CABINET

Storey Creative Industries Centre
Revenue Implications

2nd September 2008

Report of Corporate Director, Regeneration

PURPOSE OF REPORT					
To provide an update on the Storey Creative Industries Centre project and to review the level of revenue support required to assist with the initial short-term operation of the new centre.					
Key Decision	**X**	**Non-Key Decision**		**Referral from Cabinet Member**	
Date Included in Forward Plan	7th July 2008				
This report is public but the appendices are exempt from publication by virtue of Paragraph 3 of Schedule 12A of the Local Government Act 1972.					

RECOMMENDATIONS OF COUNCILLOR ROGER MACE

That Cabinet supports Option 6, in that revenue support totalling £40,600 in 2008/09, £69,700 in 2009/10, and £28,300 in 2010/11 be provided to Storey Creative Industries Centre (SCIC), up front in each year as appropriate, and that the Council's budget be updated to reflect the rental payable for the new Tourist Information Centre, subject to

- **the funding being met from a combination of using the existing reserve of £50,000 , with the additional funding requirement being built into the current review of the Medium Term Financial Strategy, for referral on to Council;**

- **an element of the SCIC support being ring-fenced to subsidise the rental offer for the arts organisations as set out; and**

- **the revenue support to SCIC being subject to annual review against the Company's Business Plan, in that, if SCIC generates significant surplus in its activities, then the Council may reduce its revenue support accordingly, or seek clawback to the value of any additional funds supplied. Any clawback condition is to be based on a clear formula relating to SCIC year end surplus balances to be negotiated between SCIC and the Director of Regeneration in conjunction with the Head of Financial Services.**

- **any financial support to SCIC being conditional on the lease of the Storey Institute building being agreed and signed by SCIC by 31st December 2008 at the latest.**

1.0 Introduction

Previous reports have been considered by Cabinet concerning the Storey Creative Industries Centre project, most recently in June 2007 when authority was given to proceed with the capital scheme. Members have been updated on potential additional capital funding of £280,000 which will enable the project team to make the centre more attractive to tenants and provide an enhanced cultural offer for Lancaster and the wider region.

An important aspect of the project has been the formation and ongoing support of a 'not for profit' company, Storey Creative Industries Centre (SCIC), to run the facility. It is managed by a board of directors with wide experience in facilities management, business development and creative business. This report provides:

- A review of the business plan being developed by SCIC and views of potential risk and reward in the current market;
- A review of Council support for two arts partner organisations, Storey Gallery and LitFest, due to return to the building as tenants of SCIC.

The June 2007 Cabinet report was supported by a detailed 5 year business plan which assessed the operational viability of the completed centre. This was produced mainly in-house by Council officers as the SCIC Board of Directors had not had time to develop a business plan of their own. The business plan attempted to show whether the new centre could operate at a break even level from its first year of operation. The report noted:

> *Officers anticipate that, realistically, it will be challenging for Storey Ltd to overachieve against the income figures shown and it will be hard for the company to meet the 'break even' budget in the short term. Storey Ltd are confident in their business plan but Officers, in recognising the financial risks, would advise providing a 'safety net' of £25,000 per year, as an earmarked reserve. This would be available, to assist Storey Ltd with any year 1 and 2 revenue shortfall, should the need arise*.

As a consequence, Cabinet resolved:

> *That Members recognise the need to provide financial cover estimated at £25,000 per annum to assist with any year 1 and 2 revenue shortfall (should the need arise) and that an earmarked reserve be created accordingly, in line with Cabinet's discretion to increase future years' spending projections, as set out in the Medium Term Financial Strategy (MTFS).*

The balance of risk in the overall project has now shifted from the capital works to the revenue viability and business plan of the completed centre. There is therefore the need to reconsider the level of revenue support required by SCIC, and the key aspects influencing this are considered in detail below.

2.0 Storey CIC Business Plan: Emerging Key Risks

Over recent months, SCIC have been building on the work done by officers and developing their own business plan as the ultimate end user of the facility. The following changing circumstances have arisen since the previous Cabinet report:

- An unexpected decision by Folly, one of the project's original three "core" partner arts organisations that their emerging business model was not compatible with a return to the Storey building. Folly was expected to operate a media gallery in the building and occupy a substantial area of workspace (approximately 314 sqm). Folly subsequently decided not to participate in the project as a tenant. Although a major disappointment, the decision should not have an adverse impact in the medium to long term as a greater area of workspace is available for commercial letting at market rates. But, in the short term it creates a challenge for SCIC to find alternative tenants for what was thought of as substantial guaranteed income from a long term partner (a projected £40,000 from rent and service charges).

- The business model assumed a catering company partner would be secured to operate the bar/restaurant and fit out and equip the kitchen (offsetting this against an initial rental deal). SCIC's open market tender exercise revealed a reluctance for prospective catering operators to take on major capital investment in the current economic climate. The catering operation is being re-tendered and this will be greatly assisted by the provision of kitchen facilities as noted in the previous capital update report. But, in case a more substantial deal is required to secure an operator SCIC is showing a lower than anticipated first year income projection.

- A 35% national reduction in Lottery funding, has hit Arts Council England (ACE) hard, and made it difficult for the remaining arts organisation (LitFest and Storey Gallery) to raise funds for fit-out of the auditorium and gallery, and to afford the increased rental they face in returning to the improved building (see Section 3.0 below). However, SCIC have raised money to employ a fundraiser to seek grants from trusts and foundations.

