CABINET

Lancaster & Morecambe Economic Development Zone
Storey Creative Industries Centre
5th June 2007

Report of Corporate Director (Regeneration)

PURPOSE OF REPORT					
For Members to consider providing additional funding to proceed with the refurbishment of Storey Institute into a Centre for Creative Industries as part of the Lancaster & Morecambe Economic Development Zone, together with resolution of associated operational matters.					
Key Decision	**Y**	**Non-Key Decision**		**Referral from Cabinet Member**	
Date Included in Forward Plan	April 2007				
This report is public					

RECOMMENDATIONS

1. **Members note the progress to date on the detailed design phase and the revenue business plan.**

2. **Should Members wish to proceed with the Storey project as outlined in the report:**

   i. **That Council be recommended to allocate an additional £200,000 to the Storey project and that the Capital Programme be updated accordingly.**

   ii. **That subject to Council agreeing to the allocation of additional funds and confirmation that the project meets existing grant funding conditions, the contract to deliver the capital scheme be let in accordance with Conlon Construction's tendered financial proposal.**

   iii. **That income received from Luneside Studios for the licence to occupy space in the Storey Institute be ring fenced for year 1 start up costs incurred by Storey Ltd**

   iv. **That Members recognise the need to provide financial cover estimated at £25,000 per annum to assist with any year 1 & 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)**

v. **That Members agree the terms of the lease and service level agreements as included at Appendices 2 and 3, including the lease being at a peppercorn rent, as a basis for negotiation between the Council and Storey Ltd, subject to agreement by the relevant Cabinet Member as an Individual Cabinet Member decision.**

vi. **That the Head of Financial Services be authorised to update the revenue budget for current and future years accordingly.**

3. **Should Members not wish to proceed with the Storey project as outlined in the report, then a further report be brought back to Cabinet on options for the disposal of the building.**

1.0 Introduction

A number of previous reports have been submitted to Cabinet concerning progress with development of the Storey Institute Creative Industries Centre project. Members should be aware that the project development has been ongoing for a number of years and the scope of the project has had to be changed as a result of difficulties in securing external funding from some sources, notably Heritage Lottery Fund.

The overall desired outcomes of the project have not changed over the project development period. In simple terms the project has always been based on:

- Restoration and conversion of the Storey Institute, a dilapidated and underused building in need of substantial investment in repair and maintenance
- Creation of a new Creative Industries Centre, operated by a new and independent not-for-profit company,
- Development of a financially sustainable business and cultural 'hub' that provides a base and resources to drive the development of the creative industries sector in the district

Within these desired outcomes the project has taken a variety of forms driven by the funding expectations experienced at particular points in the project's history. The project started out as an ambitious £7 million scheme. However, the realities of competing for scarce external funding has seen the project consistently scaled back in accordance with the prevailing financial situation. Gaining certainty on the funding package over 2006 was particularly difficult. Two major funding sources, Heritage Lottery Fund (HLF) and Lancashire County Developments (LCDL) had to be discounted. The bid to HLF failed and LCDL's investment conditions were thought, on balance, unattractive and unworkable in the context of an already challenging business plan.

A report to Cabinet on 10th October 2006 outlined a number of options for the Council, ranging from abandoning the project and selling the building on the open market, through to proceeding with a scaled back "contingency " scheme with a £3.5 million budget (which depended on a £500k capital contribution from the Council.

It was made clear to Cabinet in the October report that there would have to be significant revision of the capital costs and that this 'contingency' scheme would in itself be challenging to deliver in terms of maintaining a balance between capital cost and 'fit for purpose' viability.

Cabinet decided that it could not invest £500k in the project at that time due in part to wider pressures on the capital programme.

