not ultimately have control over the distribution of the profits.

**Figure 7 – Base Case with Gift Aid 20 years (PWLB)**




| Key | |
|---|---|
| | Cash flows to Council |
| | Cash flows to Charity |

We note this scenario is presented over a 20-year period.

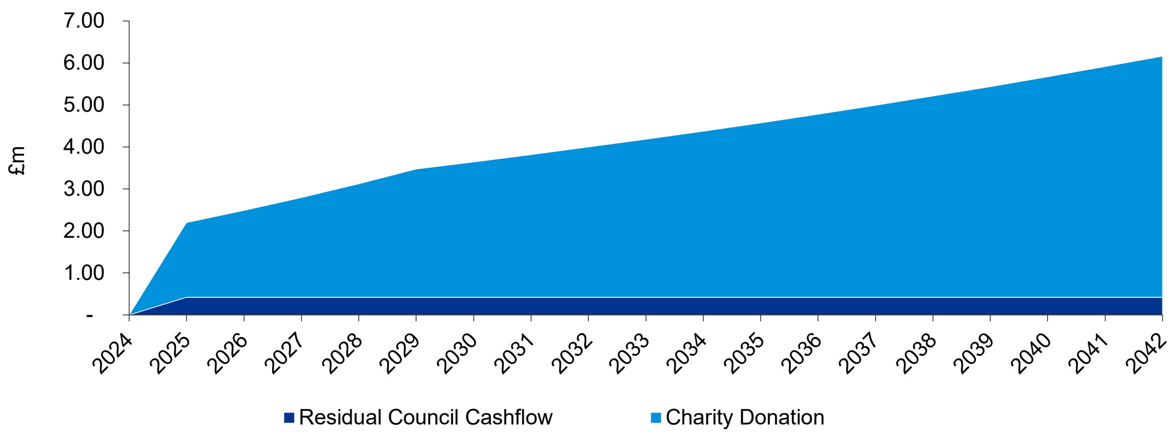
In this scenario, the majority of distributions that would otherwise be due to the Council would need to be donated to charity. Of the total £87.2m NPV of forecast distributions from the subsidiary, £32.8m would be made available to the Council with the remaining £54.4m assumed to be a donation to a local charity.

This scenario shows the level of charitable donations required to fully reduce the corporation tax charge to zero. The subsidiary could target any middle ground by making some gift aid payments but still paying some corporation tax.

Under this scenario the subsidiary would not be in a position to repay third party debt in full over the 20 year period as cash profits would need to be gift aided rather than used to fully repay debt. For the purposes of the NPV analysis, we assume the residual debt balance at the end of year 20 is a net cash outflow for the Council (i.e. the Council would settle the debt at that point).

The profile of gift aid distributions under this scenario is presented graphically below. The Council would need to determine whether suitable opportunities exist for the subsidiary to make donations to this profile such that they would benefit the residents of BCP.

**Figure 8 - Distributions**



To the extent that the charity or charities are undertaking works or services that would otherwise be paid for directly by the Council, they may have a worse VAT recoverability position than would be the case had the equivalent spend been made by the Council. This would need to be considered based on the specific situation at the time.

## 5.7 Impact on Council Capital and Revenue Budgets

The tables below indicate the impact on the Council's capital and revenue budgets of the Base Case and Base Case Plus case versus the Do Nothing option.

Both Base Case and Base Case Plus scenarios result in a capital receipt of £50m which could contribute towards BCP's transformation programme and would otherwise not be available to the Council as well as £450k per annum of investment in the Beach Huts to finance investment at no additional cost to the Council.

| Table 2: Revenue Impact (Revenue to the Council £m) | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Year** | | **0** | **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10** | **Total** |
| Do Nothing | Net Income | 0.00 | 4.32 | 4.44 | 4.57 | 4.69 | 4.82 | 4.98 | 5.15 | 5.32 | 5.50 | 5.68 | **49.47** |
| | **Total** | **0.00** | **4.32** | **4.44** | **4.57** | **4.69** | **4.82** | **4.98** | **5.15** | **5.32** | **5.50** | **5.68** | **49.47** |
| Base case | Dividend | 0.00 | 0.00 | 0.00 | 0.04 | 0.04 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | **0.38** |
| | Shareholder Loan Interest | 0.00 | 0.80 | 0.79 | 0.82 | 0.82 | 0.82 | 0.81 | 0.80 | 0.79 | 0.78 | 0.77 | **8.00** |
| | Guarantee Fee | 0.00 | 1.04 | 1.04 | 1.04 | 1.04 | 1.04 | 1.04 | 1.04 | 1.04 | 1.04 | 1.04 | **10.40** |
| | **Total** | **0.00** | **1.84** | **1.83** | **1.90** | **1.90** | **1.91** | **1.90** | **1.89** | **1.88** | **1.87** | **1.86** | **18.78** |
| | **Net Impact vs Do Nothing** | **0.00** | **(2.48)** | **(2.61)** | **(2.67)** | **(2.79)** | **(2.91)** | **(3.08)** | **(3.26)** | **(3.44)** | **(3.63)** | **(3.82)** | **(30.69)** |
| Base Case Plus | Dividend | 0.00 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.06 | 0.06 | 0.06 | 0.06 | 0.06 | **0.55** |
| | Shareholder Loan Interest | 0.00 | 0.85 | 0.88 | 0.88 | 0.87 | 0.87 | 0.86 | 0.85 | 0.83 | 0.82 | 0.80 | **8.51** |
| | Guarantee Fee | 0.00 | 0.95 | 0.95 | 0.95 | 0.95 | 0.95 | 0.95 | 0.95 | 0.95 | 0.95 | 0.95 | **9.50** |
| | **Total** | **0.00** | **1.85** | **1.88** | **1.88** | **1.87** | **1.87** | **1.87** | **1.86** | **1.84** | **1.83** | **1.81** | **18.56** |
| | **Net Impact vs Do Nothing** | **0.00** | **(2.47)** | **(2.56)** | **(2.69)** | **(2.82)** | **(2.95)** | **(3.11)** | **(3.29)** | **(3.48)** | **(3.67)** | **(3.87)** | **(30.91)** |

| Table 3: Capital Impact (Capital receipt to the Council £m) | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Year** | | **0** | **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10** | **Total** |
| Do Nothing | | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| | **Total** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** |
| Base case | Equity Contribution | (0.01) | | | | | | | | | | | **(0.01)** |
| | Shareholder Loan Drawdown | (17.04) | | | | | | | | | | | **(17.04)** |
| | Sale of Beach Huts | 67.05 | | | | | | | | | | | **67.05** |
| | Shareholder Loan Principal Repayment | 0.00 | 0.00 | 0.00 | 0.01 | 0.07 | 0.13 | 0.16 | 0.20 | 0.24 | 0.28 | 0.32 | **1.40** |
| | **Total** | **50.00** | **0.00** | **0.00** | **0.01** | **0.07** | **0.13** | **0.16** | **0.20** | **0.24** | **0.28** | **0.32** | **51.40** |
| Base Case Plus | Equity Contribution | (0.01) | | | | | | | | | | | **(0.01)** |
| | Shareholder Loan Drawdown | (17.04) | | | | | | | | | | | **(17.04)** |
| | Sale of Beach Huts | 67.05 | | | | | | | | | | | **67.05** |
| | Shareholder Loan Principal Repayment | 0.00 | 0.00 | 0.02 | 0.08 | 0.12 | 0.18 | 0.22 | 0.27 | 0.32 | 0.37 | 0.42 | **2.01** |
| | **Total** | **50.00** | **0.00** | **0.02** | **0.08** | **0.12** | **0.18** | **0.22** | **0.27** | **0.32** | **0.37** | **0.42** | **52.01** |

## 5.8 Summary

The Transaction provides potential for considerable revenue generation above the Do Nothing option as a result of the commercialisation agenda. In the Base Case, an additional revenue of £12.5m (HMT Green Book discount rate) and £17.4m (PWLB discount rate) is generated. While in the Base Case Plus, this amount is £20.7m (HMT Green Book) and £27.7m (PWLB).

The outcome of the analysis based on Council assumptions and the HMT Green book methodology demonstrates that there is benefit to the Council of undertaking the Transaction. The Transaction generates an NPV (HMT Green Book) value of £92.4m (25 years) vs the Do-nothing of £74.7m.