- Increased risk that "credit crunch" related economic downturn may reduce the level of demand for new workspace in the short term. High value added Creative Industries, at which the project is directed, are generally well placed to ride out economic cycles. There have been twelve encouraging expressions of interest from prospective tenants and City Council officers continue to assist with 'bending' core marketing resources towards the project and working as proactively as possible with SCIC to promote the space, but this presents another short term challenge and unanticipated additional risk to the business plan. Members should note that until the head lease is signed SCIC cannot formalise contracts with any prospective tenants or catering company. Abnormal increases in utility costs, over and above large increases originally anticipated, have also been considered

Cabinet should therefore note that SCIC face wholly unforeseen and added short term challenges to break even. It can be considered that in real terms an immediate loss of at least £70k Year 1 income has had to be absorbed in the revised plan.

Current Forecast

Officers have been working with SCIC to review their business plan in the context of less favourable circumstances. The analysis accompanies this report as an exempt Appendix 1. Cabinet should note that business planning is an evolving exercise and the projections reflect the Board of Director's experienced view of potential income and operational requirements to meet stated project objectives. The Business Plan is presented on 'calendar year' basis but for the purposes of this report it is necessary to equate figures to the Council's financial year. In summary, the current Business Plan indicates that SCIC projects a revenue deficit in the following amounts:

2008-09 (Part Year Only)	£35,600
2009-10	£52,200
2010-11	£19,200
Total	£107,000

If the level of lettings of Creative Workspace were to vary either upwards by 10% (subject to a prudent maximum occupancy level of 80%) or downwards by 10%, then the support required would be as follows.

	10% Higher	10% Lower
2008-09 (Part Year Only)	£31,400	£39,700
2009-10	£39,700	£64,700
2010-11	£6,500	£31,900
Total	£77,600	£136,300

In short, each variation of 10% produces a difference of approximately £12,500 pa.

The Business Plan indicates that SCIC moves into surplus by its fourth year. This is partly dependent on the receipt of income from the refurbished Third Floor and Little Gallery which officers are confident in achieving as noted in the previous report on the capital project.

The difficulties of making firm predictions on the size of short term deficit must be emphasised. SCIC remains confident that the test case position in Appendix 1 may be bettered and medium to long term sustainability is very achievable. However, there are no guarantees and a clearer picture is unlikely to emerge until the Centre has been operating for several months.

Forecast Deficit Implications and Mitigation

The company could potentially operate under cash deficit and secure support through an overdraft facility, but it is unlikely that SCIC would be able to secure an overdraft of this nature as it will have no capital assets to use as security. Experience elsewhere has shown it is not desirable for new social enterprise organisations to be dependant on sizeable overdraft or loan facilities and that this could jeopardise long term viability. Officers consider that the projected deficit indicates a high risk of SCIC insolvency and business failure in the short term.

The sum of £25,000 pa for the first two years, referred to in Section 1.0, has been set aside in accordance with Cabinet's earlier decision. It is considered that this will be required by SCIC, but given that it has been identified as a 'safety net' rather than definitely committed, its application has not yet been included in the current year budget.

Members are therefore asked to approve a proportion of the original 'set-aside' funds in 2008-09 of £35,600. In order to have maximum effectiveness in terms of cash flow benefits to SCIC this element of the Council's revenue support will need to be paid at the beginning January 2009.

Support for future years will need to be dealt with as part of the Medium Term Financial Strategy (MTFS). Any recommended support will be subject to further testing and be based on a joint view of the market and lettings between SCIC and Council officers. Again, for cash flow effectiveness any future support agreed will need to be provided at the beginning of the financial year in April 2009, and April 2010.

SCIC accepts that the overall balance of business risk in the project should fall to the company, but expect key stakeholders to understand that matters have arisen that are beyond the control of a fledgling 'not for profit' organisation. There has been a substantial commitment by the members of SCIC Board over the past 18 months in preparing for the scheme and analysing the business. SCIC have made their business plan available for Cabinet in order for the risks to be fully understood.

Cabinet should note there is no contractual obligation on SCIC to take on the building lease on completion of the capital works. In conjunction with officers, SCIC have formed their own view on the current viability of the centre and the level of risk in signing the lease (although it should be noted that SCIC have already signed an 'agreement to lease'). The implications and risks of SCIC failing to sign the lease are outlined in Sections 6.0.

However, SCIC are unlikely to withdraw from the current proposed arrangement, unless in the last resort where no 'safety net' was provided. A commitment to deliver the original £50,000 support ceiling may enable SCIC to take up the lease but it is recognised this is at high risk to their business and they have delayed signing until additional support is explored. Certainty in coverage of the additional projected short term deficit will provide the confidence for SCIC to formalise the head lease at the earliest opportunity enabling it to proceed to secure tenants.

It should be recognised that, while there is no individual liability in the limited company, SCIC Board members are staking considerable personal reputational risk in their involvement. SCIC will provide a wide range of sustainable benefits which the City Council would otherwise struggle to achieve particularly in the improved cultural offer, impact on business, and support to the night time economy. The new TIC should increase its footfall in terms of visitors and income and moving into the building allows the Council to realise a substantial capital receipt. Full options and implications are considered in Section 6.0.

3.0 Rental Support for Arts Organisations

A second element to consider regarding the ongoing viability of SCIC relates specifically to former tenants of the storey Institute. Storey Gallery and LitFest are expected to relocate back into the premises on completion at a rent to reflect improvements to the building and market rates. All stakeholders recognise that co-locating active publicly supported arts organisations, particularly those intimately associated with the building, alongside new creative industries is vital both culturally and economically. A strong arts component will assist the SCIC achieve one of ACE's key objectives for the building: to promote contemporary culture, visual arts and language in an accessible setting. It will also contribute to Lancaster's broader cultural offer.

