SURREY COUNTY COUNCIL

CABINET

DATE:	**23 JULY 2013**
REPORT OF	**MS DENISE LE GAL, CABINET MEMBER FOR BUSINESS SERVICES** **MR TONY SAMUELS, CABINET MEMBER FOR ASSETS AND REGENERATION PROGRAMMES**
LEAD OFFICER:	**JULIE FISHER STRATEGIC DIRECTOR FOR BUSINESS SERVICES**
SUBJECT:	**INVESTMENT STRATEGY**

7

SUMMARY OF ISSUE:

Following the Medium Term Financial Plan (MTFP(2013-18) Budget report in February 2013, Full County Council agreed the need;

- to take steps to ensure that the Council maintains its financial resilience and protects its long term financial position
- to explore and develop alternative sources of funding that reduce its reliance on Government grants and council tax increases in the future
- for provision in the MTFP (2013-18) to meet the costs of initiatives that will deliver savings and enhance income in the longer term.

Cabinet also reaffirmed in March 2013 the importance of innovation in the delivery of services in the interests of Surrey residents and businesses and agreed to develop the Council's approach to trading as one example of how the Council would take opportunities to improve services and value for residents.

Following further work to examine the scope for such initiatives, this paper sets out:

- the Investment Strategy to enhance income to the council in the longer term.
- the proposed governance framework, including establishment of an Investment Advisory Board to advise Cabinet on implementation of the investment strategy.
- the proposal to establish, subject to a full business case, a Property Investment Company.

RECOMMENDATIONS:

It is recommended that:

1. Cabinet approve the Investment Strategy including the proposed process that will determine which investment opportunities come forward for decision by Cabinet

2. Cabinet approve the governance arrangements and establishes an Investment Advisory Board comprising 4 Cabinet Members supported by appropriate officers (including the Monitoring Officer and the Chief Finance

Officer) who will consider individual investment opportunities and provide advice to Cabinet on investment decisions.

3. Cabinet approve the commencement of the procurement process for the appointment of an Investment Advisor or Advisors to provide advice to the Council, with contract award being approved in line with the standard process.

4. Cabinet approves the development by the Strategic Director for Business Services of a full business case for the establishment of a Property Investment Company to be wholly owned by the County Council, for consideration at a future Cabinet meeting.

REASON FOR RECOMMENDATIONS:

The proposed Investment Strategy set out in this paper will provide a framework for investing in innovative solutions and opportunities that enable the council to maintain its financial resilience and increase income whilst providing effective services.

Decisions made to implement the strategy will be in accordance with the governance arrangements described.

DETAILS

INVESTMENT STRATEGY

1. The Council's MTFP (2013-18) sets out the challenges facing the council in terms of financial resilience and its long term financial position. In addition to considering the scope for improving the efficiency of service delivery and for making substantial savings in existing budgets, the Council is examining new approaches to generate additional income that can be used to support its functions and the delivery of services. The Budget report to Council in February 2013 identified the need to enhance income and in March the Cabinet also approved arrangements for the development of trading vehicles. The paper considered in March identified that trading would improve the delivery of services but could also generate income for the council to help deliver longer term financial resilience.

2. The development of a portfolio of investments - covering investment in property and assets and in new models for service delivery – supports the Council's stated intentions of enhancing financial resilience in the longer term and will be delivered through:

   - the adoption of an Investment Strategy; and
   - the establishment of appropriate governance arrangements, including the creation of an Investment Advisory Board within the Council to provide advice to Cabinet on the implementation of the Investment Strategy.

   In addition these arrangements would also allow for investment in schemes that will support economic growth in Surrey provided that these schemes are consistent with the Investment Strategy outlined in this report.

3. The proposed strategic approach to investment is based upon the following;

- prioritising use of the Council's cash reserves and balances to support income generating investment through a Revolving Investment and Infrastructure Fund (the Investment Fund) to meet the initial revenue costs of funding initiatives that will deliver savings and enhance income in the longer term (some of which may be used to replenish the Investment Fund)
- using the Investment Fund to support investments in order to generate additional income for the council that can be used to provide additional financial support for the delivery of functions and services
- investing in a diversified and balanced portfolio to manage risk and secure an annual overall rate of return to the Council
- investing in schemes that have the potential to support economic growth in the county
- retaining assets where appropriate and undertaking effective property and asset management, and if necessary associated investment, to enhance income generation.

