Borough of Rossendale

ITEM NO. F1

TITLE:	**Prudential Borrowing**
TO/ON:	**Cabinet, 9th November 2005**
BY:	**Head of Financial Services**
LEAD MEMBER:	**Cllr. M Ormerod**
STATUS:	**For Publication**

1. PURPOSE OF THE REPORT

1.1 The purpose of the report is to inform Members of a proposal to borrow under the Prudential Code in order to support the Rossendale Leisure Trust (RLT) in its plan to extend and redevelop Haslingden Sports Centre to create a Lifestyle Centre.

2. RECOMMENDATIONS

2.1 That members note the contents of the report and

2.2 Consider whether or not to support Rossendale Leisure Trust (RLT) in its plan through the Councils borrowing powers, and if in favour of supporting such action make appropriate recommendations to the Full Council.

3. REPORT AND REASONS FOR RECOMMENDATIONS AND TIMETABLE FOR IMPLEMENTATION

3.1 RLT in association with Matrix Consultants Limited (MCL) have developed a business case which involves the expansion and redevelopment of a new fitness and leisure suite at Hasligden Sports Centre at an estimated capital cost of £1.2m. The basis of the scheme is to generate additional income for RLT which can then be invested into the other leisure facilities throughout the borough. The business case developed by RLT & MCL suggests that based on a leasing arrangement the facility would become profitable after an initial period of six months losses. Cumulative loss in the first year being £10k, with cumulative profits of £188k at the end of 5 years.

3.2 The preferred developer to manage the delivery of the facility is Alliance Leisure Services Limited. The initial financing of the project was for a leasing arrangement with the Council acting as guarantor. However, it would be more economical for the Council to use its own borrowing powers under the Prudential Code as the Council has access to less expensive financing arrangements to the commercial market, through the Public Works Loan Board (PWLB)

3.3 The Council therefore commissioned a due diligence exercise from consultants PMP on RLT's business plan with a view to considering if the business case was strong enough to support the borrowing and whether unnecessary risk was being placed on RLT's trading position.

3.4 PMP is a leading management consultancy specialising in: sport, leisure and related sectors such as health, regeneration and education. PMP provide a full range of integrated professional services to UK and overseas clients and are recognised as leading advisers in open-space planning, finance and procurement and major sporting events.

3.5 PMP conclude that overall the development could be affordable and sustainable from a revenue perspective, if identified risk is addressed, the market exists and operational delivery systems are adopted.

3.6 PMP also noted that the current business plan did not include the necessary VAT, interim, lifecycle and equipment replacement costs which could impact on the overall profitability. In addition they suggest that consideration should be given to the extent of the step change in facility provision. On this latter point PMP recommend a two stage development process in order to assess initial demand and customer usage.

3.7 In performing the due diligence exercise, PMP specifically looked at a number of areas these were:

3.7.1 *Market Demand* – concluding that currently there is a surplus of provision in the market at present. However, one may assume that the publicly accessible facilities would be more desirable than the private facilities, particularly if the public sector was to provide high quality at reasonable prices.

3.7.2 *Financial Analysis* – concluding the business plan has the capacity to absorb either a 10% adverse variance in revenue or costs, but not both. That certain areas should be reviewed further: income by activity, inclusion of a sinking fund, review of replacement fund, software costs, non-recoverable vat, cash flow impact of the build. Prudential borrowing is considered and concludes that the financing costs within the business plan, albeit slightly lower than anticipated borrowing cost, can be accommodated in the business model

3.8 *Key Risks* – the Trust business plan identifies a number of key risk areas being:

3.8.1 *Market demand* – PMP recommend not exceeding the 59 station proposal and to consider further market demand and the inclusion of additional Kinesis equipment. Kinesis is a groundbreaking technology, with limited current use elsewhere and as yet has no proven track record. However PMP do acknowledge Government initiatives in the health market with the Public sector showing the strongest growth.

3.8.2 *Operational projections* – the business plan identifies the need for cash support during the first 13 months of operation, though cost of disruption during the build phase to other operations is not included. The business plan acknowledges the risk associated with usage numbers. The plan also acknowledges the risk of customer resistance following a proposed 77% price increase, though the proposed level of pricing (£27.50 per month from £15.00) is not significantly different from existing market rates and for what is considered an inferior offer.

3.8.3 *Security of borrowing* – the plan raises the risk of insufficient financing cost being included; however PMP opinion is that the shortfall is only £18k within the first 2 years. This therefore means that so long as the assumptions within the business plan are valid, the net income and expenditure from the facility is able to service the debt financing costs and repayment of the loan. There is however concern regarding non-recoverable vat of c.£200k which has not been included in the financing calculations. Capital costs do not include any contingency it is therefore critical that the risk of cost overruns sits with the preferred contractor. The business plan does not refer to any associated risks of the Planning regulations and process (eg delays and additional design cost implications).

3.9 The Head of Communities and Partnership has recently written to RLT in order to try to resolve some of the major issues raised in PMP's due diligence report. The Trust has responded as follows, with regard to:

3.9.1 High specification, innovative systems and use of Kinesis – RLT see this as a necessary requirement in order to give it a competitive advantage and compete head on with the private sector. Kinesis is also now established or planned in 40 UK sites.

3.9.2 Size of the station expansion – RLT do not think that a reduction will materially reduce the capital commitment and that a size less than 45 - 50 would be "a severe error". Example of the success of size expansion is evident in Hyndburn Leisure Trust which saw station increases from 30 to 120.