The Storey Gallery and LitFest are recognised as significant contributors to the Cultural heritage of the District. Their work, alongside other arts/cultural organisations, is supported by the City Council and other partners including ACE and Lancashire County Council. As "Key Cultural Partners" the following direct revenue funding is committed in the current year:

Table 1:

2008/09 Funding Support (Revenue)	**Storey Gallery**	**LitFest**
Lancaster City Council	£34,700 (Note1)	£8,800
Arts Council England – North West	£31,734	£55,972
Lancashire County Council	£13,000	£17,500
Total:	**£79,434**	**£82,272**

Note 1 The revenue support payment from Lancaster City Council to the Storey Gallery of £34,700 is split £24,900 for rent contribution and £9,800 for programme activities (via a Service Level Agreement)

Negotiations have been taking place between Storey Gallery and LitFest (as potential tenants) and SCIC (as prospective landlords) to agree the terms for their re-occupation of the building. Despite the 'not for profit'/social enterprise label, SCIC has to operate and compete in the real property market for workspace and has the same drivers as any business. It has to optimise revenue generating potential of space within a relatively constrained building and the added challenge of meeting the range of objectives surrounding the project.

It was always understood that the arts organisations faced an increase in rental charges and different terms of occupation than was the case when the City Council was landlord. Early project development phases recognised that the arts organisations would require additional skills, revenue earning and audience development capacity to support their core operations in the new landlord/tenant relationship. ACE therefore contributed funding to a programme of organisational development support and transitional funding to improve Storey and LitFest audience development/business plans (Appendix 2).

The lease within the refurbished building is a commercial negotiation between third parties – the SCIC and arts organisations. But the Council has a direct interest in the outcome because it impacts on the viability of all three organisations and Lancaster's cultural offer as a whole. Figures provided by SCIC show that the combined rental and service charge offer is as follows.

Table 2:

Organisation	**SCIC Offer (rent and service charge)**			**Previous charges under City Council as Landlord**
	2009	**2010**	**2011**	
Storey Gallery	£37,140 (Note1)	£37,812	£38,484	£24,900
Litfest	£14,724 (Note2)	£14,952	£15,192	£7,106 (Note 2)

Note 1 The proposed annual rent (including service charges) offered to Storey Gallery (starting at £37,140), is on a combined reduced and partial space-sharing arrangement compared with previous occupation level. Relocation on a like-with-like space allocation under sole occupancy, would attract a charge of £63,840 reflecting the true value of the space for commercial use (within capital grant funder and covenant constraints). Under the new arrangement Storey Gallery still has sole occupation of the main large Storey Gallery, but SCIC is able to optimise revenue from refurbished areas previously underused or used intermittently by the Gallery.

Note 2 The 'previous liability' rent figure in respect of Litfest includes service charges, amounting to £2,856. The SCIC offer also includes additional space and a partial space-sharing arrangement for use of the new auditorium, which are wholly additional new facility requested by LitFest as part of the development of their business model.

SCIC has conducted negotiations with the arts organisations in a spirit of goodwill, recognising shared objectives but with an eye to commercial realities and wider project objectives. Officers agree that SCIC has offered fair terms to both organisations, at the margin of what it considers to be a necessary contribution to secure project viability while respecting the requirements of the arts organisations. The 'offer' figures are included in the Appendix 1 business plan.

Storey Gallery has a rental shortfall of £12,240 on the current space offer (it is assumed that Storey Gallery are content with the space offer with regard to operational requirements). LitFest have a rental shortfall of £7,618 but have access to the auditorium and additional, space which provides opportunities to both further develop income generating activities and draw in more grant funding. Such opportunities for both the arts organisations will only develop over time and in the short term both arts organisations contend that meeting the rent offer will restrict their operational capability in the short term.

Both Storey Gallery and LitFest have approached the Head of Cultural Services and funding partners seeking assistance in meeting the increase in their rent liability. Officers accept the arts organisations have been hampered by cutbacks in lottery and ACE funding referred to earlier in the report. Officers also accept the organisations cannot progress their business plan models and viability to the extent hoped until they are part of a newly refurbished centre.

Discussions between Lancaster City Council and the other two primary revenue funders (ACE and Lancashire County Council) can be summarised as follows:

- In view of their significant support to-date, ACE has stated that they would not be able to provide any additional revenue funding for current and subsequent years under current funding agreement.
- County Council's position is not formally stated, but indications are that it would not be in a position to provide any additional funding support beyond its current allocations.

A solution would be to give SCIC additional short-term support to specifically assist the arts organisations in becoming established in the new facilities, linked to a 3 year sliding-scale of 100% (of projected rental deficit) in Year 1; 50% in Year 2; and 25% in Year 3. By Year 4 the support would end, as the arts organisations would have had full opportunity to develop their funding/programme profile to meet the current rental offer level. If Cabinet supports this approach the equivalent rental support from the City Council to SCIC for the two arts organisations is as follows:

Table 3:

Related Organisation	**Year 1 equivalent additional support**	**Year 2 equivalent additional support**	**Year 3 equivalent additional support**
Storey Gallery	£12,240	£6,456	£3,396
LitFest	£7,618	£3,923	£2,022

When equated to Council financial years, this becomes:

Table 4:

Year	**Additional Support**
2008-09 (Part Year)	£5,000
2009-10	£17,500
2010-11	£9,100
2011-12 (Part Year)	£4,100
Total	**£35,700**

Members should be clear that the additional support is not an additional supplement to core grant to the arts organisations. The preferred structure of the support is for it to be given to SCIC and 'ring-fenced' to enable SCIC to offer the arts organisations rent at a short-term and tapering/reducing discount to market rates. The full options and implications of a decision on support are considered in Section 6.0.

