Gravesham Borough Council

Report on the impact of the Council's arrangements during 2018/19 and 2019/20 in relation to St George's Shopping Centre

October 2023

Contents

1	PREFACE	2
2	EXECUTIVE SUMMARY	2
3	METHODOLOGY AND ACKNOWLEDGEMENT	3
4	BACKGROUND	3
5	KEY FINDINGS	6
6	CONCLUSION AND RECOMMENDATIONS	16

1 PREFACE

1.1 Grant Thornton UK LLP (“Grant Thornton”) is the appointed external auditor to Gravesham Borough Council (the “Council”) for the financial years of account 2019/20 and this report is based on our value for money work on the audit for that period. This report also considers matters that have arisen in relation to the 2018/19 accounts.

1.2 The issues reported upon here concern the Council’s transaction with Reef Estates Limited (“Reef”) and Aviva Investors Commercial Assets Group Limited (“Aviva”) in June 2018 relating to: (a) the St. George’s Shopping Centre (“St George’s”) in Gravesend, (b) the Council’s due diligence prior to entering into the transaction, (c) the accounting approach used in relation to the transaction, and (d) the financial impact of the transaction on the Council.

1.3 It is acknowledged that there has been a significant passage of time between the transaction taking place and the reporting of our findings. The reason for this is that following Grant Thornton’s challenge to the accounting treatment of the St George’s transaction, Grant Thornton and the Council sought external advice on the accounting treatment. During this period, we have seen the Covid-19 pandemic and the cost-of-living crisis which has adversely affected the financial effect of the transaction. Our work has focused on the governance arrangements in place at the time of the transaction, and this report sets out our opinion and assessment of relevant matters based on our review and analysis of the evidence available. It is not the role of Grant Thornton to review the quality of external audit services provided to the Council. Therefore, this is not a review of the external audit services provided by Grant Thornton to the Council, rather it is a review of the Council’s governance arrangements in place relating to the St George’s transaction.

2 EXECUTIVE SUMMARY

2.1 The St George’s project represented a large-scale commercial transaction in proportion to the size of the Council. In 2018/19, when the initial transaction took place, the Council’s annual net revenue expenditure was £15.1m. The St Georges transaction was initially calculated at a total £131m over 50 years. The Council has advised that updated financial modelling supports the £131m calculation.

2.2 The structure of the transaction, which is known as an “income strip deal,” was novel for the local government sector at that time and the Council understood they were only the second local authority to enter into this type of transaction.

In engaging external advisers, the Council recognised there were experience gaps in-house. However, in our view and as set out in this report, there were significant weaknesses and limitations in the level of independent advice and due diligence that were undertaken to support the Council’s decision to progress the St George’s transaction in May 2018. In our view the transaction was entered into without a full understanding of the planned and potential financial impact nor a full appreciation of downside risks.

2.3 Central to our findings is that senior officers at the Council were delivering a key Council priority to regenerate the town centre which had cross-party support. Officers did not have experience of a similar transaction. This was recognised by the Council by engaging external advisers as part of their due diligence. However, officers placed inappropriate assurance and reliance on some aspects of their advisers’ due diligence and did not present some of the key due diligence findings in detail to elected Members including the LINK report which was received later than anticipated.

2.4 Members were not presented with a full business case with sufficient detail to make a fully informed decision and effectively scrutinise and challenge the proposals put forward by officers.

2.5 The decision on St George’s was taken in the context of Council’s senior officers and members feeling under significant time pressure to identify an alternate development solution by their then-development partner. Officers and members should have recognised the weaknesses in the due diligence and associated governance arrangements when they decided to proceed in May 2018, and when the contracts were signed in June 2018. In our view, the Council should have considered a brake to the transaction while all necessary actions were completed, and all risks were fully considered and understood (notwithstanding the time pressure that the Council considered it was under).

2.6 Overall, in our view and based on the issues noted above, the decision taken in relation to St George’s reflected a significant weakness in the Council’s governance arrangements supporting this decision.

2.7 The financial consequences of this decision, which have been exacerbated by the Covid-19 pandemic, in addition to recent national and global economic conditions, are still being worked through by the Council. However, the St George's transaction will have a long-term financial impact on the Council. While we recognise it would have been difficult for the Council to have anticipated in 2018 the impact of the Covid-19 pandemic and subsequent inflationary pressures, it is reasonable to have anticipated that the economic landscape might change over the 50-year lifespan of the project. The failure to fully understand the initial accounting implications when the agreement was entered into, has adversely affected the Council's ability to understand the risks it might face and its ability to respond promptly once risks started to manifest.

2.8 The Council's current position has been compounded by not appropriately analysing any downside scenarios which would make the transaction unsustainable over its 50-year term, and by not considering these scenarios (however unlikely) as part of the detailed risk assessment presented to members. The Council's financial modelling only considered relatively modest fluctuations in rental income. The decision paper presented to members lacked robust commentary on how the transaction would continue to be financially viable under differing adverse scenarios over its lifespan, notwithstanding the fact that the adverse scenarios that crystallised with Covid-19 and subsequent inflation were more extreme than could have reasonably been predicted at the time.