The decision led to a 'call-in' process. This resulted in a number of resolutions arising from a Cabinet meeting on 24th October 2006:

- *That funding drawn from the Industrial aid provision (£100k), SRB under spend (£150K), and estimated revenue savings arising from concessionary travel (£150K) and treasury management (£100K) are allocated to the Storey project to make up the current £500,000 shortfall in funding.*
- *That the Head of Financial Services be authorised to update the Revenue Budget and Capital Programme accordingly.*
- *That the above funding arrangements be reviewed as part of the 2007/08 budget process, in light of the updated revenue and capital position, and in recognition of the funding risks attached.*
- *That the terms of the lease are such that surpluses achieved in the running of the Storey project be used to provide for a development fund that could be used to complete elements of the project omitted from the current scheme and repay the Council's contribution to the project.*
- *That the terms of the lease allow for the Council to step in in the event of the business plan failing to achieve its financial and European funding targets, or in the event of additional capital costs being incurred over and above the £3.1m estimated to complete the contingency plan, to ensure any risk to the Council can be mitigated.*
- *That the terms of the lease be agreed between the board and officers before being brought back to cabinet for consideration."*

Cabinet agreed to the progression of the scaled back 'minimum' plan for the Storey project to use available resources from Arts Council, SRB, ERDF, and City Council. Significant progress has been made since then, both in terms of design of the capital scheme and also negotiations and discussions with the proposed operating company Storey Centre for Creative Industries Ltd (Storey Ltd). (Cabinet agreed the principle of handing the refurbished building over for operation by an independent, not for profit organisation (Storey Ltd) in February 2006).

A tight deadline is now being imposed on the Council in relation to ERDF and SRB funding, and it is now necessary for the Council to formally confirm its own commitment to implementing the current scheme and address issues that have arisen since the last report.

2.0 Proposal Details

Full details of the proposal concept and a range of material illustrating the main features of the design will be available at the meeting. The progression of this development proposal has overcome considerable constraints but the Council's and funders' general requirements are considered to have been met. Facilities within the building will include:

- 2800 sq m of refurbished floorspace
- A refurbished Storey Gallery
- A new 100-seat auditorium space and conference venue - the first purpose-built spoken word venue in the North-West
- New Media gallery space operated by Folly

- A new Tourist Information Centre, making full use of new technology and acting as a "hub" for the wider TIC network in the district
- Visitor hospitality facilities, including a bar/restaurant/café and toilets, and exhibition space

Economic outputs from the project include

- 129 jobs generated or safeguarded in the first three years, rising to 486 after 15 years
- 22 new creative businesses in the first three years
- A programme of creative business support

Once it becomes fully operational the building is expected to become fully self-financing, including generation of funding for future repair and maintenance of the buildings, creating a sustainable long-term future for the both the property and the activities of Storey Ltd.

Design and costs of capital works

The grant funding available for the project currently stands at £3,491,695. This figure comprises an original construction budget of around £3,100,000 with the remaining funds supporting fees, charges and grant to Storey Ltd.

The process of delivering the 'contingency' or minimum scheme involved making cutbacks in key structural areas from the more ambitious scheme which would have been delivered with HLF and LCDL funding contributions. A balance has had to be achieved between issues of time, cost and quality against:

- A strategic view of whether elements were essential requirements to a viable centre.
- The potential beneficial impact of individual elements to the proposed business plan and practical operation of the completed building.

Since the beginning of the year the project design team has attempted to ensure that the 'minimum' product would meet the aspirations of the Council and Storey Ltd (as end users) via a design workshop and close dialogue. Principal key design features agreed as necessary to provide the minimum viable scheme included:

- Retaining the separate café/restaurant and bar element rather than making a combined café/bar.
- Relocating the TIC to a different room on the Ground Floor
- Relocating reception to allow potential/flexibility for integration with the TIC
- Moving proposed Folly Gallery to first floor to create a new Arts hub alongside Storey Gallery and Litfest.

Design work was completed in March and all stakeholders agree that the project provides a viable proposition even under a minimum specification.

However, the contractor and Council's cost consultant advised that uncertainty had been introduced due to the increasing inflationary pressures on the prices estimated for the previous larger HLF/LCDL funded scheme on which the 'minimum' scheme was based. A formal market based re-costing exercise was therefore required before the contractor's suppliers could commit to price certainty on the current design.

Following this exercise the design team advised that the project could not be delivered to the quality, budget and contingencies anticipated without either wholesale reduction in fit out of key areas or progression of the scheme with no contingency sum.

The contractor and Council's cost consultant has advised that to maintain the optimum balance between price, quality and risk the overall capital budget should be increased from the original estimate of £3,100,000 to £3,248,000, a requirement for an additional £148,000. These current project costs assume a start on site date in late July 2007.