4.0 Lancaster Tourist Information Centre

In addition to the forecast revenue deficit to SCIC and additional 'ring fenced' support to Arts Organisations, the amount of rent to be charged to the Council in respect of the new TIC exceeds the current budget provision. This is a relatively minor issue overall, but still needs to be addressed in considering the cost and budget implications for the Council.

5.0 Details of Consultation

This report follows ongoing discussions between Council officers and SCIC, Storey Gallery, LitFest, Lancashire County Council and Arts Council England over recent months.

6.0 Options and Options Analysis (including risk assessment)

When taken together the total potential revenue implications of the three issues outlined are as follows:

Table 5:

Year	Forecast short – term deficit on SCIC business plan	Additional 'ring fenced' Support for Arts Organisations	TIC Rent	Total
2008-09 (Part Year)	£35,600	£5,000	£600	**£41,200**
2009-10	£52,200	£17,500	£2,300	**£72,000**
2010-11	£19,200	£9,100	£2,600	**£30,900**
	£107,000	£31,600	£5,500	**£144,100**

The full options and implications of providing SCIC support at various levels are as follows, but Members should note that the TIC rental cost issue is not considered separately due to its low relative importance when compared to the other two main issues.

Option	Advantages	Disadvantages	Risks /Mitigation
Option 1			
Abandon project – complete capital works then sell building.	No need for Cabinet decision on the potential for future support to SCIC	A requirement for clawback of funding by ACE, NWDA and ERDF, amounting to £3.5 million. Uncertainty of position and costs of TIC in a private building under a commercial owner/investor. Risk to capital receipt from existing premises. Uncertainty of position of arts organisations in returning to the building under a commercial owner/investor. Reputational cost of abandoning the project. Adverse effect on regional /national funders' views on the Council's ability to deliver complex projects. No potential for added value development of Creative Industries cluster and contribution to a national and regional economic development agenda. Uncertainty of position during building marketing period. Effect on regional /national funders' views on the Council's ability to deliver complex projects.	Clawback of all grant associated with the project (£3.5m) for non delivery. This would need to be funded initially from Unsupported Borrowing (average of £266,900 pa over the first 3 years, with reducing annual sums over the lifetime of the building). Clawback could be mitigated by building sale. But, outside of a formal valuation, there is no indication of what a sale of the building (under covenant and with no commercial sitting tenants), could achieve. It is unlikely that receipts from sale would match the level of clawback. Council may still be required to return funds. Adverse effect on regional /national funders' views on the Council's ability to deliver on wider 'Vision' agenda which could involve relationship development with third party organisations and similar risk/reward considerations. Risk to current bid for additional resources to complete 'mothballed' areas of the scheme.

Option	Advantages	Disadvantages	Risks /Mitigation
Option 2			
Complete capital scheme offering no revenue support to SCIC (neither current agreed nor any additional 'safety net') or additional 'ring fenced' support for Storey Gallery/LitFest. ***Note: it is assumed SCIC could not take on the lease under these conditions (under insolvency risk) and the project reverts to the Council to deliver.***	Council operates directly, potentially on similar lines to other operations (e.g. CityLab), as workspace with more control on cost side. Council could use minimal staffing (e.g. caretaker/receptionist) or a staffing complement sufficient to achieve some creative industries objectives in the short-term. A chance of successful delivery of some economic, business and cultural outcomes being achieved. although likelihood of achievement is at 'medium to high risk' May be able to avoid clawback on majority of capital costs if it is run as workspace and provides the cultural offer to some degree. The Council would have the option to negotiate arts organisation rental. Council could potentially generate operational surplus in the medium to long term. Certainty of place of TIC in building.	Invalidates the use of the value of the building as an 'in-kind' contribution in the capital scheme. Likely short term revenue shortfall when clawback, arts organisation rentals and market situation are considered even under minimal staffing. Development of revenue side of the building requires extensive internal staff commitment to marketing, businesses and facility management. Loss of time, commitment, energy and expertise of the SCIC Board and loss of flexibility/added value of an independent partner champion for the creative industries. Fails to achieve full economic/cultural benefit of the project as a Creative Industries Centre. Council will not be able to access finance opportunities that a third party could. Loss of innovation, potential economic/cultural reward and regional exemplar project. Attractiveness of 'creative hub' could be diminished for potential occupiers. Costs and risk are definitely internalised and officer workload increases.	The Council has some resources, skills and flexibility to operate the centre successfully to funders' expectations. But it has not planned to absorb such costs/workload. Due to loss of 'in-kind' match funding at least £450k clawback would need be financed by additional Unsupported Borrowing - over first three years this would be £34,300 pa. Also clawback risk (£67k) on ACE intervention rate if ERDF match is lost. The clawback costs would be in addition to short term deficit faced (potentially to a proportion of the level anticipated by SCIC). Losses may be mitigated in medium-long term but officers would need to 'drive' the building offer. Funders' primary concern may be to ensure that the building was continuing in the use for which grant was given (creative industries workspace) and could be supportive of this option. Clawback of the majority of capital grant may be avoided – but ACE requires a broader cultural offer. There is still medium risk of clawback on all grant if Council cannot meet overall scheme objectives or convince funders' to their satisfaction. Loss of innovation and potential longer term rewards – delivery mechanism is not tested.