7

Governance

4. Decisions on taking forward each investment opportunities will be taken by Cabinet. However, the development of the Investment Strategy is likely to mean more decisions coming forward for consideration and an Investment Advisory Board will be established to provide advice to Cabinet. This will ensure appropriate rigour in advance of Cabinet decision: by ensuring only credible options are progressed to Cabinet, and providing the forum for strategically managing the overall portfolio of investments consistent with the aims of the Investment Strategy, The Investment Advisory Board which will comprise 4 members of Cabinet:

- Leader of the Council
- Deputy Leader
- Cabinet member for Business Services
- Cabinet member for Assets and Regeneration Programmes

Officer support will be provided by:

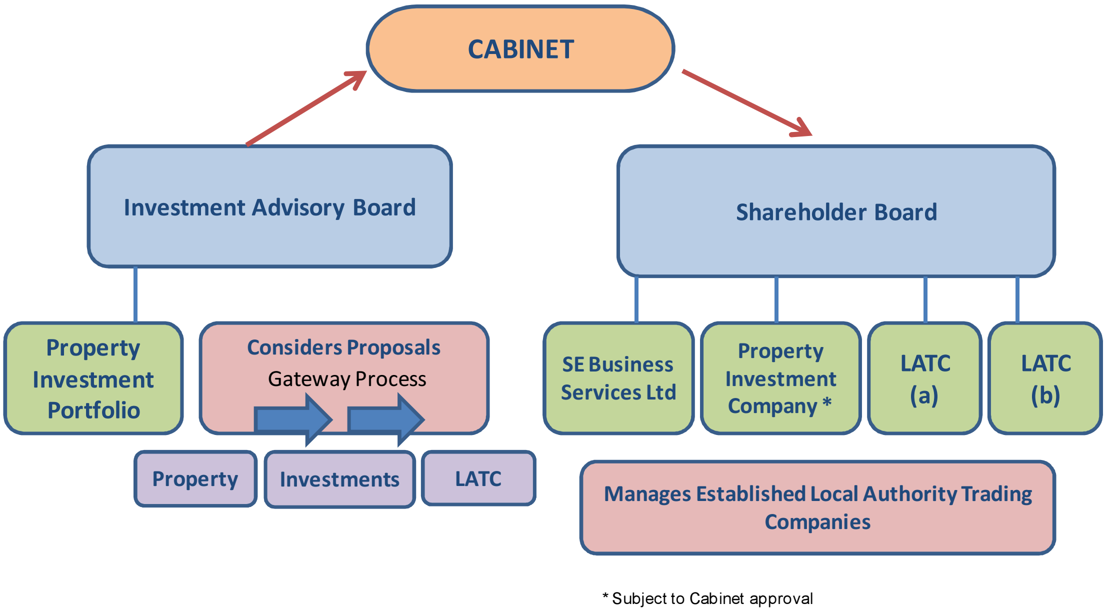
- Chief Executive
- Strategic Director for Business Services
- Chief Property Officer
- Monitoring Officer (Head of Legal Services)
- Chief Finance Officer.

5. The Investment Advisory Board would consider all proposals that contribute to the delivery of the investment strategy and meet the investment criteria. In some cases these could be investments which form part of wider proposals which have a primary focus on improving services but which may, for example, involve property or assets or trading as part of the delivery mechanisms.

7

6. Officers will provide advice on each proposal coming forward to the Board for consideration. This advice will include how each investment proposal could be taken forward, including a consideration of the risks, how it is structured in terms of appropriate delivery mechanisms, and financed.

7. The Council's interest in any trading companies which are established would be managed by the Shareholder Board which Cabinet agreed to establish in March 2013. The role of the Investment Advisory Board would be to advise on any investment opportunities which are involved in the development of proposals for new trading ventures before those proposals are considered by Cabinet.



8. This structure will allow the council to respond in a timely manner to market opportunities whilst ensuring that decisions are made in accordance with a process against which independent professional advice will be provided. It is recommended that this arrangement should be reviewed periodically, and at least annually, to ensure that it is providing an efficient and effective governance framework consistent with the objectives of the Investment.

Investment Advisors

9. The Investment Advisory Board will additionally be supported by appropriate professional advisors, including, Property investment advisors, legal and financial specialists, including taxation advice. Officers will commence the procurement process to put in place appropriate arrangements. The cost of these advisors will be set against the income delivered as a result of the Investment Strategy.