Council engineers have also indicated that it may be necessary for the Council to resolve a pressing highway issue as part of this contract. An independent report by consultant engineers has noted shearing movement in a retaining wall within the curtilage of the Storey Institute on Castle Hill. The report recommends a partial or complete reconstruction to ensure the long-term safety of highway vehicles and pedestrians. Correspondence from County Council states a view that maintenance is the responsibility of the City Council as owners of the Storey Institute and not the County as Highway Authority. This is arguable as the pavement level appears to have been raised, and the increased load on the top section of the wall has caused considerable movement of its top courses.

However, Storey Ltd cannot reasonably be left with this issue and responsibility/cost liability will not be resolved in the immediate future between City and County Council. The issue is in itself part of wider ongoing discussions between the City Council and Highway Authority over maintenance of bridges and structures. Therefore, without prejudice to future action against the Highway Authority it is recommended that the wall repair be brought into the Storey refurbishment contract. The contractor advises that a provisional sum of £50,000 be allocated for further investigation, design and mitigation.

Taking into account all the above, the project is now costed at around £200,000 over budget, a principally inflationary increase of around 6% from October and it is unlikely that further savings could be made without adding unsupportable risk into the capital project. No further matching funds can be identified. Although officers would continue to work on reducing capital costs and reviewing funding opportunities, it is considered that in order for the project to progress, the Council would need to make a further contribution to the scheme from its own resources.

Business Plan

The operating company Storey Creative Industries Centre (or Storey Ltd) would be responsible for all aspects of running the building, managing staff, tenancies and the catering/conference facilities. The Company would oversee the delivery of the creative/cultural programme within the building, and in conjunction with the regional Creative Industries network, provide dedicated business support mechanisms to the local Creative Industry sector. It also has to take ownership of the financial business plan and make key decisions on income resource allocation from the baseline case business plan provided by the City Council.

The company Board has already been heavily involved in refining the design of the building. The Board has created several sub groups and is fully aware of the need to create a detailed action plan to cover the next 18 months and beyond. Project management staff would support this planning and implementation process. However, critical to this side of the process is the early involvement of direct staffing support for Storey Ltd itself. A funding allowance of around £95,000 is included in the scheme to support the Storey Board in the 12 month period prior to the projected opening. The 12 month period is known within the project as ‘Year Minus One’, and funding would cover project management support costs, marketing, programme development advertising of key posts and other board development work.

Part of the building would be let under licence during the construction period to Luneside Studios. The terms of this negotiation are ongoing but it is assumed that the Council’s income from the licence would be reinvested in Storey Ltd as part of the Council’s support to Storey Ltd’s costs in building up to opening the facility. Cabinet are asked to confirm this arrangement. (The value of this licence is still being negotiated but is unlikely to exceed £10,000 pa).

A detailed 5 year business plan has been produced to show the viability of the scheme from opening. The ‘expenditure’ side may be viewed as pessimistic to some degree in that it is based on current core building costs. Staffing levels have been agreed by Storey Ltd as acceptable to meet their and the Council’s operational objectives. A summary is attached in Appendix 1. Estimated income streams to balance these costs are generated from:

- workspace rental income;
- catering and bar income;
- hiring out the rehearsal, workshop and meeting rooms, and the Litfest auditorium;
- hosting events and conferences
- Other project based income (as this is not guaranteed it is not included in current business plan projections)

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.

If Cabinet is minded to support the progression of the project, this ‘safety net’ could be facilitated through the discretion that Cabinet has (through the Medium Term Financial Strategy - MTFS) to increase future years’ budget projections by up to £50K per year. Any sums would also be reviewed as part of future years’ budget processes also – as would Storey Ltd’s financial position.

This would also secure/mitigate any reputational risk to the Council of an unmanageable deficit being built up by Storey Ltd in the early years of operation. .