Option	Advantages	Disadvantages	Risks /Mitigation
Option 3			
Complete capital scheme offering SCIC only current agreed ‘safety net’ £50k no additional ‘safety net’ and no additional ‘ring fenced’ support to arts organisations (Storey Gallery/LitFest). ***Note 1: while it is assumed SCIC could take on the lease under these conditions viability in the short-term is unlikely.*** ***Note 2: it is assumed revenue support is delivered up front in the relevant periods to aid cashflow.***	A small chance of successful delivery of the project and full range of economic, business and cultural outcomes being achieved. although likelihood of achievement is at ‘medium to high risk’ SCIC challenged to be more flexible in their business planning and approach to cost side of the business plan. Avoids any risk of clawback if operated successfully. Certainty of position TIC in building. In the event of SCIC short term business failure the premises would have been ‘up and running’ for a period and have some commercial activity in situ.	Uncertainty and high risk for all stakeholder organisations moving forward. Possibility that one or both of the arts organisations are unable to return to the building and/or have operational and programming difficulties. High possibility of unsustainable short-term deficit in SCIC business plan and risk of potential business failure. SCIC business failure within ERDF lifetime could still invalidate the use of the value of the building as an in-kind contribution in the capital scheme. Development of revenue side of the building requires major commitment to marketing, businesses and facility management. SCIC forced cost cutting may mean they could not deliver to funders’ expectations leading to longer term clawback risk for Council. Low but present risk that SCIC may refuse to take on the lease and leave the Council facing the situation outlined in Option 2 in full. Costs and risk could become internalised and officer workload may increase.	High risk that SCIC will run into financial deficit and fail in the short term. If SCIC business fails Council could step in and run the building facing broadly the same operational situation and internal costs and revenue cost risk as outlined in Option 2 - albeit with some base commercial activity in situ. ERDF ‘in kind’ match clawback ***may*** be avoided as transfer of building would have been made. If the building is returned to the portfolio, the Council ‘regains’ the sunk value (less the value of the term income ‘lost’ while the building was under lease to SCIC. £450k clawback must still therefore be allowed to be financed as noted in Option 2 (with associated risk to element of ACE funding). As in Option 2 clawback of the majority of capital grant may be avoided – there is still medium risk of clawback on all grant if Council cannot meet overall scheme objectives or convince funders’ to their satisfaction. Potential loss of innovation and potential longer term rewards if business fails but delivery mechanism would have been fully tested.

Option	Advantages	Disadvantages	Risks /Mitigation
Option 4			
Complete capital scheme offering SCIC current agreed ‘safety net’ £50k, but approve only additional growth in revenue support for arts organisations up to maximum level outlined in report. ***Note: it is assumed revenue support is delivered up front in relevant periods to aid cashflow.***	A chance of successful delivery of the project and full range of economic, business and cultural outcomes being achieved. although achievement is considered to be at ‘medium risk’ SCIC challenged to be more flexible in their business planning and approach to cost side of the business plan, though to a lesser degree than Option 3. Low real risk that SCIC Board refuse to take on the lease of the building. Avoids any risk of clawback if operated successfully. Certainty of position TIC in building. A small chance SCIC may not require all ‘safety net’ allowed if business overachieves in short-term – although this will be difficult in the current climate. In the event of SCIC short term business failure the premises would have been ‘up and running’ for a period and have some commercial activity in situ.	Additional short-term Council revenue costs over and above current £50k ‘safety net’ agreed. Possible lack of incentive ‘drive’ for Arts Organisations to deliver on business model improvements. But mitigated by payment of support to SCIC rather than direct to arts organisations. Possibility of unsustainable short-term deficit in SCIC business plan and risk of potential business failure. Medium risk for SCIC business in short term. SCIC business failure within ERDF lifetime could still invalidate the use of the value of the building as an in-kind contribution in the capital scheme. Development of revenue side of the building requires major commitment to marketing, businesses and facility management. SCIC cost cutting may mean they could not deliver to funders’ expectations leading to longer term clawback risk for the Council.	Risk that arts organisations fail to develop longer term sustainable business plans without dependence on future support requests to funding partners. Medium risk that SCIC fails to achieve its short term business plan targets and building reverts back to the Council to run with similar implications to Options 2 and 3 If SCIC business fails Council could step in and run the building facing broadly the same operational situation, clawback issues and internal cost and revenue cost risk as outlined in Option 3 - albeit with further commercial activity in situ. As in Option 2 clawback of the majority of capital grant may be avoided – there is still medium risk of clawback on all grant if Council cannot meet overall scheme objectives or convince funders’ to their satisfaction. Costs and risk could still become internalised and officer workload may increase.

Option	Advantages	Disadvantages	Risks /Mitigation
Option 5			
Complete capital scheme offering SCIC current agreed ‘safety net’ £50K and approve only growth for additional ‘safety net’ (subject to ongoing review of business plan targets and market conditions). No additional ‘ring fenced’ support for arts organisations (Storey Gallery/LitFest). ***Note: it is assumed revenue support is delivered up front in relevant periods to aid cashflow.***	A chance of successful delivery of the project and full range of economic and business outcomes being achieved. although achievement is considered to be at ‘medium risk’ due to impact on partner arts organisations. SCIC challenged to be more flexible in their business planning and approach to cost side of the business plan, though to a lesser degree than Option 3. Low real risk that SCIC Board refuse to take on the lease of the building. Avoids any risk of clawback if operated successfully. Certainty of position TIC in building. A small chance SCIC may not require all ‘safety net’ allowed if business overachieves in short-term – although this will be difficult in the current climate. In the event of SCIC business failure the premises would have been ‘up and running’ for a period and have commercial activity in situ.	Additional short-term Council revenue costs over and above current £50k ‘safety net’ agreed. Uncertainty for arts organisations moving forward. Possibility that one or both of the arts organisations are unable to return to the building and/or have operational and programming difficulties. Likely reduction in cultural offer and ‘knock-on’ effect on SCIC footfall Possibility of unsustainable short-term deficit in SCIC business plan and risk of potential business failure. Medium risk for SCIC business in short term if arts organisations do not take up space. SCIC business failure within ERDF lifetime could still invalidate the use of the value of the building as an in-kind contribution in the capital scheme. Development of revenue side of the building requires major commitment to marketing, businesses and facility management. SCIC cost cutting may mean they could not deliver to funders’ expectations leading to longer term clawback risk for the Council.	Arts organisations fail to integrate into the centre with revenue, events programme and cultural impacts for SCIC and the Council. Medium risk that SCIC fails to achieve its short term business plan targets and building reverts back to the Council to run with similar implications to Options 2, 3 and 4 – with commercial activity but without arts organisations in situ. As in Option 2 clawback of the majority of capital grant may be avoided – there is still medium risk of clawback on all grant if Council cannot meet overall scheme objectives or convince funders’ to their satisfaction. Loss of a major part of the cultural offer may prove a disadvantage in discussions. Costs and risk could still become internalised and officer workload may increase. Costs and risk could still become internalised and officer workload may increase.