This could be further enhanced from the Base Case Plus with an NPV (HMT Green Book) benefit of £25.47m over 22.5 years.

However, if the tax implications of the Transaction are taken into account and the Council's cost of capital by reference to PWLB rates used as the discount rate the Base Case generates an NPV deficit of £10.3m and the Base Case Plus generates a benefit of £1.2m (PWLB) (22.5 years).

The Council should consider a range of measures in considering value for money, including the principles set out by HM Treasury relating to achieving market value for asset sales.

Section 8 of this report considers how the tax position could be optimised for the Transaction.

# 6 Governance considerations

The Council currently has several subsidiary companies including Bournemouth Building & Maintenance Limited (“BBML”), BCP Future Places Ltd (BFP”) and Seascape Group Limited (“SGL”).

The Council intends to implement a governance structure for the Beach Hut subsidiary that is in line with the structure used for its current subsidiary companies.

To aid the effective governance of the subsidiary, BCP will need to consider a range of factors when establishing the subsidiary including:

- **Shareholding**: It is assumed that the subsidiary will be incorporated as a company limited by shares to act as a wholly owned subsidiary of the Council with the Council as the sole shareholder. Therefore, the Council will have 100% of the shares in the company and ultimate control.
- **Board composition:** To ensure effective governance of the subsidiary, a qualified board will be put in place. In line with BCP’s other companies, it is assumed that the board will consist of no less than three individuals. A board composition could consist of:
  - A chairman – could be a non-executive - who oversees the whole business
  - A managing director - employed by the subsidiary - who runs the Beach Huts. The managing director reports to the chairman and oversees the board of executive directors.
  - Executive directors of the subsidiary - who sit on the board and manage key areas of the business, such as finance and operations.
  - Non-executive directors - who advise on the strategic direction of the business.
- **Constitution:** The company will be formed using ‘Articles of Association’/ ‘Shareholders Agreement’ and any resolutions and agreements affecting the company’s constitution.
- **Articles of Association:** The Articles of Association will be the main integral governing document since it will specify the regulations for operations and define the subsidiary’s purpose. The document will also lay out how tasks are to be accomplished within the subsidiary, including the process for appointing directors, frequency of board and shareholder meetings, powers and duties of directors and the handling of financial records.
- **Reserved matters** can be included in the constitution to set out those decisions by the board that will require the Council’s approval. Typically, such matters are those that make a fundamental difference to the business. The Council can set out any specifics it wishes. As these reserved matters are set out in the Articles of Association or Shareholder Agreement, they could be inflexible once set. Examples of matters that can be considered include:
  - annual approval of the subsidiary business plan,
  - material variations from the company business plan to a pre-set variation in absolute (£) or relative terms (%),
  - material disposals of assets (with definitions of material and disposal including any pre-set value in absolute (£) or relative terms (%)),
  - capital expenditure other than approved in the annual business plan surpassing a pre-set value in absolute (£) or relative terms (%),
  - material third party contracts surpassing a pre-defined threshold,
  - decisions with material impacts on Key Performance Indicators (KPIs) outside of pre-set parameters,
  - changes to company objectives; and,
  - material changes to pricing strategy etc.
- **Reporting/ communication:** The Council as parent organisation will require regular reporting of matters to the board as a monitoring and oversight process. Typically, it would be expected to

see quarterly update reports for parties such as the Corporate and Community Overview and Scrutiny Committee or Place Overview and Scrutiny Committee on the performance of the subsidiary and its compliance with the established aims. The Council can also set Key Performance Indicators (KPIs) to monitor and track through an appointed committee or the Board actual outcomes against the original objectives. KPIs could be linked to the ongoing objectives of the subsidiary, the underlying operations and new activities as they arise.

- **Business Plan:** Typically a business plan/ budget is prepared annually by companies. The Council should require the company to prepare a prepare a business plan on an annual basis for a 3-5 year period for the approval of BCP.

# 7 Accounting

## Introduction

- Only the Council and specifically its s151 officer can, in consultation with its external auditors as required, determine the accounting treatment appropriate to a specific transaction based on the facts and circumstances of that transaction at the time is it entered into.
- The potential accounting implications of the Transaction (Limited company subsidiary) described in this document for consideration by the Council are set out below. This is the potential accounting treatment by BCP of the proposed transaction in its single entity accounts under ACOP and the Capital Finance Regulations as they are currently understood to apply.

## Capital expenditure and borrowing

- The subsidiary (even though a wholly owned subsidiary of the Council) will be a separate entity. Therefore, under the prudential regime – which applies only to the transactions which the Council is required to record in its own single entity accounts – there will be no capital expenditure or borrowing incurred by BCP as a consequence of the transaction. Specifically, it will not need to account for the external borrowing and acquisition of assets undertaken by the subsidiary, and such expenditure by the subsidiary will not score as capital outlay for the Council.
- Therefore, capital expenditure by the subsidiary on acquiring assets, and the external borrowing it undertakes to do so, will not fall to be capital expenditure by the Council.

## Minimum Revenue Provision (MRP) / General Fund impacts

- As the Council will not be undertaking capital expenditure or borrowing in its own right, it will not be required to make an annual MRP charge, nor will it incur interest costs on borrowing in its General Fund ("GF").

## Capital receipts considerations

- Under the proposed transaction the Council is disposing of certain assets to a wholly owned subsidiary of the Council, the subsidiary. The issue therefore arises whether the transaction gives rise to available Capital Receipts (as defined under by Capital Finance Regulations).
- Three objectives need to be met if the Council is to record capital receipts:
  - The Council must demonstrate that it has actually disposed of the underlying assets such that it is, under proper practices, required to derecognise the assets from its own single entity balance sheet (i.e., achieve a "true sale" to the subsidiary);
  - That were the Council to acquire the assets disposed of itself, that such an acquisition would fall to be capital expenditure; and
  - The consideration on the disposal of the assets must be in the form of cash. Under the Capital Finance Regulations only when cash is received, on the disposal of capital assets, can the Council recognise available Capital Receipts. Where the consideration is received in a form other than cash (say in the form of financial instruments) the Council will need to consider whether it has received Deferred Capital Receipts.
- These three conditions are considered further below in the context of the proposed transaction.

## Achieving a "true sale"

- To achieve a "true sale" of the assets to the subsidiary the Council must demonstrate both that (i) it has transferred substantially all the risks and rewards incidental to the ownership of the assets to the subsidiary (i.e. that it is the subsidiary which benefits from the economic flows associated with those assets and can control them); and (ii) that the Council has not reabsorbed those risks and rewards through other means.
- The key risks and reward associated with the assets to be transferred to the subsidiary will be around (i) rental income; (ii) maintenance and life-cycle costs; and (iii) the residual value of the assets.

- Under the proposed transaction it will be the subsidiary, rather than the Council, which will be substantially exposed to the risks and rewards incidental to the ownership of the assets in that it will be the subsidiary (and through it, its external funders) that will take the risk:
  - On variations in both the gross income and the net income generated by the assets after deducting the costs incurred by the subsidiary on maintaining the assets and meeting its obligations to users of the assets; and
  - On the residual / market value of the underlying assets. This reflects that the Council, as a single entity, will not have the right to re-acquire the assets at a nominal or undervalue at a future point. Instead, it is intended that the disposal will not contain any rights for the Council to reacquire the assets from the subsidiary (but should such rights be granted to the Council they will only be exercisable at an independently established market valuation).
- The subsidiary will control the economic benefits generated by the assets as it will have the ability to determine and direct to what use those economic benefits are put. This includes the uses to which any profits generated from the assets are put (including their use to make charitable donations) which will be solely at the discretion of the directors of the subsidiary.
- As the Council will prima facie achieve a "true sale" of the assets, consideration needs to be given to whether (i) the provision of a limited guarantee by the Council to the subsidiary's external debt funders; and / or (ii) the acceptance by the Council of financial assets in (a debt obligation from) the subsidiary in part payment for the assets dilutes this transfer of the risks and rewards of ownership to the subsidiary.

