Further Operating Model Analysis

At Policy, Resources and Economic Development Committee 10th July 2019. Members highlighted that within Appendix 9, Option 1 (Do nothing) generated a higher average net income than the proposed Option 3 (Wholly Owned Company or Third Party). As part of the recommendation to take the report to Extraordinary Council further analysis works was required around these two options to aid members in understanding why Option 3 was the recommended Option.

Currently the pavilion and surrounding site costs the Council in the region of £230k per annum. This includes costs associated with the park and play area, current pavilion, golf course, pitches and bowls area. The business case is proposing ways of improving the site and services provided there at the same time offering the best financial recommendation for the Council.

Background

Brentwood Council opted to apply the VAT sports exemption in September 2018. By applying this exemption, where sporting supplies were now exempt rated rather than standard, the Council was able to make a claim with HMRC for previous years taxed income. This generated the Council a one-off income figure of £

As the Council makes exempt supplies it must carry out an annual partial exemption calculation. Within this period the exempt input tax, should not exceed 5% of the total input VAT incurred by a local authority. If the partial exemption limit is exceeded, the local authority must repay all the VAT it has recovered in relation to its exempt supplies during the financial year.

Currently the Council's partial exemption averages around 4%. As the development of KGPF pavilion is to provide sporting and leisure services, the build costs will form part of the partial exemption calculation and the Council is likely to exceed its partial exemption limit by approximately 30%.

The Council sought advice from KPMG regarding this matter. This advice is provided within Appendix 9 with Appendix B.

Based on the advice, options regarding the pavilion's operating were investigated and financially modelled. Below is further information and analysis with regard to the two options.

Options and Analysis

Appendix 9 was formulated using the allocated budget of £7miilion, however the total cost of the build needs to be increased to £7.173, this is predominantly due to the increase in cost for the preferred Splash pad option of a recirculation system. Details of this are disclosed in Appendix 8, within Appendix B. The original budget for the Splashpad was £250k, the proposed option increases the budget by £150k with a further £23k required for professional fees and surveys associated with the whole build.

In addition, since the original report was published, it has been confirmed that HMRC do not deem soft play as sporting income and therefore income should standard

rated. Therefore, the income associated with this has reduced as the proposed fee's and Charges within the model now include VAT. It had been considered to add VAT onto these existing charges, however the view was that this would make the fees & charges too expensive. Assumptions around the business model are detailed within Appendix D

Taking these changes into account, the following Option analysis have been revised.

Option 1 – The Council builds the pavilion and operates the building.

Costs below in Table 1 highlight the increase cost of the building due to the VAT on the build costs not being able to be reclaimed by the Council. It then details the income from the operation of the building.

Table 1: Partial Exemption Increase to build Costs

	£
Required Investment	7,173,000
VAT on Investment at 20%	1,434,600
Total Investment for KGPF	**8,607,600**
Income from operation	**(1,551,911)**
Expenditure	
Expenditure on operation	888,705
Interest on Total Investment at 2.5%	215,190
Minimum Revenue Provision on investment	219,082
Total Expenditure	**1,322,977**
Net income from Operation	**(228,934)**

Due to the Council exceeding its partial exemption limit of 5% the Council would have to repay HMRC the full amount of VAT incurred on exempt supplies, not just the amount associated with KGPF or the amount that exceeds 5%.

Based on 2017/18 the Council recovered £94k of VAT relating to exempt supplies. This is broken down as £52.5k Revenue and £41.5k capital. This is assumed as an average year pressure.

Table 2 highlights the decrease to the net income from operation due to the additional VAT that would have to be repaid. As the net income from operation is a revenue income, the VAT associated with capital costs has not been deducted from the income. This is due to capital needing to be accounted separately to revenue. However, as the unclaimable VAT increases the Capital Programme costs, this will be needed to be funded, our Medium-Term Financial Plan (MTFP) assumes all capital works are fully funded by borrowing, this incurs revenue pressures.

Table 2: General Fund Impact & Option 1 Return on Investment

	£
Net income from Operation	**(228,934)**
General Fund VAT unclaimable	52,500
VAT unclaimable for Pavilion supplies	58,707
Increase in Capital Borrowing Costs	2,075
Net Income to BBC	**(115,652)**
Council Return on Investment	**1.34%**

As the newly built pavilion, under this option, will be managed by the Council. Cost's associated to running the pavilion will contribute towards the Council partial exemption calculation for future years.

