Report To:	**STRATEGIC PLANNING AND CAPITAL MONITORING PANEL**
Date:	9 October 2017
Reporting Officer:	Kathy Roe – Director of Finance
Subject:	**FINANCING ARRANGEMENTS FOR GUARDSMAN TONY DOWNES HOUSE**

Report Summary:

The construction of Guardsman Tony Downes House was completed in 2015. The cost of construction was met by Greater Manchester Pension Fund.

An opportunity exists for the Council to 'purchase' the building and for the Pension Fund to be the tenant on a long lease-type of arrangement. The report explains how this can bring financial advantages to both parties.

In addition the Council would complete the work for the use of the ground floor of the building.

Recommendations:

Members are recommended to approve:

a) The payment of £7.0 million to Greater Manchester Pension Fund, subject to the Fund agreeing:
   i) To the payment of an annual rent with effect from the 1 January 2017 to the Council of £384,250 per annum, with upward annual reviews linked to RPI, plus service charges for the running of the building and for cyclical maintenance of plant and equipment;
   ii) That in the event that the Fund vacates the building before the expiry of 25 years, it will pay the Council a sum equivalent to the total annual passing rent for the period beginning on the date of vacation of the building to the 25th anniversary of the date the Council 'purchased' the building (currently assumed to be 1 January 2043).
b) That the payment be financed from the earmarked reserve for Capital Investment.
c) That the building be taken on to the Council's balance sheet;
d) That a further report be requested on the proposed use of the ground floor of Guardsman Tony Downes House and the associated financial implications.

Financial Implications:

(Authorised by the Section 151 Officer)

These are contained in the body of the report.

Legal Implications:

(Authorised by the Borough Solicitor)

These are contained in the body of the report.

Risk Management:

The key risk for the Council is that the proposed financing arrangement cannot be captured in a formal lease agreement. The mitigation of this risk is explained in para. 3.5 of the report.

Access to Information:	Any further information can be obtained from the report author, Ian Duncan Assistant Executive Director, Finance who can be contacted on : Telephone: 0161 342 3864 e-mail: ian.duncan@tameside.gov.uk

1. INTRODUCTION

1.1 The construction of the Pension Fund building, *Guardsman Tony Downes House*, was approved by GMPF Urgent Matters Panel and by Economic Growth, Investment and Sustainability Service on 16 April 2014.

1.2 The key elements of the approvals were:

- To construct the new Pensions Building at a cost of £7.73m;
- The necessary procurement required for the above;
- An agreement for a transfer of land from the Council (value estimated at between £176k and £481k) and project management services estimated at £200,000 in return for free use of ground floor accommodation 7,136 square feet estimated to have an incremental cost of £145k or £1.142m based on floor area;
- The public space will be fitted out at the Council's cost;
- GMPF to retain ownership of the building.

1.3 The purpose of this report is to consider financing options for the building going forward, including the use of the ground floor accommodation. The proposal for consideration is for Tameside Council to bring the building on to its balance sheet, paying the Fund a capital sum and charging GMPF a rent as tenant.

1.4 This proposed option for financing the building is supported by officers of the Council and the Fund as it offers financial advantages to both organisations.

2. ALERNATIVE FINANCING OPTION

2.1 The original approval was for the building to be financed from GMPF resources and retained by the Fund. Drawbacks to this approach include:

- <u>Inefficient use of Fund capital</u>

  The Fund through its diversified portfolio has a discount rate or expected return of 5.2% per annum as assumed by Hymans the Fund's investment consultant. This return reflects the economic environment and historically has been higher.

  The current rate that the Council receives on its cash deposits is 0.5% and the current borrowing rate on a 25 year basis is 2.47% Thus this provides an opportunity for the Council to finance a building for the Pension Fund that could benefit both the Council and Fund.

- <u>Investment Risk of Owner Occupied building</u>

  An owner occupied building has to be valued at a discount to normal investment value as required by RICS standards.

2.2 If the Council were to take ownership of the building on its balance sheet and receive rent from the Fund for its occupation, as opposed to it being a Fund investment owned by Tameside as administering authority, there would be a financial benefit to both the Fund and Council. This is essentially due to the cost of capital for the Pension Fund (i.e. its expected rate of return being higher than the rate at which the council can borrow and much higher than the return than the council receives on its reserves).

2.3 There has been a negotiation between officers of the Pension Fund and the Council on the structure of the deal. The issues considered were:

- A fair rent for the building referenced to market rates and cost of capital;
- The need to resolve use of unoccupied space at the building;
- The capital sum to be paid to the Pension Fund;
- A fair sharing of the risk and reward from the transaction.

2.4 There key terms of the transaction agreed by officers and recommended to Members are:

- Effective purchase of building by Council from Pension Fund for £7m;
- Works to make good the public use space be procured by the Council, at an indicative cost of £1.4m to be met by the Council;
- Pension Fund to agree to pay a rental of £384k per annum, with annual uplifts linked to RPI for a 25 year term;
- Pension Fund to cover maintenance costs including the cyclical maintenance for plant and equipment (this is not included in analysis as would be the case if transaction did not occur).

2.5 The financial analysis of the negotiated transaction is shown below for the Pension Fund and the Council for reference.