3.0 Options and Options Analysis

Option analysis

Cabinet considered the arguments for and against proceeding with Storey Institute project in September and October last year. Essentially, the options/arguments remain as before and are summarised and updated as follows:

Option	Advantages	Disadvantages	Risks and Mitigation
1) Do nothing – Abandon the project and continue to operate Storey Institute as at present.	Avoids the risks associated with undertaking a complex, externally funded capital scheme and any risks associated with the ongoing operation of the CIC.	Immediate loss of almost £3 million of external funding from ACE and ERDF Leaves the Storey Institute in its dilapidated condition and in need of major repair and maintenance (estimated at over £2 million) The building is now unoccupied (apart from Oxford Archaeology) and there would be a substantial revenue deficit unless new tenants can be found Over £400,000 of public investment in the project development work will have been wasted. Design fees of around £70,000 will have to be funded by the Council plus 'highway' costs of around £50,000. Adverse impact on the Council's reputation with key partners. No contribution to overall Council 'vision' and economic development/regeneration objectives.	1) Leaves the Storey Institute in its dilapidated condition and in need of major repair and maintenance (estimated at over £2 million). 2) Risk of continuing revenue deficit if sufficient new tenants cannot be found 3) The main form of mitigation would be to move to option (2) below – sale of the building.
2) Abandon the project and attempt to sell the building to a private sector investor/developer	No cost to the Council's capital programme Generation of a possible capital receipt	(As for option 1): Loss of almost £3 million of external funding from ACE and ERDF (As for option 1): Over £400,000 of public investment in the project development work will have been	1) No certainty that a suitable purchaser could be found. In this case, the Council would be in the same position as for option 1, facing continued dilapidation of the building and escalating repair and maintenance bills 2) Risk that a private sector purchaser would be able to over-ride the covenant and change the use of the building to more

		abortive. Design fees of around £70,000 will have to be funded by the Council plus 'highway' costs of around £50,000. Possible adverse public reaction to the sale of the Storey Institute. No external funding available to support the private sector in developing a viable scheme.	profitable uses which are not in keeping with the original bequest to the City by Sir Thomas Storey.
3) (Preferred Option) Affirm the decision of October 2006 but increase council capital contribution by £200k and implement the scheme within acceptable quality and risk thresholds.	Secures a sustainable, long term future for one of Lancaster's key heritage assets Can achieve the full range of economic development and regeneration benefits arising from this project Maximises the financial viability of the building Storey Ltd and provides the best opportunity for creation of a viable business. Avoids unsupportable quality/risk issues which would otherwise inevitable occur. Resolves a serious highway issue.	Requires the current council capital contribution to be increased to £550,000, with no provision for recovery. Commits the council to the risks associated with undertaking a complex, externally funded capital scheme with a third party operator. Lost opportunity to generate a possibly substantial capital receipt	1) Risk of overspend is inherent in a complex, externally funded**,** capital project. These have been mitigated by the use of the Partnering approach. The project team has worked on an open basis to secure a maximum market price for the build, within which the Council's partner contractor Conlon Construction will be contractually obliged to deliver the scheme. The 'partnering' method of procurement is regarded by experts as the single most positive step a project can undertake to control capital cost risk. The risk of matters outside the contract impacting adversely on the agreed maximum price are/will be reduced by: • Early contractor involvement and commitment to partnering and ongoing value engineering against agreed work packages, provisional sums and identified risk items; • The quality of contract design documents and the upfront appreciation of end user needs/expectations; • Adequate risk contingency monies for unforeseen impacts; • Quality of the design team and their length of involvement and knowledge of the building; • Independent cost consultants employed on behalf of the Council The contractor is offering a 'maximum' price (equivalent to a tender figure) with a lower 'target cost' set as a performance indicator. It is the intention of the project team to drive towards this lower figure with any savings accrued returned to the project to assist in further mitigating potential risk items. Project costs

			and variations will also be monitored through the use of LAMP methodology and any risks of cost-over-run will be identified at the earliest practical stage so that appropriate action can be taken. In accordance with LAMP methodology, a full capital project Risk Log has been produced and is available as a background paper if required. 2) There are risks to the revenue costs of the completed building in handing it over to a not for profit organisation. These are quite complex issues and are outlined in the text below.

Discussion and Preferred Option

The issues surrounding the original proposed investment in the project by the City Council have been well rehearsed in previous reports, but can be summarised in the question: Does the benefit of maximising the capital funding available to the project outweigh the impact of doing nothing?

Should the Storey scheme be abandoned, and if the Council chooses to continue to run and operate the Storey building, the liability for running costs will fall back on the Council to generate. The Council may also have less rental income from tenants who have already left the Storey building as there is no guarantee they will return to a building that has not been maintained.