Assessment Process and Investment Criteria

10. The objective for the Investment Strategy is to help ensure that the Council has a sustainable financial position over the medium to long term. The Investment Advisory Board will consider and provide advice to Cabinet on all opportunities that require an initial investment, including property, assets and service delivery vehicles. Each investment opportunity will be assessed through a two stage (or gateway) process.

11. Gateway One comprises a number of criteria to determine whether there is an opportunity to consider and take forward. Gateway One establishes whether the opportunity can be recommended to Cabinet for in-principle agreement or full agreement, or that the opportunity does not meet the decision criteria and therefore proceeds no further. Gateway Two involves the development of a much more detailed business case to be considered by the Investment Advisory Board, and for approval by Cabinet as appropriate.

Gateway One

12. Gateway One will address the criteria listed below. Some of the criteria relate to the characteristics of the specific opportunity; others are concerned with the effect of that opportunity on the overall portfolio. The strategy envisages that the balance between different types of investment as in (d) below will be achieved over a period of 3 to 5 years. An opportunity needs to meet each of the criteria:

(a) The acquisition or investment is within the powers of the Council and can be undertaken with appropriate regard to tests of reasonableness, fiduciary duty and value for money.

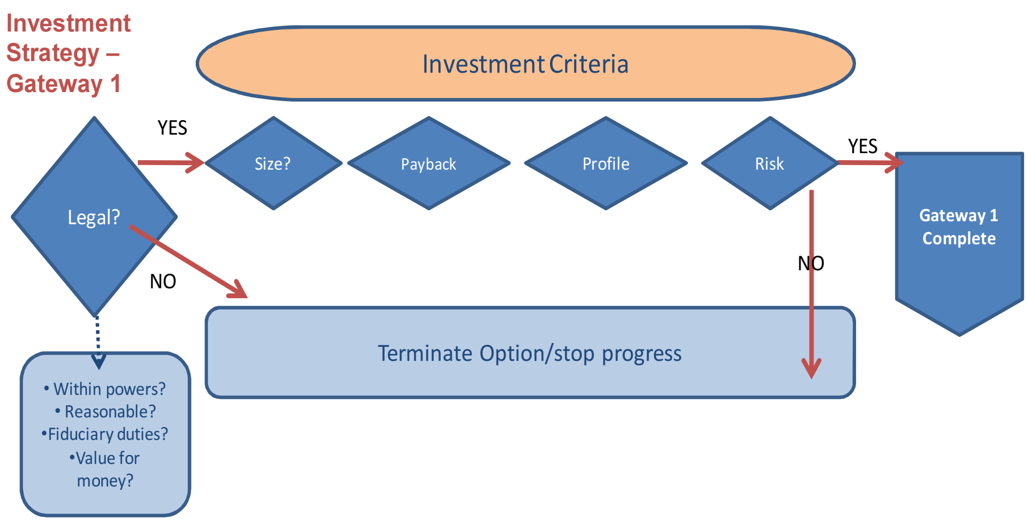
If this is the case, then the following criteria will be evaluated:

(b) The amount of investment required is greater than the threshold for investment which has been set for the Investment Strategy (initially more than £10 million except for Trading opportunities where this threshold will not apply)

(c) The period over which a return will be made is consistent with the overall balance that the Investment Strategy has set for a medium and longer term return (less or more than 5 years respectively).

(d) The opportunity will fit within the ceilings which have been set for the Investment Strategy in terms of the balance between property investment and other forms of investment.

(e) The return on the investment is consistent with the rate of return that has been set for the level of risk involved (within tolerances) which will be considered as part of the development of the full business case.



7

Gateway Two

13. Property investments will additionally be assessed by a Gateway Two process. This will identify whether the investment is appropriate to achieve the recommended balance between types of property, geographic mix and risk profile.

Please see Annex 1 for more detailed process diagrams for Gateways One and Two.

7

14. The conclusion of the Gateway One and Two process will be to determine whether the opportunity is worth further consideration, if that is the case, the Investment Advisory Board would recommend the opportunity proceeds to Cabinet (i.e. a full business case is available) for decision.

15. Where further work is required to develop a full business case, the opportunity will proceed to Cabinet to sanction any additional spend necessary to complete the due diligence and full business case, ahead of a final decision to proceed going back to Cabinet if the opportunity continues to be supported by the Investment Advisory Board.

