CABINET

Urgent Business Report
Storey Creative Industries Centre

Joint Report of Heads of Financial Services and Regeneration & Policy Services

PURPOSE OF REPORT					
To provide an update on the Storey Creative Industries Centre (SCIC) Ltd's current financial position and for Members to consider SCIC's request for financial assistance by way of a fully repayable loan.					
Key Decision	X	**Non-Key Decision**		**Referral from Cabinet Member**	
Date Included in Forward Plan	N/A – Urgent Business				
Project Appraisal Undertaken	N/A				
This report is exempt from publication by virtue of paragraph 3 of Schedule 12a of the Local Government Act 1972					

RECOMMENDATIONS

(1) That Members agree to provide a revenue loan totalling £90K to Storey Creative Industries Centre (SCIC) Ltd as requested, to be fully repaid to the Council (including interest) over a three year period commencing February 2012.

(2) That the detailed terms and conditions attached to the loan, including requirements for the prioritisation of creditor payments, be agreed by the Head of Financial Services and Head of Governance in order to protect the Council's interests.

(3) That the General Fund Revenue Budget be updated to reflect the interest receivable.

(4) That to provide cover in the event of any potential future default by SCIC, the loan be underwritten by the Council's General Fund bad debt provision, the level of which will be reviewed twice yearly under normal arrangements.

(5) That to help manage the Council's future interest in the Storey building, Officers undertake further work to assess fully the implications of opting to tax the building and the likelihood and extent of any external grant clawback, and report back to Cabinet in due course.

1 Introduction

1.1 In previous years Members have considered reports concerning the Storey Creative Industries Centre (SCIC) Ltd. The last report was considered back in September 2008, when emphasis shifted onto the viability and business plan of the completed centre. It was recognised then that it would be challenging for the company to over-achieve against its income forecasts and that it would be hard for the company to 'breakeven' in the short term. On the basis that the business plan indicated that the SCIC would move into surplus by its fourth year of operation, authority was given to provide revenue support totalling £40,600 in 2008/09, £69,700 in 2009/10 and £28,300 in 2010/11 upfront in each year. This was subject to annual review against the company's Business Plan and if SCIC generated significant surplus in its activities, then the Council could have reduced its revenue support accordingly, or sought clawback to the value of any additional funds supplied.

1.2 Such surpluses have never materialised, however, and in recent months SCIC has struggled with worsening financial difficulties to such an extent that it is considered that the company will need financial support from some source or other, probably before Christmas at the latest, or it is expected to fail.

1.3 As a result SCIC has now formally submitted a letter to the Council requesting financial assistance by way of a fully repayable loan totalling £90K to be paid back over a three year period, including 10% interest. This is attached at ***Appendix A***. The request is supported by provision of a sustainability plan and 3 years' financial projections, included at ***Appendix B***. A summary of Officer comments on the details of the request is set out at ***Appendix C***.

2 SCIC Ltd Current Financial Position

2.1 At their meeting on 19th October, the SCIC Finance Sub-Committee were presented with half yearly draft accounts showing that they owed £130K to other organisations, including £32K to the City Council. These total liabilities could reduce to c£90K if the company is successful in recovering various outstanding monies owed to it, although the financial position could also get worse if SCIC are not able to do so. In the meantime, the position is causing significant cashflow difficulties and it has reached the point where the SCIC is now struggling to operate.

2.2 At present, there are at least 2 County Court Judgments (CCJs) against the SCIC. These include HMRC and other creditors are expected to serve CCJs or winding up orders imminently. SCIC is in the process of trying to agree repayment plans with all of its creditors including the Council.

2.3 The main contributing factors to cashflow difficulties in recent months are:

- Under-recovery of service charges (including current year) from tenants since it began operating in 2009/10, due to under-estimation of big expenditure budgets such as gas and electricity;
- Some original leases with tenants were set at levels resulting in under-recovery of rent in order to increase occupancy levels;
- Some commercial type tenants not fully accepting increased service charges based on actual costs and arts type organisations not in a financial position to accept, making it difficult for SCIC to recover its full operating costs.

2.4 The combination of the above factors has led to increasing difficulty for SCIC in being able to meet urgent payment of significant creditors including HMRC, Npower, smaller local businesses (some now starting to take legal action against non-payment) and of late, its own staff.