**Provision by the Council of guarantee**

- The potential provision by the Council of a limited guarantee to the subsidiary is not considered to dilute the extent to which the risks and rewards inherent in the underlying assets are transferred on their disposal to the subsidiary.
- This reflects the fact that the guarantee will be designed to reimburse the subsidiary's external funders where the subsidiary's net income falls below a certain threshold. The threshold at which the Council's guarantee could be triggered has not yet been fixed. However, it has been assumed that the guarantee will apply where the net income of the subsidiary falls to 70% (or below) of the subsidiary's expected net income – namely, it will operate on a "last loss" basis. This means that it is the subsidiary (and its external funders) which bears any losses which might occur from all reasonably expected fluctuations in net income (i.e., the subsidiary and its funders must absorb the first 30% of any reduction in net income below that expected).
- Moreover, (i) the expected net revenues of the subsidiary will be based on a prudent and robust assessment of the expected income and costs associated with the assets (i.e. the net income threshold against which the 70% guarantee trigger will be assessed will not be artificially inflated); and (ii) the Council's guarantee can only be called after all the subsidiary's cash reserves and other income sources are exhausted or otherwise inadequate to meet the debt service requirements of the subsidiary's external funders.
- The "last loss" basis of the potential guarantee mechanism and the high threshold at which it is expected to apply would indicate that the guarantee is only likely to be triggered in remote (or at least highly unlikely) circumstances. Accordingly, it would be reasonable to conclude that the provision of the guarantee would not substantively dilute the transfer to the subsidiary of the risks and rewards of ownership of the underlying assets.

**Acceptance by the Council of debt instruments in the subsidiary in part payment**

- The Council will receive consideration for the assets as a mix of cash and a debt repayable by the subsidiary to the Council. The majority of the consideration is currently expected to be in the form of cash (rather than debt instruments). The Council's debt will be sub-ordinated to that provided by external investors to the subsidiary.
- The repayment of the debt due from the subsidiary will depend on the subsidiary's overall financial performance, which – at least in the initial stages of the subsidiary's development – will reflect the subsidiary's management of the assets it has acquired from the Council.
- This is not, however, considered to dilute the extent to which a "true sale" of the assets has been achieved. This reflects that:

- The subsidiary will remain in all circumstances liable for the repayment of the Council's loan (and interest on it). As such the risk that the asset performance is not sufficient to repay the loan (or, as is more likely, the subsidiary has to repay it with additional interest over a longer period than originally intended) is a risk retained by the subsidiary, whilst the Council is exposed to a credit risk in respect of the subsidiary as a business on its financial asset, rather than an ownership risk in the underlying assets;
- The Council's loan will not directly entitle it to share in any upside (i.e. rewards) associated with the assets, which will accrue solely to the subsidiary; and
- The Council's loan will be only be a for a minority of the fair value of the assets transferred to the subsidiary with the external debt holders providing the majority of the funding required to acquire the assets.
- Therefore, whilst the acceptance of a financial asset in the form of a debt instrument will expose the Council to credit risk in respect of the subsidiary, the Council will not be re-absorbing the majority of the risks and rewards associated with the underlying assets.

### Conclusion

- The proposed structure would achieve a "true sale" of the underlying assets to the subsidiary.

## Would the acquisition score as Capital if undertaken by the Council?

- As described by the Council the assets to be disposed of to the subsidiary, would be treated as capital expenditure by the Council if assets of this nature were acquired by the Council.
- This reflects that the fact that the assets would be (i) expected to be treated as a resource from which future economic benefits are expected to flow; and (ii) held by the Council for either the purposes of their service potential or income generating ability for a period of more than 1 year. As such they would be expected to be treated as either Property, Plant & Equipment, or Investment Properties under proper practices, and thereby fall to be capital expenditure for the purposes of the Capital Finance regulations.
- The acquisition of the assets (disposed of to the subsidiary) by the Council would be treated as capital outlay.

### Is cash received?

- As currently proposed, the consideration received by the Council will consist of both cash and a deferred capital receipt in the form of the acceptance by the subsidiary of the obligation to repay a loan (and associated interest) to the Council.
- The proposed transaction assumes that the deferred capital receipt, in the form of a loan payable to the Council, will rank lower than the borrowing undertaken externally by the subsidiary to fund its payment of the cash component of the consideration payable to the Council on the transfer of the assets.
- Only that element of the consideration received in cash by the Council will score as Available Capital Receipts. To the extent that the consideration is received in the form of a loan asset, it will be treated as a Deferred Capital Receipt (which will not be an available resource to the Council to fund capital expenditure).
- The Deferred Capital Receipt recognised in respect of the receipt of a loan asset will be reclassified to being Available Capital Receipts only to the extent that the subsidiary repays the principal of that loan.

### Treatment of other forms of non-cash consideration

- One approach under consideration is that the Council disposes of the assets in return for cash together with an obligation on the subsidiary to undertake specified services for the Council at no cost to the Council.
- Under this scenario the fair value of the consideration which the Council would need to recognise on the disposal would be the sum of the (i) the cash and any other financial assets received); and (ii) the fair value of the services to be provided by the subsidiary to (or on behalf of) the Council for which the Council will not be required to pay.

- The consideration received in the form of an undertaking by the subsidiary to provide future services at no further cost to the Council would be classified as a Deferred Capital Receipt (as the services will not yet have been provided).
- However, capital resources (such as those generated on the disposal of assets) cannot be used to fund revenue expenditure. Therefore, the Council cannot avoid the cost of services being treated as a charge to the General Fund because they are being provided in return for the transfer of capital assets. Therefore, as the services are provided by the subsidiary, the value of those services:
  - Is charged to the cost of services in the I&E, with a corresponding credit to the Capital Adjustment Account (CAA); and
  - The Council will reclassify a proportion of the Deferred Capital Receipts equal to value of the services received to Available Capital Receipts.
- This approach means that capital resources will not be improperly used to fund service provision and that the level of Available Capital Resources is appropriately stated.

### Overall conclusions: Capital Receipts considerations

- The Council will achieve a "true sale" on the disposal of assets to the subsidiary in return for consideration in the form of cash consideration and the acceptance of a loan obligation by the subsidiary to the Council.
- The Council will recognise capital receipts to the extent it has received cash consideration. This reflects that no borrowing remains outstanding in respect of the assets being disposed and accordingly, the Council does not need to consider – on the grounds of prudence – setting aside a proportion of the Available Capital Receipts to the Capital Financing Reserve).
- This reflects that the prudential regime applies only to the Council's single entity (rather than group) accounts and that therefore cash consideration arising on asset disposals, even to a wholly owned subsidiary, will score as capital receipts (as the acquisition by the Council of those assets would score as capital expenditure).
- And s.21(3) of the Local Government Act 2003 requires that, in the event of conflict between statutory provisions and proper practices, that the statutory provisions (namely that capital receipts are recognised in respect of the cash consideration) will prevail.
- The consideration received by the Council in the form of a loan repayable by the subsidiary to the Council will be treated as Deferred Capital Receipts. These will only become Available Capital Receipts as loan principal is repaid by the subsidiary.
- If non-cash consideration is received in the form of an undertaking by the subsidiary to provide services to the Council at no cost to the Council, then (i) the fair value of those services will count as consideration on the disposal of assets and be recognised as Deferred Capital Receipts; and (ii) that consideration will not be available to fund service expenditure. Therefore, the fair value cost of the services will need to be charged to the I&E as they are provided (with a corresponding credit to the CAA).
- In preparing its group accounts, the Council – noting the application of s.21(3) of the LGA 2003 – will not apply group accounting in full as it will not eliminate those transactions between itself and the subsidiary which give rise to Available Capital Receipts and Deferred Capital Receipt balances in its single entity accounts. This is to ensure that the level of reserves shown in the group accounts is not artificially depressed by the elimination on consolidation of the Available and Deferred Capital reserves arising on transactions with the subsidiary.

## Summary of accounting considerations arising on the disposal to the subsidiary

The preceding analysis has identified that in the Council's single entity accounts:

- The transfer of the assets to the subsidiary will in substance be a "true sale" of the assets; and that
- The Council will recognise a mix of Available and Deferred Capital receipts depending on the nature of the consideration received.
- As a disposal of the assets that Council will therefore need to derecognise the assets from its balance sheet and recognise a profit / loss on disposal in the I&E Account when the disposal is

complete (i.e., the risks and rewards and control of the assets have been transferred to the subsidiary);

- This will require that the carrying value of the assets (at the time of disposal) is removed from the balance sheet and debited to the I&E Account) and that the fair value of the total consideration received is credited to the I&E with corresponding debits to both cash and financial assets (loans) reflecting the split of the consideration between cash and financial assets;
- However, as the General Fund is not permitted to benefit (or suffer) from capital transactions the net impact of the disposal will need to be neutralised in the General Fund. This will require that – through the Movement in Reserves – the profit / loss on disposal is debited / credited (as appropriate) to the Capital Adjustment Account (CAA) with the cash proceeds being credited to Available Capital Receipts and non-cash consideration being credited to Deferred Capital Receipts.