Property Investment Company

16. To comply with legislation, as explained below, to operate property investment on a commercial basis, the Council would need to establish a property investment company. Section 1 of the Localism Act 2011 (‘the power of general competence) enables local authorities to do anything that a private individual is empowered to do, subject to certain statutory limitations. The power includes the ability to do such things for a commercial purpose but any such commercial activity must be undertaken through a company within the meaning of section 1 of the Companies Act 2006. Local authorities also have powers to trade under section 95 of the Local Government Act 2003. It is likely that aspects of the investment scheme will overlap the S95 power to trade and so the Council would be bound by the conditions set out in the Local Government (Best Value Authorities) (Power to Trade) Order 2009 which requires that before exercising such powers the authority should prepare and approve a business case.

17. The Business Case for the creation of a Property Investment Company will be developed for consideration at a future Cabinet meeting and will cover the following aspects:

- The objectives of the business
- The investment and other resources required to achieve those objectives
- Any risks the business might face and how significant those risks are and
- The expected financial results of the business, together with any relevant outcomes the business is expected to achieve.

18. The precise funding mechanism for the Company will be considered as part of the development of the full business case. However, such a mechanism could include a loan or series of loans by the Council to the Company to allow it to invest in accordance with the strategy, decision making and investment

criteria described above. Under such circumstances, borrowing costs would be met by the Company. Loans would be made available to the Company on a basis which is compliant with the Market Economy Investor Principle so that the terms of funding are similar to those which would be achievable by a private funder given the structure and risks associated with the portfolio. This is important both in the context of Competition law and State Aid rules and further specialist advice will be sought as the part of the development of the business case.

19. For property investments the detailed Gateway Two process would require specific criteria for a property Investment Strategy to be established to be 7
applied by the Company. Within each criteria 'ceilings' (i.e. upper limits) are proposed in order to ensure a balanced portfolio is established and the agreed risk profile maintained:

(a) The opportunity will fit within the ceilings that have been set for the balance between investment in existing property and assets and in higher risk development schemes (80% and 20% respectively of the overall value of the investments within the property portfolio). Development related investment opportunities have higher risks but also provide a greater rate of return. If situated within Surrey, wider benefits can be achieved such as additional housing development, new business premises or town centre developments which will generate additional economic growth. Where there is a choice of investment opportunities with a comparable financial return, the Company will give priority to securing such additional benefits for Surrey.

(b) The opportunity will fit within the ceilings which have been set for the Property Investment Strategy in terms of the balance between retail, industrial, office and other property. These have been set at 52.5%, 22.5%, 12.5% and 12.5% respectively of the overall value of the investments, once fully invested, with a tolerance of +/- 5%. This mix will be reviewed on a minimum of an annual basis by the Investment Advisory Board.

(c) The opportunity will fit within the ceilings that have been set for the balance between investments in London and the South East and the rest of the UK.

(d) The return on the investment is consistent with the rate of return that has been set for the level of risk involved.

20. Once investments have been made, ensuring that target rate of return is achieved for the property investment portfolio will require specialist advice on:

(a) investment management to optimise value with annual Business Plans for each investment which examine the scope to add value, the risks involved and the time scale for delivering the investment opportunity and which, taken together, allow for portfolio management. Performance analysis will take place on an annual basis including benchmarking against similar funds and will be supported by independent valuations.

(b) asset and property management to maintain and improve the financial performance of an investment property including ensuring statutory and regulatory compliance, tenant compliance, landlord responsibilities, securing receipt of rents, dealing with voids and insurance matters.

RISK MANAGEMENT AND IMPLICATIONS:

21. The adoption of the Investment Strategy and its implementation will have an impact on the council's finances and financial standing, and the council will be managing risk differently to now. Decisions made under this strategy and by Cabinet will need to take into account the unique fiduciary duty that the council holds towards residents. Due consideration will be required to ensure that the confidence and faith placed by the public in the council's ability to manage and protect their financial interests is secured and that investments made are judged to be reasonable.

7

22. The Investment Strategy will test the statutory and legal boundaries set by the Localism Act 2011 and particular attention is drawn to the QC advice covered in the Monitoring Officer's report. Furthermore, the council may be subject to increased scrutiny because it is innovative, and it will be essential that the Investment Strategy and the governance arrangements are deemed to be reasonable and robust by external auditors.