3 METHODOLOGY AND ACKNOWLEDGEMENT

3.1 This report is based on extensive documentary review, a range of interviews with current officers and members of the Council and consultation of drafts. A number of senior officers holding roles at the Council in the period leading up to the St George's transaction have subsequently left the Council and they have not been interviewed as part of this work.

3.2 This report sets out our opinion and assessment of relevant matters based on our review and analysis of the underlying facts.

3.3 We would like to thank all those who participated in our work in producing this report. In particular, we would like to acknowledge the Council's current officers, who ensured we were provided with the support and information to complete our work.

3.4 We also acknowledge that the passage of time has rendered this review more difficult, in terms of the work needed to ensure accuracy of findings.

4 BACKGROUND

4.1 The Council owned the freehold of St George's in Gravesend as an investment asset and had derived rental income from the shopping centre. In 2004, the Council identified the need to develop and modernise the shopping centre to benefit residents and optimise its rental income. This formed part of wider Council plans for the development and regeneration of Gravesend town centre, including a major housebuilding programme. This became a key Council policy, with a high degree of cross-party support.

4.2 Edinburgh House Estates Limited ("Edinburgh House") had a lease interest in St George's from 1980 when the shopping centre first opened. In 2004, Edinburgh House approached the Council and engaged in a discussion to extend that lease to include other Council owned sites. This led to a development agreement being signed between the Council and Edinburgh House in 2008. The development agreement comprised St George's, the area behind St George's (then known as the Western Quarter) and the area behind Gravesend market (then-known as the Eastern Quarter) – collectively known as the heritage quarter. The proposal from Edinburgh House was to revive the town centre through retail and a mix of other uses, including the regeneration of St George's. A Special Purpose Vehicle ("SPV") called Queenridge Properties was named in the development agreement by Edinburgh House to take the proposed regeneration activity forward. Queenridge Properties had been incorporated in 1994.

4.3 A planning application was submitted for the Eastern and Western Quarters by Edinburgh House in July 2008. It was considered and deferred by the Council's Planning Committee on 26 May 2009 because of issues raised by the Council to be addressed by the developer. The application was considered again by the Planning Committee on 19 April 2010 and it was rejected. An amended planning application was submitted in November 2012 and permission was granted by the Council on 1 May 2014 requiring commencement of the development within five years for the Eastern Quarter and two years for the Western Quarter.

4.4 In 2014 a judicial review of the planning decision was sought by Urban Gravesham, a civic society, with the High Court decision ruling in favour of the Council in March 2015. Urban Gravesham accepted the judge's decision and chose not to appeal. In 2016, the planning permission for the Western Quarter expired. In 2017, the Council agreed a two-year extension to the development agreement with Edinburgh House to 30 April 2019 for the Western Quarter, to align it with the original planning approval deadline for the Eastern Quarter.

4.5 In the summer of 2017, Edinburgh House marketed their interests in the Heritage Quarter site through CBRE Limited ("CBRE"). The interests being marketed were the purchase of the long-term lease of the St George's Centre, properties within the Edinburgh House group and rights to the development agreement with the Council. Several companies expressed an interest in the development opportunity, but it is understood that none were taken forward by Edinburgh House. During the Autumn of 2017, Edinburgh House advised the Council that they would explore further opportunities to progress the development themselves whilst continuing to market their interests.

4.6 Subsequently, another developer, Reef, contacted the Council's then-Chief Executive in November 2017 after becoming aware of Edinburgh House marketing their interests via CBRE, Reef made the approach due to land owned by the Council upon which the Council had granted leasehold interest to Edinburgh House. During December 2017, dialogue commenced between officers of the Council and Reef in relation to Reef's proposals to the Council in relation to the site.

4.7 The Reef development proposal to the Council related to the Eastern and Western Quarters and included St George's. The proposal was for the Council to retain the freehold of the development site and grant a long-term (150-year) head lease to Aviva who would act as the investor and provide funding to the Council. In return, the Council would pay Aviva on the return of that funding in the form of lease payments. Reef would act as the developer and the asset manager of the property and in so doing provide services to the Council. The Council would receive a non-assignable operational lease for 50 years on the three sites from Aviva in exchange for an annual rental payment. At the end of the 50-year lease period there would be the potential for the head lease to revert back to the Council for a token payment of £1.

4.8 The then-leader of the Council and then-leader of the opposition at the Council were briefed on the proposal by senior officers and were agreeable for officers to progress dialogue with Reef.