### Proper purpose considerations

- The Council will recognise Available Capital Receipts on the disposal of assets to its wholly owned subsidiary to the extent that the subsidiary pays cash consideration for those assets, which the subsidiary would fund by way of external borrowing.
- This requires the Council to consider whether the transaction is for a proper purpose (i.e. that it is not solely a device to generate available capital receipts funded by way of external debt).
- Whilst this is a matter on which the Council will need to satisfy itself, the current understanding is that the motivation for undertaking the transaction is for commercial and strategic reasons. The generation of available capital receipts is incidental to that core purpose. This reflects that:
  - The primary driver of BCP's proposed structure is the Council's strategic desire, as part of its wider transformation programme, to introduce significantly greater commerciality to its utilisation of assets and thereby increase the level of income and service benefits generated by its extensive asset base;
  - The subsidiary is a mechanism by which to collate those assets with scope for income and service benefit optimisation. BCP expects the subsidiary to grow and complement the Council's wider place-making agenda over time; and to this end
  - The subsidiary is likely to, within a robust overall governance and oversight framework which the Council will design and implement, have meaningful autonomy of action and greater flexibility to take rapid and market focussed decisions. This autonomy will be reflected in the subsidiary's Board of Directors and the management team which will run it on a day-to-day basis; and
  - The use of external funders to support the subsidiary is seen by the Council as not only a mechanism by which to introduce sharpened commercial disciplines but also to insulate the Council's finances and other activities from the subsidiary (as well as reinforce the subsidiary's autonomy) as the substantial majority of all the reasonably foreseeable risks and rewards associated with the assets will be borne by the external funders.
- Whilst this is a matter for the Council to decide upon, the current understanding of BCP's proposed structure would suggest that it is driven by a proper purpose and that the generation of available capital receipts is incidental to that purpose.

## Other accounting considerations

### The treatment of the Council guarantee

- The guarantee will fall to be a financial guarantee (as defined by IFRS 9) as it is assumed it will require the Council to reimburse the losses which would be incurred if a specified debtor (the subsidiary) fails to make payments due under a debt instrument (the subsidiary's loans from external investors).
- The Council will charge a market-based premium for the provision of the guarantee.
- Under IFRS 9 the Council will be required to:
  - Initially recognise the guarantee at its fair value on the balance sheet (i.e. as a liability). That liability is then unwound (or amortised) to the I&E as services are provided (i.e. it is a credit to the I&E). Where the guarantee is entered into on a commercial basis the fair value will be equal to the premium received; then

- A loss allowance is calculated for the guarantee. The loss allowance is a probability weighted risk-adjusted assessment of the likelihood of the guarantee being called on and the costs which would be expected to fall on the Council if it were (taking into account the potential for the Council to recover monies from others). There are two bases for the calculation of the loss allowance. The first is the life-time loss allowance, namely all the losses which could occur over the whole life of the guarantee; the second is the 12-month loss allowance which is a measure of the proportion of life-time losses which could occur due to default events over the next year; and then
- The guarantee is subsequently carried at the higher of (i) the initially recognised fair value less any amounts amortised to revenue; and (ii) the loss allowance calculated for the guarantee. This means that provided the initial fair value (less amounts amortised to revenue) remains greater than the loss allowance, no further provision is required.

### The treatment of the loan between Council and the subsidiary

- A portion of the consideration provided by the subsidiary on the disposal of assets is in the form of the acceptance by the subsidiary of a loan obligation to the Council which will give rise to a financial asset and deferred capital receipt on the Council's balance sheet.
- The Council will need to account for its financial asset (loan to the subsidiary) under IFRS 9, on the amortised cost basis (as it is assumed that the Council's business model for holding the financial asset will be solely for payments of principal and interest).
- This will require the Council to make an appropriate Expected Credit Loss (ECL) provision (a probability weighted risk-adjusted assessment of the likelihood of credit losses arising on the loan) when the loan asset is first recognised. In this context it should be noted that:
  - Any increase in the ECL arising on the principal would not be expected to be a charge to the GF as the loan balance represents a deferred capital receipt (and the original asset disposed of was fully funded through capital resources). Any provision required in respect of unpaid interest would however be a charge to the I&E account; and
  - Interest income on the loan (measured on the effective interest rate method which will typically be the same as the nominal interest rate on the loan and at a commercial rate) will be credited to the I&E when earned. To the extent that the subsidiary has not paid interest due by the year-end, the Council will recognise a short-term financial receivable for the amount due.

# 8 Tax

## Scope of work

The tax scope of work covers:

- ***Phase 1a*** – Outlining the tax implications of transferring the Beach Hut activity into a wholly owned SPV.
- ***Phase 1b*** – Review of the potential tax charge for the SPV, this will include:
  - High level comments on interest deductibility from a transfer pricing and Corporate Interest Restriction perspective, this will include consideration of the guarantee arrangements between BCP and the third-party lender.
  - High level comments on the proposed management charge from BCP to the SPV in respect of ongoing administrative services.
  - An outline of the potential tax issues in transferring additional obligations (and costs) into the SPV. Please note that further work will be needed to establish whether this is feasible from a legal and governance perspective, and therefore the comments are included in this report for discussion purposes only. It is recommended that legal advice is sought on the transfer of additional obligations.
- This analysis does not constitute formal transfer pricing advice or documentation and is for the purpose of the financial analysis exercise only to provide an indication of the tax relief available. The report will make recommendations where further work will be required if the project reaches implementation stage.
- ***Phase 2*** – Review of the tax charge in the financial model to ensure that the charge reflects the findings at Phase 1.

### Assumptions

- A local authority is not liable to corporation tax. While it is expected that BCP will meet the definition of a local authority for these purposes as set out in s.1130 CTA 2010 (and reproduced in Appendix [1]), this should be confirmed by BCP.
- It is understood that BCP is not registered as a Royal Charter organisation however this should be confirmed by BCP.
- It is assumed that the accounting for the transaction will show a sale of assets by BCP and the acquisition of fixed assets by the subsidiary – the 'true sale' position referred to above. This is important, as corporation tax uses the accounting treatment as its starting position.

## Tax analysis of transaction

### Corporation tax

- There should be no corporation tax implications for BCP on the disposal of the Beach Hut assets to the subsidiary, as any gain arising will not be subject to tax as BCP is outside the scope of corporation tax.
- From the subsidiary's perspective, as the transfer takes place within a chargeable gains group (see definition below) it will transfer across on a no gain no loss basis. As such, the tax base cost in the asset for the subsidiary will be the original purchase price paid for the Beach Hut assets by BCP, as adjusted for any enhancement expenditure/disposals during BCP's ownership. In addition, 'indexation allowance' is available as a deduction from chargeable gains to reflect the impact of inflation, however it is only available up to 31 December 2017.
- A company, referred to as the `principal company of the group', and all its 75% subsidiaries form a chargeable gains group, together with any 75% subsidiaries of those subsidiaries. This 75% subsidiary requirement is in terms of beneficial ownership of ordinary share capital.
- In addition, a subsidiary can only be a group member if it is also an `effective 51% subsidiary' of the principal company. This means that the principal company must have a beneficial entitlement (either direct or indirect) to more than 50% of any: i) profits available for distribution to equity

holders of the subsidiary; and ii) assets of the subsidiary available for distribution to its equity holders on a winding-up.

- A company for these purposes includes (but is not limited to) a company within the meaning of the Companies Act 2006 or a company constituted under any other Act or a Royal Charter or letters patent or formed under the law of a foreign country. Note that a company without ordinary share capital may only be a member of a group as its principal company. As such, the Council will form a chargeable gains group with the SPV and the asset will transfer on a no gain no loss basis.
- A chargeable gains groups allows disposal of assets within the group to be transferred at nil gain/nil loss. The gains are therefore only taxed when the transferee leaves the chargeable gains group – known as a “de-grouping charge”.