2.5 Furthermore it should be noted that until recently, when the extent of SCIC's difficulties were clarified, the Council had been withholding payments relating to Lancaster Visitor Information Centre (LVIC) rent and service charges. This was tied in with seeking agreement on an acceptable repayment plan for monies owed to the Council for Npower and insurance related payments.

2.6 In order to help with SCIC's emerging short term cashflow difficulties however, and to enable Officers more time to form a view on whether the SCIC could reasonably continue to operate viably (even with extra financial support from some source), the Council is now currently releasing payment of around £2K for monthly LVIC rent and service charges. It has also had to release full payment of backdated service charges for previous years totalling £8.9K, so that SCIC staff could be paid in November.

2.7 In recent weeks, although the SCIC have successfully negotiated correct recovery of current year service charges with the majority of its other existing tenants, the Company has agreed that these tenants can pay backdated service charges (totalling around £50K) over a 12 month period, to assist with their own individual cashflows. This does not provide any further relief for SCIC's current cashflow problems though.

3 Details of Consultation

3.1 There has been no formal consultation other than discussion with SCIC's Chief Executive and Finance Sub-Committee members.

4 Options and Options Analysis (including risk assessment)

4.1 Option 1 – Approve Loan Request

4.1.1 *Financial Implications* – The £90K loan would be used for cashflow purposes only. As it is not linked to financing capital works, the principal amount of the loan would not feature directly in the Council's revenue budget. Instead, it would be facilitated through the Council's balance sheet. Any provision for non-recovery would impact indirectly on the Council's revenue position, however.

4.1.2 In light of SCIC's recent financial performance, it would be prudent to underwrite any loan as there would still be risk that SCIC could default on some of its repayments and ultimately fail. As reported in Quarter 2 corporate financial monitoring, the Council's current bad debt provision is currently over-provided by £64K. This could therefore provide cover at this stage; future provision levels would be reviewed as part of the budget and at outturn in line with normal arrangements.

4.1.3 It is reiterated that the repayment plan proposed by SCIC includes 10% interest. If Members were minded to grant the loan, the actual interest costs for the Council would not be as high, but it is considered reasonable to apply such a rate when the following are taken into account:

- risk of non-recovery of full loan: SCIC would be unable to obtain a similar loan from a bank or elsewhere based on current financial performance, etc.

- the significant time and effort already spent, and still to be undertaken, by Council staff on this issue.

4.1.4 A summary of this option is provided below. Any loan granted would need various terms and conditions attached to help protect and manage the Council's interests.

Advantages	Disadvantages	Risks
More likely that SCIC Ltd will be able to continue to trade successfully. Security of SCIC Ltd short to medium term trading position should provide existing tenants with the confidence to remain in situ. Less financial and operational impact expected for the Council, i.e. LVIC can continue to operate as 'business as usual', no forfeiture of current head lease between LCC and SCIC, no external grant clawback or VAT implications (see later sections).	No guarantee that SCIC Ltd will remain solvent and that the Council can recover the full loan – so it may still cost the Council if the loan is not fully repaid.	Known expense of providing financial support verses unknown full financial / operational implications for the Council of SCIC being wound up. Whilst SCIC remains solvent and if able to recover its full costs, from the financial forecasts provided the ongoing viability of its Business Plan 'appears' achievable. Officers are still awaiting some further evidence to support these statements however, therefore a fully objective view cannot yet be provided on SCIC's assumptions. Reputational risks either way – Council could either be seen as 'not helping' or potentially 'throwing good money after bad'. Difficult to manage these risks in current media climate. The Council could help protect its interests by attaching conditions to loan, e.g. staged payments (subject to agreement with SCIC's other creditors), continued officer attendance at Finance Sub-Committee, regular monitoring of SCIC financial position, etc – but involves Officer time.

4.2 **Option 2 – Refuse Loan Request**

4.2.1 *Financial Implications* – If the loan is not approved then realistically the SCIC will be unable to continue with its operations much beyond December 2011. The full implications for the Council of this scenario cannot be determined accurately at this stage, as they will very much depend on (amongst other things) the type and outcome of any potential administration proceedings; whether or not the company can be rescued or forced into liquidation; impact on existing tenancy base; future management structure for the building, etc. There are two important factors that require specific mention, however:

Clawback of External Funding

4.2.2 Although it is not yet possible to fully quantify the operational and financial implications arising under this option, there is a potential risk that a change in use or ownership of the building could trigger clawback of ERDF, SRB, NWDA and Arts Council grant funding originally invested in the capital phase of the project. The probability of this happening is considered low in the current economic climate, particularly for NWDA and SRB.