Increasing the financial risk that the Council would breach its partial exemption limit year on year.

Potential Pressure to the General Fund would be an increase of **£113,282 per annum.**

In order to mitigate this financial risk, the proposed Option is Option 3. However another option was considered before this proposal.

Option 2 – Pavilion operated by an Unconnected Party

Appendix 8 within Appendix B, does refer to a further option. This option involves the Council building the pavilion building and then contracting the operation of the pavilion to an established leisure company not connected with the Council.

This option would receive a Commercial rent and therefore would be subject to VAT so the build costs associated with the new pavilion would not form part of the Council's partial exemption calculation.

The Council would only receive the lease income from this option. Table 5 highlights the return on investment for this option.

Table 3: Option 2 Return on Investment

	£
Total Build Costs	7,173,000
Lease Income	(400,000)
Car Parking Income	(116,000)
Saving on existing Expenditure	(71,672)
Total Income	**(587,672)**
Total MRP & Interest	398,407
Net Income to BBC	**189,265**
Return On Investment	**2.64%**

Option 2 creates a higher return than Option 1, Option 3 supersedes this return to the Council.

Option 3 – Contract operation to Wholly Owned Company or Third Party.

This option transfers the operation of the pavilion and leisure services to a Wholly Owned Company. By doing this, the Wholly Owned Company does not need to apply the sports exemption to the sporting services provided. Instead the Fees & Charges would include VAT as the wholly owned company would look to opt to tax the building and surrounding area of supply.

As the Council is choosing to opt to tax the land associated with the pavilion and new services provided, the rental charge to the Wholly Owned company would be standard rated, therefore the build costs would not count towards the Council's partial exemption limit.

Currently, the lease income from the Wholly Owned Company is £33,995 less than the Council's financing costs. Originally the financial model, assumed the Wholly Owned Company would retain the car parking income. However, it has been recommended the Council would maintain ownership of the car park, setting the fees and charges and enforcing the car park. Therefore, in order to make a reasonable return to a wholly owned company for operating the pavilion the lease income was reduced, with the conclusion that £33,995 of the car parking income would fund the Borrowing costs not covered.

Information regarding the assumptions on Car parking Income is detailed within Appendix D

The business model of the Wholly Owned Company has developed since original publication. It is assumed that the WoC would require to borrow working capital in order to support the cashflow required for the first year of operation. Generating an additional income to the Council.

Service Support Recharge is an assumption that BBC will provide some back-office support element to the WoC and therefore would charge the WoC for these services.

As the Pavilion would be operated and managed by the WoC, the Council would no longer need to budget for the running costs associated with the pavilion. This would generate a saving to the current General Fund budget.

Table 3 details the income to the Council if a WoC managed the operation of KGPF Pavilion.

Table 4: Option 3 WoC Return on Investment

	£
Total Investment	**7,173,000**
Income to BBC	
Car Parking Income	(116,000)
Lease Income from WoC	(364,412)
Interest at 2% on Working Capital Loan	(23,506)
Service Support Recharge	(79,171)
Saving on existing expenditure	(71,672)
Total Income to BBC	**(654,761)**
Expenditure	
Interest on borrowing	179,325
MRP on Borrowing	219,082
Total Expenditure	**398,407**
Net Income to BBC	**(256,354)**
Council Return on Investment	**3.57%**

Table 4 below details the Income and Expenditure associated to the WoC for operating the pavilion and associated services.

The financial model assumes the WoC will charge VAT on it's Fees & charges and reclaim VAT on expenditure. Option 1's gross income is higher than the income in Table 4, as the majority of the income is not standard rated due to applying the vatable exemption to the fees & charges,

It should be noted that it is assumed the WoC is 100% owned by the Council as shareholders and therefore any profit made on operations, can be reinvested into the Pavilion or paid as a dividend income to the Council which would increase Investment Income in the General Fund.

Table 5: WoC Operating Return on Investment

	£
Total Income	(1,301,483)
Total Expenditure	1,171,562
Operator Surplus	**(129,921)**
Interest on working Capital	47,063
Profit after interest	**(82,858)**
Corporation tax	14,914
Profit After Tax	**(67,944)**
Return on Operating	**5.22%**