This situation points to an option, where in order to avoid high ongoing net running costs and a call on the capital programme, the City Council could choose to try and dispose of the building. This option also has other difficulties in terms of:

- Trying to sell a poor quality building in need of high investment with a restrictive covenant;
- A building within the Council's portfolio continuing to deteriorate;
- Popular community reaction against the council selling off a building to which it is a 'custodian'.

It does have the advantage, however, of generating a possible capital receipt, to help fund the capital programme.

Through inflationary pressures and a detailed market based testing exercise the £3.1 million budget is, unfortunately, considered to be insufficient to deliver the minimum viable scheme without unacceptable cost risk to the Council. The introduction of the recent highway issue introduces another element of cost/risk burden to the scheme. The council's cost consultant, working closely with the contractor, has clearly advised that to reduce high cost/core elements of the scheme (particularly building envelope and mechanical and electrical work) will lead to problems in the ability of the contractor's supply chain to deliver. There is no further benefit, in terms of price, to be gained from driving down the price offers from key subcontractors.

There may be small gains to be made on fit out elements, but the end user must be given a building that is fit for purpose as a minimum and which can generate income from day one. It is not feasible for the Council to deliver to Storey Ltd a simple 'shell' as may be expected under a standard commercial arrangement for premises or workspace. The project specified a minimum standard fit out allowance for key public areas such as the auditorium, bar, café and gallery spaces for optimum income generation. It will be 'false economy' to reduce allowances for items which will be key to the end building experience.

Therefore, the preferred option is Option 3 – additional capital funding to allow the minimum scheme to proceed.

Members should note that since October, design costs of around £70,000 have been incurred in revising and developing the scheme and these would have to be paid by the Council if the project did not proceed.

If members agree to the approval of additional £200,000 this will bring the Council's capital investment in the project to £550,000.

Risks/Benefits associated with the preferred option

Cabinet agreed the principle of handing the refurbished building over for operation by an independent, not for profit organisation (Storey Ltd) in February 2006. For the City Council, this is an innovative approach, and members will need to be aware of the specific risks and benefits that this approach presents.

Primarily, these relate to the risk that Storey Ltd fails to achieve the income targets in its business plan, and runs into financial difficulties, either at an early stage or later in its operational life. Should this lead to a change in the use or ownership of the building, this could potentially trigger clawback of the ERDF, SRB and Arts Council grant aid invested in the building.

Should Storey Ltd run into financial difficulty, the Council would be faced with three main options:

Option	Comments	Clawback risk
1) Provide short term revenue support to Storey Ltd to help it keep trading and recover	This would have to be judged on the circumstances at the time, including availability of funding within the Council's own budgets and an assessment of the strength of Storey Ltd's prospects for recovery.	Minimal, provided Storey Ltd continue to operate and let the workspace for grant eligible activities (ie small /medium businesses)
2) Repossess the building under the terms of the lease, and operate it directly, on similar lines to its recent operation, as flexible workspace with minimal staffing (eg caretaker/receptionist)	This effectively puts the Council back to where it is at present, but with a refurbished and repaired building with no immediate maintenance and repairs liability. There may be a short-term income deficit if the building is not fully occupied, but on past experience the building may be capable of running at break even or better.	Negotiations would have to be held with GO-NW to determine whether this would invalidate the use of the value of the building as an in-kind contribution in the capital scheme. Potentially, this could lead to clawback of part or all the ERDF grant. It is expected that GO-NW's primary concern would be to ensure that the building was continuing in the use for which grant was given (ie managed workspace) and that they would be supportive of the Councils' actions under this option.
3) Repossess the building under the terms of the lease and sell it to a third party at market value.	The building value would have been enhanced by the refurbishment scheme and would exceed the current £900k valuation, but cannot be quantified at present.	Clawback of both SRB, ACE and ERDF grant would be triggered. This would be offset by the receipt from sale of the property. It is not possible at this stage to say whether the receipt would meet or exceed the clawback amount.

Members should note that the risk of Storey Ltd's failure has been mitigated as far as possible by recruiting company directors of considerable quality and experience. A recruitment process facilitated by Business in the Arts North West (BIANW) appointed the members necessary to allow the company to legally discharge its responsibilities. Individual directors have considerable experience of running companies in both the profit and non-profit making sectors and there is particular expertise in workshop facility and marketing/events management. Project management staff will continue to support the company's planning and implementation process.