4.2.3 In the case of ERDF, a key condition of match funding was that the Council would make a contribution in-kind, i.e. the building independently valued at £900K had to be treated as a transaction with another third party organisation. The usual period of clawback for ERDF capital schemes is 20 years, however for every year that passes the risk reduces. Indeed, the ERDF programme under which this particular scheme was funded will also be 'signed off' by European auditors in 2015 and therefore should no longer bear stringent audit requirements.

4.2.4 It is also considered that under the circumstances the funders' primary concern would be to ensure that the building continues to operate in line with its original use and lets workspace for grant eligible activities such as small / medium business space and ancillary services. That said, a further consideration is the current economic climate, which is a major issue for EU institutions – there will be many ERDF part-funded schemes and programmes that will have been curtailed and will not have delivered against their original planned outcomes. Furthermore the demise of the Government Offices will have bearing. This means that future monitoring and audit arrangements will have to be undertaken by Central government instead.

4.2.5 Overall, the likelihood of clawback does still require more investigation and assessment by Officers and so although seen as a reasonably low risk, it should not be completely ruled out at this stage.

VAT Considerations

4.2.6 A far more immediate and certain issue arising for the Council to consider relates to the complex VAT implications arising from the treatment of the original capital project.

4.2.7 As a reminder, the Storey building was refurbished through external grant funding totalling £3.5M between 2006/07 and 2008/09. This was then let on a peppercorn lease to SCIC, an independent management company (as required by ERDF funders). The arrangement was granted 'non-business supply' status by HMRC and this meant that the Council was able to reclaim all the VAT incurred on the capital phase.

4.2.8 Should SCIC cease trading and if subsequently the Council became directly involved in managing and letting out the building, either temporarily or permanently, it is reasonable to assume that the VAT implications arising would be two-fold:

- The Council would in all likelihood breach what is known as its 'Partial Exemption' limit. Whilst this is a complex area, the upshot of this occurring would be that the Council would no longer be able to recover VAT on certain supplies, and so would incur additional costs currently estimated at around £170K per year. The Council could avoid this charge only if it were able to empty the building and then sell it on, or if there was some major change in the

Council's other activities that significantly improved the VAT position.

- Under VAT regulations regarding the 'Capital Goods Scheme (CGS)', building projects are subject to a retrospective, proportionate correction to reclaimed VAT where there is a change of use (for VAT purposes) within approximately 10 years of completion. By becoming involved in direct management of the building, in all likelihood this would change the VAT purpose from 'non-business' to 'business'. This would result in a further £60K VAT charge per year, due up to 2018/19 (the tenth year after completion).

4.2.9 One way to avoid these implications is to 'opt to tax' the building, although this means that any subsequent business supply (e.g. sale or let) of the building would then be subject to VAT.

4.3 These VAT issues are complex and material but need to be taken into account should option 2 be approved, particularly as this would present further scenarios for the ongoing operation.

Scenarios under Option 2 (refusing the loan request)

4.3.1 Should SCIC ultimately fold then the Council would probably be faced with the following three main scenarios. For all of them, various incidental costs would be incurred but for now, only the key issues are highlighted.

Scenario 1 – transfer to alternative third party management company
Under this scenario, the Council would repossess the building under the terms of the head lease and look to regain the position of granting a peppercorn lease to a third party as a non-business transaction, the main risk being over what would happen in the interim, i.e. the Council may need to 'step in' to manage the building and its tenants if an alternative third party provider could not immediately be put into place. Depending on the timescales involved and the certainty with which the business could be passed over, with reference to the Council's VAT position the best option might be to opt to tax the building.