Option	Advantages	Disadvantages	Risks /Mitigation
Option 6			
Complete capital scheme offering SCIC current agreed ‘safety net’ £50K and approve growth for additional ‘safety net’ for SCIC (subject to ongoing review of business plan targets and market conditions) and ‘ring fenced’ support for arts organisations for incorporation into MTFS. ***Note: it is assumed revenue support is delivered up front in relevant periods to aid cashflow.*** **This is the Preferred Option**	Highest chance of successful delivery of the project and the full range of economic and cultural outcomes being achieved. SCIC has full confidence in their business plan and approach to managing costs/objectives. The company is still challenged to be flexible in their business planning due to market circumstances. No risk that SCIC Board refuse to take on the lease of the building. Avoids any risk of clawback if operated successfully. SCIC may not require all additional ‘headroom’ allowed. Both of the arts organisations are able to return to the building and avoid short term operation and programming difficulties. Tapered incentive (via SCIC market discount) for arts organisations to deliver on business model improvements. Certainty of position TIC in building. SCIC may not require all additional ‘headroom’ allowed if business overachieves in short-term. In the event of SCIC business failure the premises would have been ‘up and running’ for a period and have commercial activity in situ.	Additional short-term Council revenue costs over and above current £50k ‘safety net’ agreed. Lowest possibility of short-term deficit in SCIC business plan, lowest risk of potential business failure. Possible lack of incentive ‘drive’ for Arts Organisations to deliver on business model improvements. But mitigated by payment of support to SCIC rather than direct to arts organisations. Possibility of unsustainable short-term deficit in SCIC business plan and risk of potential business failure. Medium risk for SCIC business in short term. SCIC business failure within ERDF lifetime could still invalidate the use of the value of the building as an in-kind contribution in the capital scheme. Development of revenue side of the building requires major commitment to marketing, businesses and facility management. SCIC cost cutting may mean they could not deliver to funders’ expectations leading to longer term clawback risk for the Council.	Risk that arts organisations fail to develop longer term sustainable business plans without dependence on future support requests to funding partners. However, SCIC *may* be in a position to assist if the wider project is successful. Lowest risk that SCIC fails to achieve its short term business plan targets with implications for Council under previous Options. SCIC business could still fail but Council could step in and run the building facing broadly the same operational situation, clawback issues and internal cost and revenue cost risk as outlined in Options 2, 3 and 4 - albeit with more commercial activity in situ. Costs and risk could still become internalised and officer workload may increase. Lowest risk that SCIC fails to achieve its short term business plan. Lowest chance of business failure and the building reverting back to the Council to run with similar implications to Options 2, 3 and 4.

7.0 Officer Preferred Option (and comments)

Option 6 is the preferred option.

Under Option 1 the Council chooses to abandon the project and attempts to dispose of the building on completion. A possible capital receipt could be generated but this is unlikely to mitigate the effect of clawback of all grant funding for non-delivery. But Option 1 is not considered palatable as it will not achieve regeneration objectives and will have wider implications on the Council's reputation for delivery of major projects.

The other options (2,3,4,5 and 6) offer variations on the degree of financial support allowed to SCIC (and the 'ring fenced' arts organisations support in the short term), and consider the potential risks to the overall Council revenue position, other impacts and potential to achieve objectives across the business plan period. The key mitigating position (under SCIC future 'business failure' or in the event of the lease not being signed), is for the Council to manage the Centre. At the time of the June 2007 report, this alternative was effectively excluded because VAT regulations meant that if the Council ran the Centre itself, tax of up £750,000 would not be recoverable. Following recent changes made by HMRC this risk no longer applies (refer to Financial Implications) and it is therefore possible for the Council to take on management without recoverable VAT risk.

It is difficult to make firm predictions, however, and in judging the degree of risk in the options the following has been assumed:

- The 'un-refurbished' Storey building value is used as "in-kind" match funding for ERDF grant, but there has to be a legal transfer of the building to a third party before the end of December 2008. If this is not achieved, the Council faces clawback of £450,000 ERDF (and £67k potential ACE match against this). Unsupported Borrowing finance to cover this over the first three years would be £34,300 pa. In the event of SCIC 'failure' and the building reverting to the Council the clawback liability is still be considered to be applicable (see Financial Implications).