### Stamp duty land tax (‘SDLT’)

- Based on our understanding of the corporate group (i.e., the subsidiary will be associated with the Council in at least a 75% group relationship in terms of ordinary share capital and entitlement of equity holders to assets and profits) BCP and the subsidiary would qualify as being in a SDLT group relief group and therefore SDLT group relief should be available on the transfer subject to meeting the relevant conditions.
- These conditions include that there must be no arrangements in place at the time of the transfers for a change of control or de-grouping of subsidiary, for the consideration for the transfer to be provided or received by someone from outside of the group and that the transaction is carried out for bona fide commercial reasons and not for the avoidance of stamp duty, income tax, corporation tax, capital gains tax or SDLT.
- The SDLT return would have to be submitted to HMRC within 14 days of the transfer and it must declare on the return that the parties meet the conditions of ‘associated body corporates’ and therefore meet the requirements for SDLT group relief. We would recommend that the commercial rationale for transferring the property is documented, so that contemporaneous evidence can be provided in the event of an HMRC enquiry.

### VAT

- Whether VAT is applied to the land will primarily depend on whether BCP has opted to tax the land.
- It is understood/anticipated that an option to tax will be in place prior to the land transfer to the SPV, and that it is expected that the transfer will meet the conditions for the Transfer of a Going Concern (‘TOGC’). Where the conditions are met, VAT will not be chargeable on the sale as the transaction will be outside the scope for VAT purposes.

## Ongoing tax considerations for the subsidiary

### Corporation tax

#### Tax administration

- On incorporation of the subsidiary, Companies House will notify HMRC of the company’s existence which will trigger the issuance of a notice (CT603) to file an annual corporation tax return (CT600). The corporation tax return is due for submission within 12 months from the end of the period of account. The corporation tax return gives details of the income a company has earned and the gains it has made, together with the calculation of the corporation tax liability. When a company submits its form CT600, it will also submit a set of accounts together with any other detailed analysis and computations necessary to show that the return is complete and correct and provides support for the figures included in the form CT600.
- Corporation tax returns are required to be filed online. A full copy of the company accounts, suitably ‘tagged’ in Inline eXtensible Business Reporting Language (iXBRL), must be filed online with the corporation tax return.
- The Subsidiary will be subject to corporation tax (currently at a rate of 19% but rising to 25% from April 2023) on taxable profits.
- As a general rule, corporation tax payable for an accounting period is due nine months and one day from the end of that period (e.g. 1 October 2023 for a 31 December 2022 year-end).

However, the Corporation Tax (Instalment Payments) Regulations set the due dates for payment of the total liability of companies which are defined as being large or very large and require payment of corporation tax in instalments, which can accelerate the payment dates.

### Trading v property rental business

- It is understood that the portfolio of Beach Hut assets comprises of a range of occupation types being: 'Superhuts' which are operated on 25 long leaseholds, annual licences, casual occupancies which are booked for weekly blocks and overnight lodges.
- The Beach Huts themselves are not suitable for overnight use, in fact it is prohibited for the guests to do so, and there are no bathroom facilities available in each of the Beach Huts. In addition, it is understood that the Council currently provides public facilities (including public toilets) to the users of the Beach Huts but also to the general public that may visit the beach front.
- When considering the activity of the subsidiary, it must be established whether the activity is one of a 'trading' nature or whether the activity constitutes a 'property rental business'. The tax adjusted profits of each activity are broadly computed by reference to the same principles for tax purposes, but there are some slight differences when it comes to the use of losses and the availability of certain exemptions when it comes to the Corporate Interest Restriction ('CIR') rules.
- A property rental business is carried on by a person where they own an interest in land, and they enter into transactions that produce rents or other receipts from that land or property. However, where additional ancillary services are provided as part of the operation of the site then the activity is considered to amount to trading. As such, it is considered that the activity of the subsidiary is a trade for tax purposes, on the basis that the rentals are on a short-term basis, the subsidiary will provide ancillary services (which may be procured from the Council) such as the provision of public facilities to the customers, and the occupants have limited rights when it comes to the use of the property. HMRC manual PIM4300 provides specific examples of caravan sites and guest houses being treated as a trade for tax purposes.

### Interest deductibility

- As the acquisition of the Beach Huts by the subsidiary will largely be debt funded by loans from BCP and third parties, consideration will need to be given to the tax relief that is available for interest and other financing costs.
- As a basic principle, interest payable by a UK company is normally deductible for corporation tax purposes in line with its recognition in the income statement in the company's GAAP compliant accounts under the "loan relationships" regime.
- However, deductibility of interest can be restricted under various UK corporation tax rules, including, in particular the:
  - Transfer pricing legislation (Part 4 TIOPA 2010);
  - Unallowable purpose rule (sections 441 & 442 CTA 2009);
  - Corporate Interest Restriction ('CIR') (Part 10 TIOPA).
  - Late paid interest rules (section 373 et seq CTA 2009)
- A commentary on the application of these provisions to the proposed funding arrangements for subsidiary is provided below.

### Transfer Pricing

- It is understood that the third-party senior loans to the subsidiary will be guaranteed by BCP and that a guarantee fee will be charged to the subsidiary:
- Under the UK transfer pricing rules, tax deductions should be available for interest incurred on debt provided it is obtained on arm's length terms. If a related party transaction is not on arm's length terms, tax adjustments are required to disallow elements of the transaction which are not arm's length.
- The shareholder loan from BCP to the subsidiary and (by virtue of the guarantee arrangement in place) the senior loan to the subsidiary will be caught by the transfer pricing legislation and therefore will require documentation to be in place to demonstrate that:
  - both the amount of debt funding and the interest rates on the debt can be supported as arm's length; and

- that this debt funding would have been taken on at arm's length. The documentation should assist the position in the event of any challenge.

- The proposed gearing of the subsidiary of 100% is considered unsupportable from a transfer pricing perspective. The position of total gearing at 85% of the Beach Hut business valuation at the terms as currently modelled may be supportable as being aligned with the arm's length principle subject to certain financial ratios for transfer pricing purposes being met.
- The deemed non-arm's length element of shareholder debt (of 15%) should be excluded from any ratio calculations and any interest arising on the non-arm's length element will not be deductible for corporation tax purposes.
- The guarantee fee to be paid to BCP by the subsidiary in respect of the third-party senior loan is also subject to the UK transfer pricing rules. The indicative guarantee fee appears reasonable but should also be considered in detail as part of a transfer pricing study.
- This analysis does not constitute formal transfer pricing advice or documentation and is for the purpose of the financial analysis exercise only to provide an indication of the tax relief available. It is recommended that further work is undertaken to document the filing position to be taken in the subsidiary's tax computations and note that it would be necessary to reflect on the TP position on a period by period basis depending on the performance of the business.

### Unallowable purpose

- The unallowable purposes rules can apply where the purposes for which a company is party to a loan includes an "unallowable purpose", which is broadly a purpose that is not amongst the company's business or other commercial purposes.
- If the rule applies, any debits attributable to the unallowable purpose (on a just and reasonable apportionment) are disallowed for corporation tax purposes.
- The question whether a company is party to a loan relationship for an "unallowable purpose" is a question of fact, which will need to be determined based on the precise circumstances of each case and therefore should be considered further once the exact funding arrangements are known as this will depend on the commercial nature of the funding arrangements between the subsidiary and the council.

### Corporate Interest Restriction ('CIR')

- The CIR regime was introduced in April 2017 and can apply to further restrict tax relief that is available for interest costs – the CIR rules apply after transfer pricing and the unallowable purpose rules.
- Broadly, the CIR is applied at the level of the "worldwide group" for its "period of account" and then allocated to individual UK tax-paying companies within the group.
- A group will only suffer a disallowance to the extent that its "aggregate net tax-interest expense" ("ANTIE") (i.e. broadly, net tax deductible interest-like expenses across the group) exceeds its "interest capacity" for the period.
- Subject to carry forward rules, the "interest capacity" is calculated as the lower of:
  - 30% of the group's "aggregate tax-EBITDA", broadly, the group's taxable earnings before relief for tax-interest expenses, capital allowances, intangibles amortisation and certain other specific tax reliefs; and
  - The group's "adjusted net group-interest expense" ("ANGIE"), broadly, the net finance cost recognised in P&L in the group's financial statements in respect of finance transactions, subject to certain adjustments,
  - but subject to a minimum "interest capacity" of £2m p/a.
- However, it is also possible for a group to make a "group ratio election", under which the "interest capacity" for the period is calculated as the lower of:
  - The group's "qualifying net group-interest expense" ("QNGIE"), broadly, the group's ANGIE, but excluding certain types of expenses (including related party finance costs); and
  - The "group ratio percentage" of the group's aggregate tax-EBITDA, which is defined as QNGIE divided by "group EBITDA" (broadly, based on the group's PBT in its financial statements, subject to certain adjustments).