Scenario 2 – Council takes over operation itself
Under this scenario the Council would repossess the building under the terms of the head lease and take over operational responsibility on similar lines as SCIC, the main financial risk/implication revolves around whether the Council would breach its Partial Exemption limit, as discussed above. Again an option to mitigate this would be to opt to tax the building; the downside is that VAT would have to be added to the rents and service charges. The Council would have to consider the impact of this on tenants; those who are VAT registered should not be impacted on but those who are not would have a real increase in their charges, unless some other compensation adjustment was agreed.

From an operational side, future management of the operation would need further consideration as there is currently no dedicated full time capacity within the Council to take on management of the building. There may also be 'Transfer of Going Concern' issues linked to opting to tax the building and further work would be required by Officers to assess the impact of these.

Scenario 3 – Council closes or sells building
If the Council were to close the building (assuming that this would be possible) there would be no issues from a VAT point of view as there would be no business supplies from the closed building. There may need to be negotiation regarding clawback liabilities, however.

If the Council sought to sell the building on but with tenants still in situ, then there could be VAT implications arising from the sale.

There would be significant short to medium term operational implications for the Lancaster Visitor Information Centre (LVIC), which would need to be able to operate from alternative premises and will also likely lead to additional one-off financial implications to cover relocation costs.

5 Officer Preferred Option

5.1 Option 1 is the preferred option as the potential risk of non-recovery of loan repayments is considered more manageable for the Council when compared to the increased likelihood of far more significant operational and financial implications arising should SCIC Ltd cease trading. That said, it is recommended that further work be done to assess VAT options and to clarify (with the aim of avoiding) clawback liabilities, in order to give the Council greater flexibility in managing its interests in the building.

6 Conclusion

6.1 There is an opportunity for the Council to prevent SCIC Ltd failing in at least the short to medium term by providing it financial assistance by way of a loan on a fully repayable basis over three years. If approved, it is reasonable to assume that provided the SCIC at worst case continues to maintain its current occupancy levels, it can become a self sustainable operation based on its current financial projections. This should in turn protect economic benefits for the district by ongoing support of the development of the creative and cultural industries and visitor economy. There is no guarantee of such an outcome, however.

RELATIONSHIP TO POLICY FRAMEWORK

The Corporate Plan (2011-14)

The continued delivery of the Storey Creative Industries Centre (SCIC) project, with its focus on economic development within the creative industries and being home to significant public funded Arts Partners, contributes to the council's vision to "...secure a safe and prosperous community that's proud of its natural and cultural assets and provides lasting opportunities for all" and "In Lancaster this means being recognised as an important University city with an envied quality of life, strong economic opportunity and rich heritage."

The main link is to the priority "Economic Regeneration" and the focus that "Lancaster will be targeted with actions to make far more of its heritage assets, public spaces and retail offer". Other relevant lines under this priority are:

Outcomes: More tourists coming to the district and tourist income is maximised; Improve the district as a place to visit; Improved cultural, retail and tourism offer; Recognised as a visitor destination.

Actions: Maximise cultural, heritage and retail offer

Outcomes The voluntary, community and faith sector will have capacity to deliver services for the district.

Actions Develop a joint public sector approach to delivering services; Ensure our key partnerships work effectively; Work with the voluntary, community, faith sector to deliver local services.

The key strategies that support our Resource Management Framework are supported by a number of other important policy documents mentioned in the Corporate Plan. The SCIC project delivery is noted in:

Sustainable Community Strategy 2008-11

The project delivers against the following LDLSP Community Strategy priority:

- Increase economic opportunity in the whole district, facilitate access to our natural and built environment and implement an integrated transport solution to bring the major urban centres in the district together

Particular relevant 'targets' include**:**

Maximise employment and economic activity in the KNOWLEDGE ECONOMY

Place shape LANCASTER CITY and RIVERSIDE as a regionally significant visitor and shopping destination a competitive employment destination with an outstanding waterfront.

Economic Vision/Regeneration Strategy
The support for development of a "flagship creative industries centre" was a key element of the Vision strategy subscribed to by the City Council.

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

Diversity – The proposal aims to maintain a wider range of employment opportunities to residents of the area.

Human rights – No adverse impact.

Community Safety – No adverse impact.

Sustainability – The proposal aims to support the SCIC wider operation ensuring that local employment opportunities are maintained and to prevent organisations going out of business.