Assumptions	
Term	25 years
Borrowing rate for Council	2.47% on an annuity basis
Rate of Return for Fund	5.2%
Rental Value	£384,250 per annum £14.50 per sqft. for 26,500 sqft. Upward only annual reviews in line with RPI

Benefit to Fund

Benefit to GMPF	
Nominal Cash Flows	**NPV**
-£776,101	£3,630,210

The Fund would receive £7m and be able to invest this at 5.2% per annum thereafter it would pay rent of £384,250. The NPV in the table provides a present value for the cashflows by discounting them using the Funds expected return of 5.2%.

Benefit to Council (if borrowing to purchase)

Benefit to Tameside	
Nominal Cash Flows	**NPV (borrowing rate)**
£5,091,389	£3,315,585

The Council could finance this purchase from borrowing, which this minimises any interest rate exposure. The annual illustrative PWLB loan payments for TMBC to finance the purchase of the building are £376,963. The Council would pay out an initial £7m then receive rent and pay out loan repayments. Future cash flows have been discounted by the borrowing rate of 2.47% to produce a net present value.

Benefit to the Council (use of reserves)

Annual Rent	£384,250
Current Return	£17,500
Net Benefit per annum	£366,750

This table shows the effects of the Council financing transaction from reserves. As interest rates rise the Council's net benefit reduces and at an interest rate of 5.5% it would break even on a revenue basis. Clearly if low interest rates persist there is a potential significant benefit.

3 CONSIDERATIONS FOR THE COUNCIL

3.1 Discussion and negotiation has been carried out between officers with a joint desire to find an arrangement that offers reasonable financial returns for each party. The Council and the Pension Fund have jointly commissioned an independent valuation of the building. The indicative value is around £14-£15psqft for the office accommodation and £7m for the capital value, formal confirmation is attached herewith at **Appendix A** from the external valuer.

3.2 As explained in para 2.5 above, the most advantageous option for the Council's challenging position on the revenue budget is to use reserves to finance the purchase. This is because of the low interest rates currently available on its cash balances and the fact that if borrowing was used it would require principal and interest to be charged to the revenue budget, thus diminishing the benefit to the bottom line of the budget.

3.3 The benefit to the revenue budget is £366k per annum as shown in para 2.5 above. If the Council was to borrow to finance the purchase then the annual repayments over a 25 year period (annuity basis) would reduce this benefit to £8k per annum. These figures exclude the exclude the annual indexation of the rent.

3.4 Given the financial analysis above it is recommended that the Council agrees to the purchase for the following reasons:

- Linking the rent to upward movements in RPI preserves the real terms benefit to the Council's budget;
- It assists with one of the biggest, and unprecedented, challenges the Council faces in having to identify sustainable measures to balance its revenue budget;
- The use of reserves in this way offers a much greater impact than simply releasing £7m in annual instalments over 25 years as general support to the budget. The annual instalment would equate to £280k, which compares to the £366k (plus indexation) for the recommended option.

3.5 A major risk for the Council is that the occupation of the Guardsman Tony Downes House by GMPF will not be secured in form of a binding lease agreement, because the Council can't enter into legal agreements with itself. There is the possibility that at some point over the next 25 years the Pension Fund no longer wishes to occupy the building. In order to protect its position the Council will be seeking a commitment from the Pension Fund that if it moves out of Guardsman Tony Downes House that it will pay Tameside Council a sum equivalent to the NPV of the total annual passing rent for the period beginning on the date of vacation of the building to the 25th anniversary of the date the Council 'purchased' the building (currently assumed to be 1 January 2043 and discount rate for NPV purposes 5.2%).

3.6 The ground floor has not yet been developed. It was originally planned that the Pension Fund would pay to bring the ground floor into use but given that the expected occupier will be the Council, and it will be the landlord under the proposed financing arrangement, then it would be more appropriate for the Council to carry out the necessary works (the alternative would be for the Pension Fund to carry out works and for the Council to pay a higher price for the building). At this stage it is recommended that a sum of £1.4m is set aside in the capital investment programme for these works. A future report will be presented with details of the plans for the ground floor.

3.7 The Fund is not a separate legal entity from the administering authority / Council and does not account for assets other than investment assets of the Fund. Therefore the only way in which the Fund can own a building is as an investment asset.

3.8 The sale of the building to the Council will be treated as a sale of an investment asset in the Fund's accounts and in the Council's accounts it will become a fixed asset.

4 LEGAL IMPLICATIONS

4.1 It is essential that any transaction between the Fund and Council is undertaken on a fair and equitable basis.

4.2 The proposal has been tested with the external auditor for the Fund and Council and they do not object to the proposals in principle but we will confirm with them when final terms are agreed.

5 CONCLUSION

5.1 The construction of the Pension Fund building has been completed broadly on time and on cost and the building has been well received.

5.2 The environment since the original plan for the financing of the building and the use of the ground floor space has changed significantly.

5.3 The options of the Council taking the building onto its balance sheet and charging GMPF a rent for use whilst GMPF completes ground floor space in advance of the specific occupier fit out requirements has a number of compelling advantages

- Provides a practical solution for use of remaining space within the building
- Provides a financial benefit to the Fund.
- Provides a financial benefit to the Council.

5.4 The rationale and implications of this proposal have been discussed with the Council's and Fund's auditors. Neither auditor has objected to the proposal set out in the report in principle, subject to final confirmation of terms.

6 RECOMMENDATIONS

6.1 Set out at the front of the report.