In broad terms this 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 benefits of this type of management and ownership outweighs the risks and any opportunity costs. There are risks, but they can be minimised and managed – there is plenty of experience to draw on. All parties are working together in a business focussed approach which, while not the norm within the public sector, is an approach that works. The stake that Storey Ltd has in the building imposes a degree of financial and legal responsibility but also gives greater freedom to exploit the building's potential. There has been a rational and thorough consideration of the risks and officers consider this project to be a 'smart' investment of public funds and the council's own asset which has the potential to achieve high level outcomes.

4.0 VAT, Lease and Service Level Agreement

Members should be aware of the impact of certain resolutions made by Cabinet if it agrees to proceed with the capital scheme as outlined above.

Previous detailed VAT studies indicated that the preferred Management structure for the completed building would involve the development of an Independent third party trust/management company to take on a fully repairing and insuring lease and run the refurbished building. The creation of such a body ensured that VAT on the capital build cost incurred by the Council would be reclaimable if a lease was offered at a true 'peppercorn' and as 'non-business supply'. This approach eliminated the risk of Lancaster City Council exceeding its VAT threshold on 'non-statutory/essential' activity.

However, as noted in Section 1.0 Cabinet has resolved:

> *That the terms of the lease are such that surpluses achieved in the running of the Storey project be used to provide for a development fund that could be used to complete elements of the project omitted from the current scheme and repay the Council's contribution to the project.*

This resolution has a fundamental impact on the project approach and VAT risk. Informal advice from the HMRC is clear that the capital project's 'non-business' status would be invalidated by lease clauses that demand:

- A requirement for the repayment of any capital sum expended on the refurbishment
- A requirement to deliver the building back to the Council in an improved form
- A requirement to carry out, or make financial contributions towards, any arts/creative industries activities beyond those involved in meeting the Centre's own output objectives (though the Council can be specific about what those outputs are to be).

If Cabinet wishes to control or make use of the income generated during the period of the lease then it has to use an 'Option-to-Tax' route to be certain to reclaim VAT on the build costs. However, under this route a 'demonstrably commercial' rent must be set or the arrangement could be viewed as contrived and in contravention of anti-avoidance legislation. For certainty, then, the lease should be clearly either a 'commercial' or 'non-commercial' arrangement.

The main problem with a 'commercial' arrangement is that the business plan has been developed on the basis that there will be no rental liability on Storey Ltd. It is difficult to define what is commercial in terms of HMRC attitudes and the context of this project. If the Centre could obviously make £150k a year before rent and rent was set at £1k, then this would appear to look like a preferential, not commercial, arrangement. However, if the company is making very modest profits then £1k could be considered 'commercial'. There is also the risk of protracted negotiation between the company and the Council before this issue could be resolved. It is inevitable that a rent would have to be low making 'payback' relatively meaningless when compared to the Council's capital investment.

The Council is however able to exercise control through a number of elements in a 'non-commercial' approach that reduce the risk of non-performance of the company while giving VAT certainty. A 'peppercorn' lease is still able to define overall use of space and include the grant funder's use terms (Draft terms currently being discussed are attached in Appendix 2). It also allows the Council to 'step-in' in the event that Storey Ltd's business objects or terms of reference are altered to move the company from its current 'not for profit' status.

There is no VAT issue if the Council defines targets and actions through direct grant funding to Storey Ltd. In section 2.0 it was noted that some grant will be paid to Storey Ltd for project development purposes. Storey Ltd's access and use of these funds can be made conditional on specific achievements in terms of outputs and outcomes. A draft service Level Agreement is attached for information (Appendix 3).

In summary, Cabinet could commit to the arrangement with Storey Ltd as 'non business' under the broad lease and Service Level terms outlined and be confident that its own VAT position is secure and that an appropriate degree of control is being exercised over project outcomes. The apparent downside to this is that the Council would not be able to recover any of its capital contribution to the project, if Storey Ltd ever generated sufficient profits in future – but realistically there is little prospect of this situation occurring. (Members should also note, however, that recovery of the Council's contributions to the capital scheme could have led to complications with external funders, notably ERDF, as such repayments could be subject to clawback). This is different to the resolutions of Cabinet back in October, hence the re-consideration of this issue.