LEGAL IMPLICATIONS

The preferred option of a loan would appear to be the only way of keeping the company solvent. In terms of pursuing this arrangement the Council would firstly have to be satisfied that the other creditors were willing to agree to postpone their legal proceedings and to enter into an arrangement with the Company for the repayment of their debts in a structured manner.

FINANCIAL IMPLICATIONS

The main financial implications are incorporated within the body of the report.

It is emphasised here however, that the preferred Option 1 to provide a loan is not without its risks. The most obvious one being that should SCIC fall into financial difficulties again within the next three years, it may well default on some of its loan repayments and at worst case ultimately become insolvent anyway.

It would appear from the financial projections provided by SCIC though (attached at Appendix B), that its operation should become self sustainable over the coming months and that approving the loan is probably the only realistic means of facilitating this, subject to SCIC be able to:

- Maintain a minimum 85% occupancy level (note expected to rise to 95% during January 2012)
- Review its costs and service charges periodically and set at an appropriate level to ensure full recovery of its operating costs
- Recover monies owed by its tenants in a structured and timely manner
- Create lettable space on the third floor (to be initially occupied by the PROUD Project from early 2012 for approximately 2.5 years of which SCIC and Lancaster University are two of six partners in an Interreg ERDF funded scheme with rent and services charges payable by Lancaster University during this period.)

At this stage it should be further noted that Officers have not been able to fully provide an objective view on the financial information provided as the Council is still awaiting some evidence from SCIC Ltd to support its assumptions, in particular whether its tenants have signed up to new leases where appropriate and agreed to pay increased service charges, thereby covering actual costs being incurred. Summary Officer comments on the financial projections can be found at Appendix C. On a positive note, SCIC have provided evidence demonstrating that there is currently more interest in the building than actual lettable space available so in the short term at least there should be no real problems in maintaining the current 85% (or more) occupancy levels.

Under this option, there is no VAT consequence to the Council as there is no change of use and any further revenue grant awarded to SCIC Ltd would be ‘outside scope’. It is also not expected that there would be any external grant clawback arising.

Under Option 2, there are 3 main probable scenarios arising with varying degrees of operational and financial risk for the Council, including implications for the operation of the Council’s LVIC.

In summary, with regard to providing a revenue loan to SCIC Ltd, as it is assumed that this will be fully repaid (including interest) over a three year period commencing from February 2012 there should be no real cost to the Council and therefore no additional impact on the General Fund Revenue Budget. In light of their recent financial performance however, and on the presumption that the SCIC might still fail in the next 12-month period, it is considered prudent to mitigate the risk of non-payment to some degree by underwriting the loan from within the Council’s current bad debt provision, which is currently over-provided for by £64K.

Subject to Option 1 being approved, the General Fund Revenue Budget will need to be updated and reviewed on an annual basis to reflect the net impact of interest included in subsequent loan repayments by SCIC Ltd.

In addition, prior to entering into any contractual arrangement with the SCIC, all necessary terms and conditions deemed necessary to protect the Council's interests will need to be agreed by the Head of Financial Services and Head of Governance.

Should Members resolve not to approve a loan to SCIC Ltd, then a further more detailed report covering full operational and financial implications arising for the Council will need to be brought back to members once the outcome of subsequent administration/insolvency proceedings are known.

Regardless of which option is decided, Officers will continue to explore the feasibility of opting to tax the building and the likelihood of how certain grant clawback will be under the current circumstances in order to inform fully any future decisions.

SECTION 151 OFFICER'S COMMENTS

The s151 Officer has contributed to the production of this report. In the circumstances and given the implications of other options and scenarios, the granting of a loan (with associated recommendations as set out) is considered a reasonable course of action, albeit with risk attached.

MONITORING OFFICER'S COMMENTS

Provided that the loan is subject to terms and conditions which enable the Council to satisfy itself that the funding is used in such a way as to ensure so far as possible that the company is able to continue trading, the granting of the loan would seem to be a reasonable response to the problem, particularly bearing in mind the financial risks to the Council of Option 2.

BACKGROUND PAPERS Previous Cabinet reports dated June 2007 and September 2008, Briefing note by HFS to Cabinet Nov 2011, sustainability plan and Financial Projections provided by SCIC Ltd	**Contact Officer:** Julie Raffaelli **Telephone:** 01524 58124 **E-mail:** jraffaelli@lancaster.gov.uk