- It is the current intention for BCP to provide a guarantee to the third-party lender, in order to increase the subsidiary's borrowing capacity. Where an entity borrows from a third party, and that loan is subject to a guarantee from a related party, the third-party loan is treated as though it is a related party loan for the purpose of calculating QNGIE. As such. If the only interest costs in the subsidiary are the amounts payable to BCP on the sub-ordinated debt, and the interest payable on the senior debt (which is guaranteed by BCP) it is unlikely that the group ratio method will improve the interest capacity of subsidiary.
- Based on the numbers currently being modelled, it is expected that the subsidiary will suffer a tax restriction on interest costs based upon the fixed ratio method (being 30% of tax-EBITDA). Tax relief for interest will be limited to the £2m de-minimis, and any amounts disallowed in the subsidiary will be carried forward and should be available to "reactivate" in later periods where there is increased interest capacity as the senior debt is repaid and the interest costs reduce. In theory, it should be possible to take tax relief for the amounts of interest disallowed under the CIR rules over the 20-year life of the project.
- The CIR position should be remodelled once the exact funding arrangements are known. In addition, please note that the Corporate Interest Restriction would need to be considered on an annual basis outside of this exercise.

### Late paid interest rules

- Where a close company, being one under the control of five or fewer persons, accrues for interest payable on a loan to one of those persons, corporation tax relief may be deferred, unless it is paid within 12 months of the company's year end.
- These rules will apply to any interest payable by SPV to BCP due to the fact that BCP is exempt from corporation tax and thus does not 'bring into account' the income for tax purposes. In addition, these rules use a definition of 'company' which does not include a local authority.

### Management services provided by BCP to the subsidiary

- It is understood that the BCP will provide some ongoing administrative services to the subsidiary (for example, accounting support, IT, marketing, maintenance, legal services etc) and that a charge will be made to the subsidiary from BCP for these services. We understand that BCP has entered into a Service Level Agreement with other existing subsidiaries for similar services. Currently no charge has been reflected in the financial analysis.
- Any such charge will be subject to the transfer pricing provisions and will need to be supportable as being on an arm's length basis in order for tax relief to be claimed in the subsidiary.

## Tax reliefs and allowances

### Group relief

- Group relief allows losses to be surrendered from loss-making companies to profitable companies in the same 75% group. This applies to current year losses but has been extended to carried forward losses from 1 April 2017.
- For group relief to apply, one company must be a 75% subsidiary of the other, or they must both be 75% of a third company.
- A company is a 75% subsidiary of another company for corporation tax purposes when all three of the following conditions are met:
  - The parent company has at least 75% ownership of the ordinary share capital of the company; and
  - The parent is beneficially entitled to at least 75% or 90% of any profits available for distribution to equity holders of the subsidiary, and
  - Those shares entitle the holder to at least 75% of the company's assets that are available or distribution to the equity holders on a winding up.
- As per the group structure provided (included in Appendix 3), it is understood that the subsidiaries included in the appendix are all wholly owned by the Council.
- Looking at the subsidiary accounts on Companies House (without sight of the tax computations for these entities) it is noted that there are potentially losses in Seascape Group Limited and Seascape Home Property Limited that could be surrendered to the subsidiary to reduce the

taxable profits, however they are relatively small amounts in the context of the expected profits of the subsidiary.

- The Finance (No. 2) Act 2017 introduced reformed corporate loss rules into UK legislation. The new rules broadly achieve two main aims:
  - They introduce a restriction on the use of carried forward losses against profits arising from 1 April 2017, which essentially means a company's "relevant profits" can only be reduced by 50% by brought forward losses. Each company or group is entitled to a deductions allowance of £5 million annually apportioned for periods of less than a year. A group for tax purposes is broadly the current definition of a group relief group but with a broader definition to include non-corporate or non-share entities.
  - They give greater flexibility in the use of losses that arise after 1 April 2017.
- The loss relaxation measure applies for carried-forward losses arising on or after 1 April 2017. This applies to: trade losses, non-trading loan relationship deficits ("NTLRDs"), non-trading losses on intangible fixed assets ("NTLIFAs"), and management expenses.
- Losses arising from 1 April 2017 can be set against total profits of the company or can be offset against the profits of other group companies arising in the same period or future periods.

### Capital allowances

- The subsidiary could potentially claim capital allowances on the Beach Hut assets and on other qualifying plant and machinery. A brief overview of capital allowances is set out below.
- Capital allowance claims (including amended claims and withdrawal of claims) must be made in a company's return, or in an amended return, for the accounting period for which the claim is made. The company may claim less than the full amount available, however the full amount claimed must be specified.
- When a company incurs expenditure of a capital nature, such costs are not deductible from trading profits because the expenditure will have an 'enduring benefit' for the trade.
- Instead, where a company employs capital assets for use in the business (eg machinery and motor vehicles), it receives a measure of relief in the form of 'capital allowances'. Capital allowances are also available for buildings (and structures) used by a business, where construction begins on or after 29 October 2018.
- Capital allowances cannot be claimed on land. Therefore as the majority of the market value of the Beach Huts is tied up in the land value, it is expected that the quantum of capital allowances relief will be limited.
- Capital allowances are not available in respect of residential property. While ordinarily the Beach Huts are not expected to be viewed as residential property, to the extent that they do, then capital allowances may alternatively be allowed by reason of them amounting to 'furnished holiday lettings'. This legislation has detailed requirements that need to be met concerning the time during a year for which they are available for use, are actually in use, and are not used excessively by a single customer. Guidance on this specific matter can be provided as required.
- In order for the subsidiary to claim any capital allowances on the fixtures in the Beach Huts, the Council will have to ensure the pooling requirement is met.
- The pooling requirement is that the seller has previously either:
  - claimed a First Year Allowance or the Annual Investment Allowance on the fixtures; or
  - allocated the cost of the fixtures to a capital allowance pool (even if no written down allowance has been claimed on them, it is sufficient that HMRC have been formally notified of them within a tax return).
- Capital allowances are not available to any future purchaser on any part of the seller's qualifying expenditure in respect of fixtures that have not been pooled.

### Qualifying charitable donations

- Where the subsidiary makes a taxable profit, this tax liability may be mitigated by use of making a charitable donation to a registered charity.
- CTA10/S189 allows the deduction of qualifying charitable donations from a company's total profits computing CT chargeable for the accounting period in which they are paid.

- The maximum payment in respect of QCDs that could be made to mitigate the tax liability is the taxable profits in the year, any unutilised QCDs will not carry forward as a tax asset of the entity making the donation.
- BCP has stated that under Charity Law, the Council cannot discharge a statutory function by making a donation to a charity.
- The charity would need to review its own position in relation to the VAT recovery on costs that it incurs, in the context of the nature of supplies that it provides.