- Should SCIC run into financial difficulty under any agreed level of support the Council would still be faced with the options:

  a) Provide short term revenue support to SCIC to help it keep trading until recovery;
  b) Abandon the project and attempt to sell the building to a third party;
  c) Repossess the building and operate it directly;

  Members would have to judge this on the circumstances at the time, including availability of funding/impact on the Council's own budgets assessed against the strength of SCIC's prospects for recovery. But, for the purposes of the analysis it is assumed: no further support other than that agreed under this report would be forthcoming; future sale of the building is unpalatable under similar circumstances as noted in Option 1; the Council would 'step-in' judging that the innovative delivery mechanism had 'been tried but failed'.

- Under such adverse circumstances the Council could potentially take on the building and achieve staffing savings – with 'management' functions being carried out using existing staff resources. But the Council would face similar market pressures and will find it difficult to improve on the income position shown in Appendix 1. The Council would need to show sufficient staffing support for objectives to be achieved or risk clawback on the majority of grant funding. However, funders are likely to be supportive.

When clawback is taken into account it is unlikely the Council would improve on the revenue deficit shown in Table 5, particularly if taking on the building at the outset or under circumstances of SCIC failure in, say, the first year. The Council could potentially turn in a surplus over and above unsupported borrowing costs for clawback and building running costs in the medium to long term. However, event and catering are essential to make the centre viable and the Council would have to expend significant staff resource in development. In the absence of a definitive steer from funders as to what would be an acceptable offer it is difficult to analyse how much it would cost the City. All things considered, there is unlikely to be real advantage gain in budget terms than if the building is run by SCIC, being 'driven' by a highly committed Board and staff team. There is substantial grant clawback risk in bringing the project back into the Council portfolio and the loss of time, commitment, energy expertise of the SCIC Board and the loss of flexibility and added value an independent partner champion for the Creative Industries are also important considerations. SCIC will be far quicker and clinical at reacting to difficulties, making changes and assessing risk across all areas of the business, being outside a public bureaucratic framework.

The Council is not likely to improve on SCIC delivery under options 2, 3, 4 and 5 and risks the loss of an experienced driving force for creative industries and cultural development. Members should note that SCIC's greatest chance of success is achieved by adopting Option 6 – and this is the preferred option.

Transfer of public assets for ownership and management by a social enterprise realises social, economic and community benefits in appropriate circumstances.   Officers consider that the potential benefits of the management and ownership model outweigh the risk, which can be minimised and managed. The ultimate 'fall-back' position of the building returning to the Council to run is a manageable position, although this would be highly unlikely under Option 6.

By adopting the preferred ownership and management model the Council will avoid long term repair and maintenance liabilities. Pre-scheme Storey budget costs varied depending on the amount of running costs and rental income received. Actual net costs to the Council in previous years were £4,300, £43,300 and £17,400 in 2003/04, 2004/05 and 2005/06 respectively. In 2007/08 wage costs were £25,300 but these posts have been removed from the establishment and staff redeployed to existing posts. These items have been taken into consideration corporately as part of the 2008/09 budget processes so defining a 'saving' is difficult. But, it should be recognised that removal of long-term revenue liabilities have already been used to provide headroom in the Council's wider Budget setting process.

8.0 Conclusion

Storey Creative Industries Centre is a complex and ambitious project, implemented in a form which has been significantly scaled back from the original concept, due to loss of anticipated external funding from Heritage Lottery Fund. It was recognised that the business plan for SCIC was based on a number of assumptions about income sources, and some limited provision was made in the capital reserve as a contingency to cover the possibility that the initial operation of the centre may need a degree of revenue support.

Progress with the capital scheme has gone well and the Council should be able to hand over to SCIC a building which will be fit for purpose and capable of long term successful operation as a creative industries centre, once established. SCIC has an experienced and professional Board of Directors who are determined to carry out their responsibilities and provide a facility that is sustainable and an exemplar project. Members should recall that the creation of SCIC was driven by the Council in response to detailed consideration over how best to achieve the physical, social, cultural and economic objectives. The reasoning and advantages in having a ‘stand alone’ not-for profit operator are still present when the issues are looked at in the round. However, there have been adverse circumstances adding short term income risk, due primarily to the unanticipated exit of Folly and economic downturn. At the same time, partner arts organisations, Storey Gallery and Litfest, have been affected by the national reduction in Arts Lottery funding associated with the diversion of funds to the London Olympics.

There is therefore a requirement for the Council to provide some additional short term revenue funding, as outlined in this report. If this can be provided, there are good prospects that the SCIC will become successfully established as a self sustainable operation as well as achieving significant economic benefits for the district by supporting development of the creative and cultural industries and visitor economy.

RELATIONSHIP TO POLICY FRAMEWORK

Directly contributes towards Corporate Plan Priority Outcome 12: Improve Economic Prosperity throughout Lancaster District.

Storey Creative Industries Centre is a key project within the Lancaster & Morecambe EDZ programme and is featured in the Lancaster & Morecambe Vision.

The project will also directly contribute towards LAA target NI 171 New Business Registration Rate

CONCLUSION OF IMPACT ASSESSMENT
(including Diversity, Human Rights, Community Safety, Sustainability and Rural Proofing)

Diversity – The proposal aims to provide a wider range of employment opportunities to residents of the area.
Human rights – No adverse impact.
Community Safety – No adverse impact.
Sustainability – The proposal looks to support development which will lead to local employment opportunities.

FINANCIAL IMPLICATIONS

Summary & Financing

In total over the three years, the two elements of potential revenue support to SCIC and the costs associated with the TIC can be summarised as follows, as shown earlier in the report:

Year	Forecast short – term deficit on SCIC business plan	Additional ‘ring fenced’ Support for Arts Organisations	TIC Rent	Total
2008-09 (Part Year)	£35,600	£5,000	£600	**£41,200**
2009-10	£52,200	£17,500	£2,300	**£72,000**
2010-11	£19,200	£9,100	£2,600	**£30,900**
	£107,000	£31,600	£5,500	**£144,100**

The amount currently set aside within Earmarked Reserves is £50,000, in accordance with the Cabinet decision of June 2007, although it should be noted that there will be some re-profiling required across 2008/09 and 2009/10 with this and other related Capital Reserves, if Cabinet supports the preferred option.