23. The implementation of the Investment Strategy means the council will be managing different financial risks. Investments will be subject to inherent economic and market risks, and therefore a balanced portfolio of investment is recommended. However a balanced portfolio will take some time to create and will be dependent upon appropriate opportunities coming to the market.

24. The governance process recommended is designed to mitigate these risks. All investment opportunities will be based upon a robust business case, developed using appropriate technical advisors and which take into account due and proper consideration of the balance between risk and reward and an assessment of the underlying security of the investment to ensure compliance with the fiduciary duty the council holds.

25. Specific mitigation measures in relation to property investment additionally include:

    - Annual valuation plus reporting by an investment advisor to inform the acquisition and disposal strategy to achieve a balanced portfolio at any given time

    - A target rate of return which allows for the financing costs of delivering the Investment Strategy to be met and the generation of an annual surplus and which will be subject to annual assessment

    - Each investment acquisition will be subject to a detailed business case that clearly sets out the risks and associated mitigation measures and addresses market, legal, financial, property and reputational issues.

    - Property assets will be of good quality with income derived from good covenanted tenants in good or growth locations to include mixed schemes avoiding, at least in the short term, asset management requirements.

    - An overall investment scheme provision that there will be an agreed cap on the percentage of income that is derived from a single organisation or tenant and a cap on the single asset value as a percentage of Gross Asset Value.

- Professional advice on asset management will be sought as part of the appointment of investment advisors given the significance of asset management to the generation of returns.

Financial and Value for Money Implications

7

26. The objective of the Investment Strategy is to use the council's resources to invest in income generating assets and trading opportunity proposals to partially offset the impact of the reduction in government grants over the longer term and to protect service provision while minimising the burden on the local council tax payer.

27. The Council may fund investments through using its reserves, capital receipts and prudential borrowing, where the council has the powers to do so. Any borrowing required would need to be made in accordance with the conditions of the Prudential Code, which includes the council approving any changes required to the prudential indicators. The code requires borrowing to be affordable, sustainable and provide value for money. The return on any investment would therefore need to be in excess of the capital financing costs of the borrowing, which consist of the interest payable and the statutory minimum revenue provision (MRP) that sets aside funds for the repayment of the borrowing.

28. The Investment Strategy is being brought forward under the extended powers created by the Localism Act 2011. The Monitoring Officer's report below outlines the council's ability to proceed under these powers and highlights legal advice received which urges a degree of caution. Furthermore, it is the opinion of the external legal advice obtained, that borrowing to invest for return is still considered unlawful for local authorities and that the intention of the Localism Act is not to change this restriction. The underlying principals of investment by local government are governed by the priority of security, liquidity and yield-in that order of priority. The DCLG acknowledges that the Localism Act could potentially increase the risks taken by local authorities, but states that in their opinion there is a complex system of checks and balances in place to prevent inappropriate risk taking that would lead to concerns about the use of public funds. These checks include the Prudential Code and the requirement to exercise sound fiduciary duty.

29. All investments will require a robust business case to ensure that the investment is affordable, sustainable and provides value for money. Some investments will generate a return in the medium to long term but make a loss in the earlier years. The council has provided a Revolving Investment & Infrastructure Fund of £20m that will be used to fund the initial capital financing costs in the short-term until investments generate a net return. Returns made on investments will repay this fund, which in turn will enable further future investments to be made.

30. Assets created through these investments, and the associated liabilities, including those that are made by the proposed Property Investment Company, will be consolidated in the Council's balance sheet and treated in accordance with the Code of Practice on Local Authority Accounting in the

United Kingdom, which is supported by International Financial Reporting Standards.

CONSULTATION:

31. Due to the strategic significance of the proposals, there has been wide consultation within the Council and external QC advice has been sought in advance of considering the proposals, as set out at the end of this report.

7

Section 151 Officer Commentary

32. The adoption of the Investment Strategy and its implementation will have a significant impact on the council's finances and financial standing. Whilst the Investment Strategy has the potential to generate substantial income for the council in the future, there are significant risks in this. In implementing the strategy, Cabinet will need to ensure that decisions made recognise the unique fiduciary duty that is owed towards residents.

33. The governance arrangements outlined, including the requirement for each investment to have a robust business case approved by the Investment Advisory Board, provide the necessary control of these risks. In approving a business case, the Board will satisfy itself that the investment is within the council's legal powers, it has properly considered the advice from its advisors (both internal and external) and its structure provides the best value for money taking into account all financial considerations, including taxation. Full due and proper consideration will need to be given to the balance achieved between risk and reward and the underlying security of the investments proposed to ensure compliance with the fiduciary duty to ensure that the financial standing of the council is protected.