5.0 Conclusion

There is an opportunity to bring to fruition a development project that will contribute to the growth of the local economy by the provision of new employment generating workspace and supporting the Storey Ltd to become a powerful advocate for the creative industries sector in the district. This will require a significant financial contribution outside of the current Capital Investment framework and budgetary projections, however. Members are therefore asked to consider whether this scheme should proceed or not, under the terms outlined in the recommendations.

RELATIONSHIP TO POLICY FRAMEWORK

Corporate Plan - The project contributes towards the following Strategic Objectives Corporate Plan Priority 4 – "To lead the regeneration of our district

The capital financing position of the project falls outside of the Council's approved Capital Investment Strategy, however. That is why Cabinet would need to make recommendations on to Council, should it wish the project to proceed.

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

CAPITAL

In line with the Council's Capital Investment Strategy, funding of the increase of £200,000 in the capital cost of the scheme will require approval by Council. The basic options are:

- use of prudential (unsupported) borrowing,
- additional use of revenue funding, and
- reductions elsewhere within the Capital Programme.

The outline implications of each are as follows. These would be assessed in greater detail for any subsequent report to Council.

- Including both interest and repayment of principal, the costs of borrowing would be between £17-20K per annum over the 25 year term of the project.

  Cabinet may be aware that following additional grant funding being obtained for the Luneside Scheme, there is almost £0.5M of 'unused' prudential borrowing, the costs of which have been provided within the revenue budget. Nonetheless, if Members choose to allocate any of this borrowing to the Storey project, there will be borrowing costs incurred as outlined – these would be avoided if the scheme did not progress.

- With the use of revenue funding, then compensating savings would need to be found, which could impact directly on the achievement of other objectives or priorities. Alternatively, if additional revenue reserves could be identified, there could still be a loss in investment interest of around £12,000 per annum.

- Reductions elsewhere within the Capital Programme would also impact directly on the achievement of other identified objectives and priorities.

REVENUE

The latest financial projections, as prepared by the Board of Storey Limited, have been reviewed in detail. In summary:

- adequate provision is made for expenditure, including levels of staffing sufficient to support the operation of the Centre,
- the one amendment that has been identified is that allowance should be made for irrecoverable VAT, estimated at approximately £15,000 pa, (note- this concerns Storey Limited's ability to recover VAT and is a separate matter to the VAT implications of the project for the Council, which are dealt with below,)
- there are remaining risks around two of the three main income streams, as follows:
  - lettings of creative space – targets are attainable, but challenging, with material risk of non-achievement, and
  - casual lettings of auditorium, etc – high risk of non-achievement,
  - the Board has identified a number of potential additional income streams which can be reasonably expected to mitigate these.

Taken together, these indicate that there is a material level of risk that financial targets will not be met, and that Storey Limited will require financial support during its early years of operation. Should this be the case then there are a number of potential sources of such support, but direct support by the Council may very well be needed and so some provision should be made for this at an early stage.

There are no net cost savings arising directly from the project to cover this. A number of possible other savings and additional income have been identified, but these are not yet definite. However, the key issue now is that, if approval is to be given to the progression of the scheme, the need for this provision is recognised and this is reflected in the recommendations. This could be provided through the existing flexibility and discretion that Cabinet has to increase future years' budget forecasts, as outlined in the report. Further detailed consideration would also be included within the 2008-09 budget process.

The recommended minimum level for such provision is £25,000 per annum for the first two years.

Storey Limited has a good prospect of its operations being self-financing by no later than the fifth year, but the possibility that it will require financial support, even if at a reduced level, into the fifth year and beyond, cannot be ruled out entirely, and Members would need to accept this residual risk. Should the performance of Storey Ltd be considerably poorer than anticipated, the Council would need to consider alternatives as set out in the report - such as stepping in as landlord and assuming control of the building, or agreeing a revised plan with some further initial short term revenue support - if there was convincing case that this would achieve a sustainable future for the Centre in the longer term.

Given the ongoing revenue position, as set out above, there is, unfortunately, no real prospect of Storey Limited being in a position to make the repayment of the Council's contribution to the capital cost, as was previously envisaged. Members should also note, however, that recovery of the Council's contributions to the capital scheme could have led to complications with external funders, notably ERDF, as such repayments could be subject to clawback.