In total therefore, if Option 6 is supported, the net additional budgetary provision needed amounts to an extra £94,100 over the three years. Whilst 2010/11 costs can be accommodated within Cabinet’s delegated authority to increase future years’ budgets, 2009/10 exceeds the £50k limit and therefore it is recommended that additional budget provision over and above the Earmarked Reserve is incorporated into the MTFS review in October 2008, for referral onto Council. It should be further noted that the full allocation will only be awarded to the SCIC should the need arise and that 2009/10 to 2010/11 allocations will be subject to annual review.

If an alternative option is approved, then the cost may reduce, but clearly this will ultimately depend on how successful SCIC is against its Business Plan

Although the scenario of SCIC generating substantial surplus is not envisaged at this stage, Members may also want to consider whether there should be a condition of clawback attached to any of the additional monies due and/or paid should SCIC’s financial position significantly improve during the period in question. Such conditions should however be based on a clear formula relating to year end surplus balances to ensure clarity for both SCIC and the Council moving forward. The detail of any clawback condition, if required, should be negotiated between SCIC and the Director of Regeneration in conjunction with the Head of Financial Services.

SCIC Business Plan Issues

The current view of SCIC is that the Business Plan position, as presented, is achievable and may very well be bettered, but there are a number of factors within the Business Plan which need to be noted, as follows.

a) Achievement of a surplus by the fourth year of operation is dependent on income from a refurbished third floor and the Little Gallery, and it is not yet formally known that this is certain – although there is a strong possibility that capital funds are forthcoming. Without this income, SCIC will find it difficult to break-even and may experience ongoing cash flow difficulties under its current business model and staffing structure.
b) The assumed level of income from the Cafe/Bar is likewise crucial to the forecast position. Although reduced to £10,000 in the first year, this rises to £32,000 in year 2 and £35,000 in year 3. Despite the considerable efforts made, this income stream cannot be considered to have been secured. Ultimate success in doing so may, again, depends on a successful tender and additional works for kitchen fit out - although there is confidence that this will be achieved.

c) The assumed levels of lettings of creative workspace are probably achievable, but they remain challenging, especially given current market conditions. SCIC report twelve substantive queries and viewing requests.
d) The level of Event Income in the first year has been set at a very modest level (under £10,000) and this may well be exceeded. By the later years this has risen to a little over £36,000. This appears realistic and again could be bettered, albeit this will have to be achieved in a competitive market.
e) Discussions with SCIC indicate that the cost base, including major staff costs, is relatively inflexible, leaving little scope for compensating cost savings if projected income levels are not achieved. But officers consider that flexibility has yet to be fully explored to their satisfaction in this very significant cost area.

Sensitivity analysis on the figures implies a number of potential variations which could seriously undermine the achievement of the forecast position – especially if adverse variations occur in combination. There are significant mitigating opportunities and there is no immediate reason to assume the actual deficit recorded will be higher than forecast. But given the risks and options, future requests for support beyond current forecast (to avoid for instance insolvency on the part of SCIC) cannot be ruled out. Under the assumptions in the report the Council would 'step-in' judging that the innovative delivery mechanism had 'been tried but failed'.

Other Issues

In respect of the change in VAT regulations referred to earlier, confirmation has now been received from HMRC that the variation, originally introduced for 2007-08 only, will remain in place for 2008-09. Therefore, if the Council were to take on the direct management of the Centre, there would be no implications in respect of irrecoverable VAT.

If the building is not transferred to the third party clawback of ERDF Grant of £450,000 will need to be considered. Unsupported borrowing cost of failing to achieve a transfer to a third party by 31st December 2008, would be an average of £34,300 pa over the first three years, with reducing annual sums over the lifetime of the building. In the event of SCIC 'failure' in the short term and the project/building reverting to the Council clawback liability must still be considered The 'in-kind' value of match funding to ERDF is based on the consideration that, by transferring the building and making it a part of the project, the Council has lost income potential in perpetuity – in effect, the total value of the un-refurbished building (£900k). It may be considered that, if the building is returned to the portfolio, the Council 'regains' this sunk value (less the value of the term income 'lost' while the building was under lease to SCIC). Simply, SCIC business failure and return of the project to the Council within ERDF lifetime may still invalidate the use of the value of the building as an in-kind contribution in the capital scheme. This is taken into account in the Options analysis.

If a situation arose that would lead to clawback of all public grant totalling £3.5m, and that this would have to be funded from Unsupported Borrowing, then the cost to the Council of a decision to abandon the project would be an average of £266,900 pa over the first three years, with reducing annual sums over the lifetime of the building. This could be mitigated by building sale although, outside of a formal valuation, there is no indication of what a sale of the building, under covenant and with no commercial sitting tenants, could achieve.

SECTION 151 OFFICER'S COMMENTS	
The s151 Officer has been consulted and her comments incorporated into the report.	
LEGAL IMPLICATIONS	
Legal services has been consulted and have no further comments.	
MONITORING OFFICER'S COMMENTS	
The Monitoring Officer has been consulted and has no further comments.	
BACKGROUND PAPERS Previous reports to Cabinet, June 2007, September 2006, and resolutions from Cabinet 24th October 2006	**Contact Officer:** Peter Sandford **Telephone:** 01524 582094 **E-mail:** psandford@lancaster.gov.uk **Ref:** PWS