Legal Implications – Monitoring Officer

34. The proposal to create an Investment Strategy is made possible by the "general power of competence" introduced by Section 1 of the Localism Act 2011. Local authorities now have a general power that enables them to do anything that a private individual is entitled to do, subject to certain statutory limitations. The power is designed to give local authorities considerable breadth of operation and specifically gives to Councils "power to do anything that individuals generally may do"......... "even though they are in nature, extent or otherwise" "unlike anything the authority may do apart from [the power]". It also confers power to do that thing "in any way whatever, including" "to do it for a commercial purpose" and "to do it for, or otherwise than for, the benefit of the authority, its area or persons resident or present in its area".

35. Whilst the power, at first sight, is extremely widely drawn there are boundaries, three of which are of potential relevance to the investment scheme:

- The general power does not enable an authority to do "anything which the authority is unable to do by virtue of a pre-commencement limitation". This is defined as a "prohibition, restriction or other limitation expressly imposed by a statutory provision" contained in the Localism Act, or in any existing previous Act.

- Secondly, if the exercise of a “pre-commencement power” is “subject to restrictions, those restrictions apply also to exercise of the general power so far as it is overlapped by the pre-commencement power”. A “pre-commencement power” means, among other things, a power conferred by an existing Act or statutory instrument.
- Lastly, a Council may “do things for a commercial purpose only if they are things which the authority may, in exercise of the general power, do otherwise than for a commercial purpose”.

36. Cabinet will also wish to note that any things done for a commercial purpose must be done “through a company”, principally being a company within the meaning of s.1(1) Companies Act 2006. Usually where a separate legal entity is established, there will be corporation/income tax and VAT considerations, which do not apply to the Council’s core activities. Tax implications would need to be considered in the context of the business case, probably with specialist advice from external advisors. 7

37. Each individual investment proposal would need to be thoroughly examined before proceeding. However, testing the principle of the proposed investment scheme against the general power, an individual has power to buy, let, develop, and manage property for investment purposes and commercial gain and to set up or purchase a company for these purposes. The Council also has power to buy and manage property for non commercial purposes and so should be able to use the general power, to buy and manage property for commercial purposes.

38. Nevertheless, the advice received to date urges a degree of caution: To quote from the QC consulted by the Head of Legal and Democratic Services

“*The Council’s proposed schemes are, undoubtedly, novel” “I am not aware of any [local Authorities] that are proposing schemes similar to these. Although the general power of competence under s.1 LA 2011 is widely drawn, there is almost no Guidance on its use and no case authority on its meaning. The Council needs to be fully aware of these uncertainties in deciding whether, and how, to proceed”*

39. General principles of decision making apply continue to apply to schemes enabled by the Localism Act, and so must be made in good faith, taking into account all relevant considerations, ignoring irrelevant matters, not irrational, balancing the risks against the potential rewards alongside the other relevant duties. In considering a new form of investment strategy Cabinet particularly needs to bear in mind its fiduciary duty to Surrey taxpayers and has to demonstrate that its decisions are those which a prudent and reasonable local authority would enter into, adopting an evidenced-based approach and prudent use of the Council’s financial and other resources. The preparation of a thoroughly researched business case is key to that properly evidenced decision process.

Equalities and Diversity

40. There are no direct equalities and diversity implications in creating and managing the Investment Strategy although the Investment Advisory Board will take into account ethical issues when making recommendations to acquire investment opportunities.

WHAT HAPPENS NEXT:

- The Investment Advisory Board will be created and appointments confirmed.
- Officers will proceed with the procurement of appropriate technical and investment advisors in accordance with Procurement Standing Orders.
- Officers will prepare a full business case and associated Articles of Association for the creation of a Property Investment Company for consideration at a future Cabinet meeting.

7

Contact Officer:
Julie Fisher – Strategic Director for Business Services 0208 541 7216

Consulted:
Cabinet – through informal workshops
Chair of Overview Scrutiny Committee
Ranjit Bhose QC
Corporate Leadership Team
Chief Executive
Chief Finance Officer
Monitoring Officer
Chief Property Officer

Annexes:
Annex 1: Process diagrams

Background papers:
None