3.9.3 £210k Non-recoverable VAT (being 17.5% of £1.2M) – RLT have discussed with their financial advisors on how best to deal with this issue. There are 2 main options and consequences available to RLT:

Option	Advantage	Disadvantage
1 – Separate VAT registered company (New Co.) created for the project	- All VAT recoverable by New Co. - Could revert back to an exempt activity after 10 years	- VAT liable on all revenue, increasing membership costs - potential negative impact on the business model - Corporation Tax liable on

		all profits, reducing profits available to RLT, though this may be mitigated via eligible tax deductible covenants. - New Co. statutory administration.
2 – Absorb the VAT impact within the current Trust set up		- assuming RBC is able to loan £1.2M, trust would have to reduce net capital investment, before VAT to £1.0M - potential negative impact on the business model due to reduced customer experience
3 – An extension on 1 above, direct some non-building works via the Trust to be recharged to the New Co. with VAT	- recovers immediately VAT incurred on non-building works (c. £250k) - expands the Trusts' vatable income base, increasing its ability to recover other VAT incurred - increase retained income within the trust - Reduces taxable profits within any separate VAT registered company - increases medium and long term cashflow for the trust	

NB –

i) *The Council is unable to claim back the VAT on behalf of the Trust as the value involved (in excess of £200k) is greater than existing tolerances within the Councils own VAT exemptions.*

ii) *If Option 2 were to be the method by which the Trust resolved the VAT issue. The proposal would be to reduce the investment by £185k. The most significant impact on customer experience will be the dropping of Kinesis and the Sports Wall saving £120k. However, the Trust has stated that the business plan did not contain significant incomes from theses areas and so the forecasts remain unchanged. The Trust is still investigating Option 1 but has to ensure that Option 1 is viable from an overall tax impact (VAT and corporation tax) and forecast income generation. At this stage it is therefore keeping its options open.*

3.9.4 Adequacy of a building sinking fund and equipment replacement reserve – RLT have stated that £90k in total is budgeted over years 4 and 5.

3.10 The recommendations to Cabinet from Overview and Scrutiny were as follows: "That whilst supporting the Trust and its objectives, this Committee has significant concerns regarding the uncertainties of the business case at this stage of its development particularly in respect of the doubts surrounding the available market for the service and the insufficient information available to give a considered view. In the circumstances, they are unable at this stage to submit recommendations on the matter to the Cabinet"

3.11 It should be emphasised that this project commences the strategy as stated in the Trusts Partnership Delivery Plan "Raising our Game". It was made clear that there were there clear drivers: facility investment, Partnership delivery and innovation in leisure management. The current proposal involves all these elements.

3.12 In addition the Partnership Delivery Plan contained a number of core objectives, two of these objectives are to be meet from the current proposals, namely:

- Objective F1 – Achieving 10% growth in turnover and protecting bottom line performance up to 2007, thereafter increasing turnover by 15%.
- Objective LG2 – the upgrade of three facility areas by March 2008

3.13 RLT have ensured that the extension design is able to accommodate any future ambitions for a swimming pool on the Sports Centre site. The current design plans themselves also incorporate the development of a combat room generally for judo and karate. Subject to requirements and detailed discussions, RLT maybe able to consider other physical sports such as boxing.

3.14 Council priorities for leisure state that new funding should come from external resources. The current proposal reflects Council priorities for leisure in that the borrowing cost will be funded entirely by the Trust. The trust is not in a position to secure its own borrowing arrangements as it does not have the necessary security via an asset base, or a trading track record, which any lender would demand. The alternative would be a loan at higher interest rates and almost certainly backed by a Council guarantee. The proposal therefore reduces potential borrowing costs and strengthens partnership working between the Council and RLT.

3.15 Council officers have agreed with the Trust to limit additional payback to RBC from year 3 of the new income stream to 50% or £20,000 per annum, whichever is the lower. This would be used to support additional borrowing in the future which would be used to fund maintenance works on the portfolio of leisure buildings. This is to be reinforced in any final agreement between the Council and the Trust.

3.16 Council Officers consider that, either of the options being pursued by the Trust in relation to resolving the VAT issue will succeed in mitigating the risk in this area to the Council. On this basis the business proposal does have the basis for injecting new financial resources into the Trust and making it less reliant on Council grant funding.

4. CORPORATE IMPROVEMENT PRIORITIES

4.1 FINANCE AND RISK MANAGEMENT

4.1.1 See main report

4.2 MEMBER DEVELOPMENT AND POLITICAL ARRANGEMENTS

4.2.1 No material issues other than Member focus on Council priorities.

4.3 HUMAN RESOURCES

4.3.1 There are no material Human Resource issues

4.4 ANY OTHER RELEVANT CORPORATE PRIORITIES

4.4.1 The are no other material corporate priority implications

5 RISK

5.1 See main report.
5.2 Any contract between the Trust and Alliance would have to ensure that risk around cost overrun is transferred to Alliance. The Trust have assured officers that this is a standard part of Alliance's contracting framework..

6. LEGAL IMPLICATIONS ARISING FROM THE REPORT

6.1 There are no material legal implications at this stage although appropriate contractual arrangements would be necessary to make clear the extent of the Council's commitment and security arrangements on the loan (eg via Charges on assets, Trust guarantees, etc.)

7. EQUALITIES ISSUES ARISING FROM THE REPORT

7.1 There are no material equality issues arising. Current DDA works for Haslingden Sports Centre have been postponed pending the outcome the redevelopment proposal in order to complete DDA work in the optimum manner.

8. WARDS AFFECTED

8.1 All wards are affected

9. CONSULTATIONS

9.1 Executive Director of Resources, Head of Communities and Partnerships, Rossendale Leisure Trust, Overview & Scrutiny.

Background documents:
Rossendale Leisure Trust – Business Plan
Leisure Trust Due Diligence – Report by PMP
Correspondence

For further information on the details of this report, please contact:
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