## Additional assets/activity to be transferred into the subsidiary

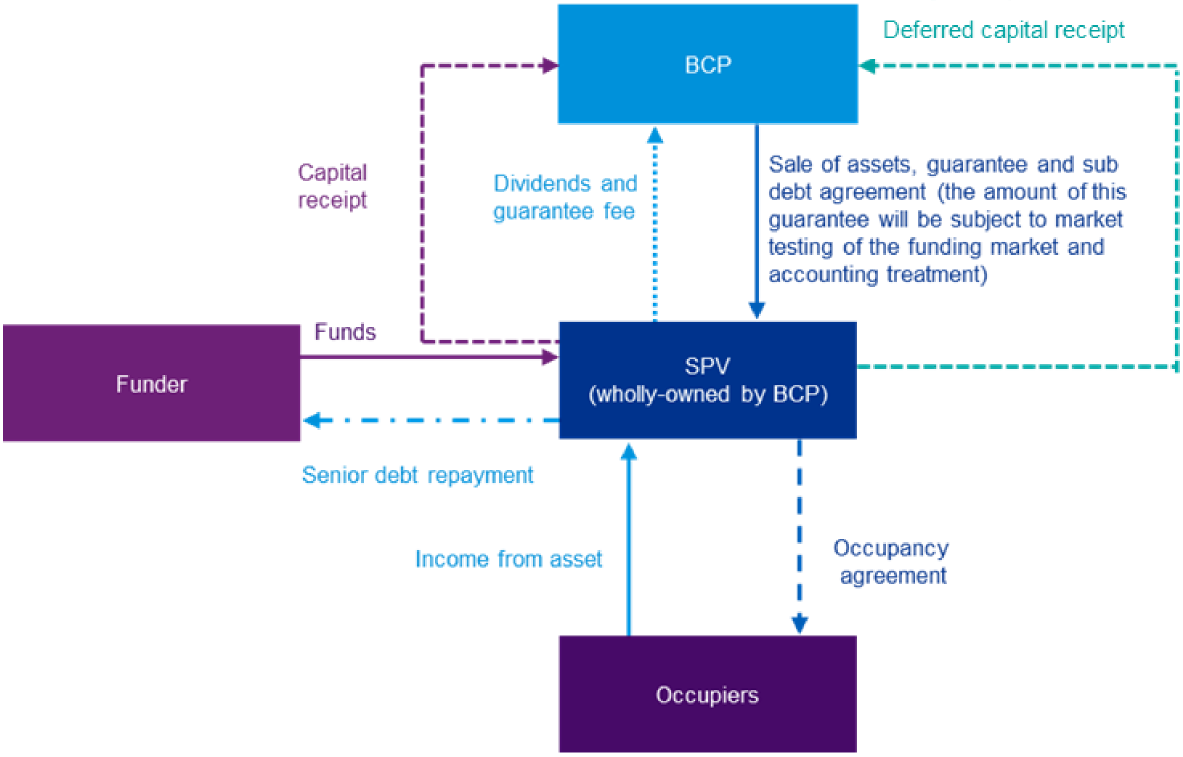
- Turning to the tax implications of the subsidiary undertaking additional ancillary services in relation to maintaining the beach front area. It is understood that certain services are currently undertaken by the Council which in part, benefit the users of the Beach Huts, but are more generally available to the public.
- Allowing the Beach Hut subsidiary to perform additional ancillary services is primarily a commercial decision, and BCP should seek legal advice to understand the extent to which this is legally possible and also consider the accounting implications of such a transfer.
- In order to comment on the tax implications more fully, the subsidiary would need to establish the ongoing arrangements with the Council, the impact of transferring an obligation to the subsidiary alongside the Beach Huts (and the impact on the valuation of those assets) and whether this would create income in the subsidiary to the extent that the subsidiary is providing a service to the Council.
- From a purely corporate tax perspective, the subsidiary and the Council should be alert to the following tax risks:
  - If the costs are not incurred for the purpose of the subsidiary's trade or are incurred on an uncommercial basis, they are likely to be disallowed for tax purposes as they are not incurred "wholly and exclusively" the purpose of subsidiary's trade.
  - Alternatively, if the Council transfers some of its services to the subsidiary while retaining the obligation to deliver those services to the public, then HMRC would expect the subsidiary to charge the Council for the delivery of those services on an arm's length basis. This would likely result in additional taxable profits in the subsidiary.
  - To the extent that the obligation to deliver ancillary services is transferred alongside the Beach Hut assets, one would expect this to reduce the aggregate value of the assets being transferred. A third party valuation might be thought appropriate to confirm this matter. This may have an implication for the transfer pricing analysis on interest deductibility costs, as the overall project gearing, specifically the Loan to Value ratio will be increased. In addition, where the subsidiary is incurring additional cost this will impact the subsidiary's ability to service the interest which may further impact the transfer pricing analysis.
  - Depending on the accounting analysis of the potential transfer, there is a risk that the obligation to deliver services to the council is recognised as a liability on the balance sheet of the subsidiary which would be unwound over the term of the arrangements. To the extent that this is effectively accrued income for the subsidiary, this would result in additional taxable profits in the subsidiary.

### VAT

The provision of holiday accommodation is a standard rated activity and therefore the subsidiary will need to account for VAT on charges to its customers. As a result, the subsidiary will be able to recover VAT on costs incurred in relation to the provision of those services.

- To the extent that additional activities are transferred to the SPV that do not relate to the provision of holiday accommodation, the VAT incurred on such costs would likely be irrecoverable as they are not related to the trade. Further analysis would be needed once the exact fact pattern is known.

# Appendix 1 Structure



# Appendix 2 Key assumptions

**(Updated June 2022)**

This appendix states the key assumptions which were provided by or agreed with the Council following further work undertaken by the Council after the previous KPMG report. The figures have been extrapolated over a likely debt term to get an indication on how much capital the subsidiary could raise.

- **Purchase price of assets:** BCP has provided the book value of the assets. It is noted that to achieve the desired accounting treatment and meet the Council's best value requirements, the assets will need to be transferred at fair value. In the absence of a formal valuation of the assets, a capitalisation method agreed by the Council has been used to estimate the value of the assets. This will need to be replaced by a formal valuation if the Project is progressed. To provide a high-level estimate of the fair value a net initial yield of 8% was applied to the 2021 annual income of £5.4m. This results in a proxy for fair value of £67m which is used in this report. The net initial yield of 8% reflects the non-prime purpose-built student accommodation in regional locations according to CBRE in Residential Investments Q3' 2021. This yield has been used since there are limited large scale transactions similar to the Beach Hut asset class. Additionally, the assets have similarities to student accommodation, such as a stable income stream, low operating cost base and a waiting list in most cases.
- **Asset base:** BCP has worked with its legal team and estimates that not all of the Beach Huts will be transferred to the subsidiary due to leasing arrangements. The current estimate stands at 3,461 huts (out of 3,749).
- **Inflation:** The Office for Budget Responsibility ("OBR") RPI forecast was considered. The OBR provides forecasts for inflation. In the forecast as of 9th May 2022, which covers the period until Q1 2027, RPI has a maximum rate of 5.12% and then stabilises in the latter years to around 2.74%. A compound average rate was calculated using the OBR forecasts for RPI. This results in a rate of approximately 3.33%.
- **Revenue forecast (Do Nothing scenario):** BCP has provided a revenue forecast for 5 years which it is understood assumes an increase in the number of assets. For the analysis, BCP has confirmed that the budgeted revenue estimate for year 2022/23 should be increased by an inflation rate of 3.33% for each year over the appraisal period.
- **Revenue forecast (Base Case):** BCP has provided a revenue forecast for 5 years should the Transaction proceed. This considers an increase in the income derived from the assets taking into account price and policy harmonisation across the geographical areas BCP controls. In the first 5 years, the Council has requested that a 5-year weighted average price increase of 6.2% is applied year on year with harmonisation of prices completed in year 2027/28. For year 2028/29 onwards BCP requested that the revenue be increased by an inflation rate of 3.33% for each year over the remaining period.
- **Operating and maintenance cost (Do Nothing scenario):** BCP has provided an expenditure forecast for 5 years. For the analysis, BCP has advised to increase the budgeted direct costs and indirect costs estimate for year 2022/23 by 5.63% and 5.40% respectively for each of the first 5 years, then by inflation of 3.33% pa. over the remainder of the period.
- **Operating and maintenance cost (Base Case):** BCP has provided an expenditure forecast for 5 years which it is understood assumes an increase in assets. For the analysis, BCP requested that the budgeted direct costs and indirect costs estimate for year 2022/23 be increased by 3.45% and 2.12% for each of the first 5 years, then by inflation of 3.33% pa. over the remainder of the period. These costs include an investment into Beach Hut assets which pushes the total costs in the base year (2022/23) to £1.62m from £1.01m (Do nothing).