Other revenue implications to note are as follows:

Luneside Studios: The recommendations provide for this income, estimated in the region of up to £10,000 pa to be used to help with Storey's start up costs. This has not previously been budgeted for, and so would not have any net impact on the Council.

Storey Gallery: At present the City Council provides grant funding to this organisation, which leases premises within Storey Institute. Once the Centre has opened, its rent payable will increase but it is assumed that the level of City Council grant funding will remain at current levels.

ASSET MANAGEMENT

The Council's principal contribution to the project, i.e. the commitment of a key asset with an estimated market value of £900,000, remains unchanged.

GRANT FUNDING

In the light of the changes made to the project, compared to the original proposals, clarification is being sought in order to ensure that these developments have had no impact on the validity of the existing grant funding approvals. This is for completeness and to ensure that the Council's interests are safeguarded, rather than because there is perceived to be an immediate problem. Should any difficulty be encountered then this would be referred to Cabinet.

VAT

A number of complexities in respect of VAT have been addressed.

In summary, in order to recover the VAT incurred on the capital project (a sum in excess of £500,000), and avoid rendering certain other amounts irrecoverable, the Council must either:

- charge Storey Limited only a peppercorn rent and classify the arrangement as 'non-business, or
- charge Storey Limited a 'commercial rent' and opt to charge VAT on this amount.

The latest advice from HM Revenue and Customs has indicated that, in this instance, a commercial level of rent could be a relatively low amount, eg £1,000 pa, which would not, in itself, jeopardise Storey Limited's financial viability.

The key distinction is that if the Council wished to require Storey Limited to either:

- make repayments of the Council's contribution to the capital scheme,
- carry out further development works to the building
- use its resources to contribute to the Council's activities beyond the operation of the Centre and its objectives, or
- provide the Council with any form of service, other than at full market price,

then the 'non-business' option would be invalidated and a 'commercial rent' would have to be charged.

If the Council does not wish to make any such requirement (and see above comments on the likelihood of the Business Plan being able to support them), then the 'non-business' route (i.e. based on a peppercorn rent) is the less complicated and the more appropriate of the two.

Should Members wish to pursue the option of disposing of the property instead of completing the project, then more work would be required to firm up options and likely disposal values. In essence though, the more development constraints etc. that Members wished to attach to the building, the lower the likely sale proceeds.

SECTION 151 OFFICER'S COMMENTS

The report provides up to date information on the estimated costs, together with financial and other associated risks attached to the project, based on contract prices and a more robust appraisal of the business plan. It also includes available indicative information on the implications for disposal of the property, although more work would be required to assess detailed options for this and this is reflected in the recommendations.

In essence the report sets out a clear choice for Members, i.e. whether to identify and allocate further capital and revenue funding to allow the scheme to progress, or whether to pursue disposal of the property. Each of these options would help support different objectives under the Corporate Plan – it is a question as to which one should take priority.

In reaching a decision, the s151 Officer would advise Cabinet to have regard to the financial outlook of the Council, in particular:

- capital prospects, including the need to generate capital receipts to fund the existing programme, as well as yet unquantified capital pressures such as those in relation to the wider accommodation review.

- Revenue prospects and the need (and scope) to make ongoing revenue savings if Council Tax / MTFS targets are to be achieved. This also includes consideration of prospects for Government funding, in line with the Comprehensive Spending Review.

The completion of the project would add further pressures to the Council's financial position. If Members wish the project to go ahead, therefore, the s151 would advise that Members need to be satisfied that they can achieve sufficient income and / or savings in order to deliver a balanced capital programme and revenue budget for the future.

The current Capital Investment Strategy, which was approved by Council in March, basically provides for any extra capital resources (such as from additional land sales or from unused prudential borrowing) to be 'set aside to cover any potential funding difficulties attached to the forecast capital receipts assumptions. It will not be used to support new or additional capital investment'. Should Cabinet wish the project to proceed, the extra investment required would be contra to the Strategy, hence the reason why referral on to full Council would be required.

LEGAL IMPLICATIONS

Legal Services have been consulted and will advise on the form of lease and service level agreement to satisfy the requirements for this proposed scheme

MONITORING OFFICER'S COMMENTS

The Monitoring Officer has been consulted and has no further comments.

BACKGROUND PAPERS	Contact Officer: Paul Rogers
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