- **Subsidiary /Company costs:** BCP has provided a budget estimate for annual company costs. The year 2022/23 figure has been taken and increased by BCP's projected cost growth rate of 5.6% for the first 5 years. BCP has also instructed that after the first 5 years, an inflation rate of 3.33% is used for the remainder of the period.
- **Tax:** For corporation tax, a tax rate of 20% (25% as of year 2023/24 onwards) was applied simply to any annual surplus. Senior debt interest is deemed to be deductible but interest on subordinated debt payable to the Council is not totally deductible due to transfer pricing rules (see Tax section). In addition, as a company liable to corporation tax, the corporation interest rate restriction rules may apply, total interest in a given year may be deductible to the extent of the lower of £2m and deductible interest after transfer pricing rules are considered. Please see tax section for detailed rulings.
- **Lease:** It is assumed that the leasehold is of at least 99 years (and more likely 125 years+) and therefore represents a true disposal of land interest.
- **Discount rate:** A discount rate of PWLB gilts + 80bps has been used, which is between 2.50% and 3.00%, instead of the HMT Green Book rate of 6.09% (nominal). The PWLB rate reflects BCP's cost of capital, and this rate is adjusted daily. The HMT Green Book rate is based on the economic concept of a Social Time Preference Rate. Given this analysis is a financial one and not an economic analysis, KPMG has agreed with BCP that the PWLB is a better measure for this purpose. The HMT Green Book rate has not changed in several years despite a reducing interest rate environment. Note that using the HMT Green Book rate, the NPC analysis for the proposals would be more favourable.

| Input assumptions | | | | |
|---|---|---|---|---|
| | **Previous Report** | **Do Nothing** | **Subsidiary (Base Case)** | **Base Case Plus** |
| Revenue | £5.83m | £5.22m | £5.22m | £5.22m |
| Operating Costs (Direct / Indirect) | £0.72m | £1.01m | £1.62m | £1.62m |
| Company Costs | £0.1m | - | £0.09m | £0.09m |
| Inflation rates | 2.90% | 3.33% | 3.33% | 3.33% |
| **Growth rates first 5 years** | | | | |
| Revenue | | 3.33% | 5.88% | 12.60% (2 years) / 5.22% (3 years) |
| Operating Costs (Direct / Indirect) | | 5.63% / 5.4% | 3.45% / 2.12% | 5.67% / 2.12% |
| Company Costs | | - | 5.60% | 5.60% |

# Appendix 3 Debt assumptions

| Debt assumptions | | |
|---|---|---|
| | **Definition** | **BCP guarantee** |
| **Tenor** | Number of years to pay the senior debt back | 25 years (Base Case) / 22.5 years (Base Case Plus) |
| **Repayment profile** | The profile under which debt is repaid and whether it is repaid in full over the tenor of the debt. | Repaid in full over the debt term with a sculpted amortisation profile to hit the Debt Service Cover Ratio. |
| **Transaction cost** | Transaction costs are cost related with executing the financing transaction. This includes legal fees, financial advice, etc. These costs will be reimbursed by the funder at financial close. | 800k |
| **Inflation hedging** | Private placements can be structured as fixed rate, index linked or combination of both. | Fixed |
| **Debt Service Cover Ratio** | This is the ratio of a Project's CFADS to its debt service obligations. | 1.3x |
| **Debt Service Reserve Account ('DSRA')** | DSRA provides for some cash (enough to meet the next debt service payment, generally 6-12 months) to be set aside to provide liquidity and secured in favour of lenders | 6 months |
| **Guarantee fee** | A guarantee fee is the amount charged by BCP for providing a guarantee to the subsidiary. It is assumed that this is the difference in margin between the guarantee and no guarantee debt option equivalent. In this case 1.25%. | 1.95% |

- **Subordinated debt (deferred capital receipt):** Sub-ordinated debt is debt that ranks after senior debt for interest and repayment. For the proposed structure, the subsidiary will have to purchase the assets from BCP at a purchase price which represents fair value. As such, a sub-debt from BCP to the subsidiary will be required to make up for the difference between purchase price and the amount of senior funding. In the analysis, the sub-debt is priced at a coupon of 2.58%. This is derived to ensure the subsidiary is able to service the debt without roll up of interest costs through the appraisal period. This is indicative only and not material to the overall analysis at this stage. In the scenario run, the subsidiary is able to repay all interest of the sub-ordinated debt as it falls due.
- **Dividend:** Based on the DSCR levels for the proposed transaction, taking into account the other assumptions, there will be a surplus after servicing the senior debt. This amount will be returned to BCP as a combination of the sub-debt repayment, sub-debt interest, guarantee fee and dividend.

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Department for Levelling Up, Housing & Communities

**Kemi Badenoch MP**
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Councillor Drew Mellor
BCP Council Civic Centre
Bourne Avenue
Bournemouth
BH2 6DY

16 June 2022

Dear Cllr Mellor,

**USE OF GENERAL CAPITAL RECEIPTS FLEXIBILITY**

I am writing to you with respect to Bournemouth, Christchurch and Poole Council's proposal to set up a subsidiary for the purposes of purchasing the Council's beach huts. I understand that the intent is to use the proceeds generated to fund ongoing revenue costs of transformation using the general Flexible Use of Capital Receipts direction (the direction).

Following representation expressing concern about the Council's proposal, my officials have engaged with your officers on the issue. As indicated in those discussions, we have been considering the proposal and whether it aligns with the direction and how the government expects it to be used. The direction exists to provide councils additional support to fund the revenue costs of projects which give ongoing cost savings or efficiencies, and which councils might otherwise not be able to afford to take forward.

The direction allows local authorities to determine which projects meet the criteria and determine for themselves how best to use the flexibility, but in so doing councils should also ensure they also operate within the spirit and intent of the freedoms provided.

In this case, I have concerns that the flexibility is not being used appropriately, as the assets ultimately remain within the Council's group structure and, were the direction to be used, the liabilities incurred by the subsidiary with respect to the purchase ultimately fund the revenue costs of the Council. I recognise this type of arrangement is not explicitly disallowed by the direction, as currently worded. I have asked my officials to review the direction and consider whether amendments are necessary to make sure that it is used only in a manner consistent with the government's intent.

Finally, I think it is important to emphasise that the flexibilities afforded by the direction are not intended to address budget pressures. I expect that any authority that has concerns over financial sustainability would apply to my department for Exceptional Finance Support, through the normal process. My officials can advise on the details, as needed.

I hope that this has been useful in clarifying my position on the use of the direction. I would be grateful if Council officers could keep my officials apprised of further developments.

Yours sincerely,

Kemi Badenoch

**KEMI BADENOCH MP**

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Department for Levelling Up, Housing & Communities

**The Rt Hon Greg Clark MP**
*Secretary of State for Levelling up Housing & Communities*

***Department for Levelling Up, Housing and Communities***
4th Floor, Fry Building
2 Marsham Street
London SW1P 4DF

Council Leaders in England

1st August 2022

Dear Leader,

**FLEXIBLE USE OF CAPITAL RECEIPTS FOR TRANSFORMATION PROJECTS**

Today, I have issued an amended direction allowing the flexible use of capital receipts for transformation costs (the Direction). In making the change, I have clarified the Government's intention for use of the Direction by setting out explicitly what constitutes a qualifying disposal. This makes clear that capital receipts used in accordance with the Direction **must only be from disposals where the authority does not still retain some direct or indirect control of the assets.** This clarification can only be deviated from, on an exceptional basis, with the express permission from the Secretary of State.

This flexibility has been in place since 2016, to enable local authorities to use the value of assets to fund transformation projects that produce long-term savings or reduce the costs of service delivery. Most councils use the flexibilities sensibly and will not be affected by this change. Nevertheless, some councils have sought ways to use the Direction in direct conflict with its spirit and intent. This has made it necessary to amend the Direction to make sure that, where it is used, it is done so in line with the intended purpose.

To be clear, I am not seeking to prevent disposals as part of normal business. I understand that local authority companies and joint arrangements are helpful for the delivery of a range of services, and I am not seeking to prevent that. The clarifications are only applicable to the use of capital receipts in accordance with the Direction.

The Prudential Framework enables local decision-making while protecting local tax payers from risk that arises from investment and borrowing. As set out in our local government capital strategy, published July 2021, we are strengthening the capital framework to constrain risk better as well as monitoring the sector carefully. I will not hesitate to act where the spirit of the law is ignored or flouted and where we believe councils are engaging in practices that put local tax payers at unacceptable risk.

Tackling these issues is essential for preserving the freedom for most councils to take sensible decisions about investments to benefit their communities. It is vital, therefore, that councils do not expend valuable time and resource on exploring novel practices and ways to circumvent the rules set by government. Equally, commercial firms and companies encouraging councils to design schemes that ultimately increase risk to local taxpayers should pay close attention to this amended direction.

I hope this clarification is helpful, and my officials will be happy to provide any further detail if required.

**Yours ever,**

Greg Clark

**Rt Hon Greg Clark MP**
Secretary of State for Levelling Up, Housing & Communities

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