4.9 From January 2018 onwards the Council undertook due diligence in relation to the proposal from Reef, including the engagement of external advisors. The key due diligence actions were:

a) Company checks in relation to Reef, Aviva and Edinburgh House.

b) Engaging external legal advisors Trowers and Hamlins LLP ("Trowers") to provide advice on procurement and the contracts relating to the proposed transaction.

c) Engaging external advisors Jones Lang LaSalle ("JLL") to advise on the financial options presented by Reef, the heads of terms of the head lease and the occupational leases and review the proposed service charge.

d) Engaging the Council's treasury management advisors Link Group ("Link") to provide advice on various aspects of the proposed transaction including: a high level review of risks associated with the proposed funding structure, a high level review of the business case, a high level review of the financial case and affordability, comparison of alternative funding options, sensitivity analysis of key variables, financial due diligence of the developer, provide details of measures the Council could consider to include in the arrangements to limit the Council's financial commitment and to ensure the developer bears the risks of all cost overruns, an evaluation of the statutory powers, associated regulatory framework and accounting implications of the proposal.

e) Having a conversation with representatives of Gloucester City Council who had already entered into a similar transaction, which at the time was innovative for the local government sector.

f) The Council also developed its own financial model to forecast the cash flow and borrowing implications of the proposed transaction.

4.10 On 27 March 2018, the Council notified Grant Thornton, as the Council's external auditors, of the proposed transaction. On 9 May 2018, it met with representatives of Grant Thornton to discuss the Council's plans for the Heritage Quarter, which the Council considered to be part of its (i.e. the Council's) due diligence, albeit external auditors can play no formal part in due diligence.

4.11 On 30 April 2018 and 3 May 2018, there were reports made to the Council's Cabinet and Overview Scrutiny Committee respectively. The reports summarised the proposal from Reef for the development of the Heritage Quarter, including presentations from representatives of Reef, with the discussion with Reef focussing on the qualitative aspects of the planned development.

4.12 The 30 April 2018 Cabinet report summarised the implications against key consideration criteria (relating to legal implications, risk assessment and linkages to Corporate Plan objectives, and a high-level summary of the scheme and ongoing actions and next steps, including the conclusion of due diligence work then taking place, in particular with Trowers and JLL. Project risks were presented as part of the restricted agenda papers. We note that papers presented to Cabinet and Overview and Scrutiny were accessible to all Members and the council's senior officers, including restricted papers. An all-member briefing was held on 7 May 2018 on the proposed transaction and involved representatives from Reef Estates.

4.13 On 21 May 2018 the Council's Cabinet considered an updated report on the proposals. This set out that in order to progress the project and continue the momentum that had already been generated, both officers from the Council and representatives from Reef proposed that a 'soft decoupling' of the two main elements of the project would assist in driving the development forward. This resulted in the following approach being approved:

a) Phase 1: seek approval for the progression of the scheme in relation to the St George's as a separate entity. It was felt that significant work has been undertaken on this aspect of the project and, as such, it was at a stage where the St George's element of the transaction could progress.

b) Phase 2: additional work was still required on the detailed proposals for the Eastern and Western Quarters due to the need to focus on the proposals specifically in relation to the St George's. This was further driven by the imposed deadlines of Edinburgh House and Fortress Investment Group ("Fortress") (the financier of Edinburgh House) for the completion of the disposal of their interests to Reef.

4.14 There was a break that evening where the proposal was then considered by the Council's Overview Scrutiny Committee. We note that the papers for this meeting, and the Cabinet meeting that preceded it, were made available to all Members and the council's senior officers. The Cabinet then reconvened, on the same evening, to discuss decisions required to progress Phase 1 in relation to St George's. At this second meeting, the Cabinet approved authority for the Council to enter into the necessary legal agreements to give effect to the funding principles contained within the report and confirmed delegated authority (to the Council's senior officers in consultation with the then-Leader and Chair of Overview and Scrutiny) to take all necessary financial and legal actions required to finalise the transaction. Specific decisions were to:

a) terminate the legal agreement with the SPV Queenridge Properties.

b) enter into agreement with Reef for an exclusivity arrangement for the Western & Eastern Quarters.

c) provide delegated authority to Chief Executive and Director of Corporate Services to progress the initiative, and ring fence the capital investment fund.

4.15 Council senior officers with delegated authority in consultation with the then-Council Leader and the Chair of Overview and Scrutiny Committee, then finalised the transaction relating to Phase 1 of the project. Legal agreements between the Council and Edinburgh House were signed on 11 June 2018 to terminate the existing development agreement between the parties. The Council entered into a lease agreement in relation to St George's with Aviva, for a 150-year head lease for peppercorn rent of £1 per year, with a break clause after 50 years. Simultaneously, Aviva leased it back to the Council for 50 years, at an annual rent of £1.15m on the 1st year, £1.19m on the 2nd year, £1.23m in the 3rd year and £1.275m in the 4th year. After the 4th year, the rent was to be reviewed annually and increase based on inflation with the increase capped at 5%.

4.16 This transaction enabled the Council to extract itself from its arrangement with Edinburgh House. The rights to develop the site were sold by Edinburgh House to Aviva, with Reef acting as agent. Reef secured a role as asset manager to manage the St George's development in return for a percentage of the rental income from the shopping centre. The Council also guaranteed Reef exclusivity on other Council development projects in the Heritage Quarter for a period of two years with an opportunity for a twelve-month extension, which was granted by the Council. The Council has advised that this extension was to provide sufficient certainty to Reef to effectively resource the project, and to ensure progress on the site and to avoid further delays. This exclusivity agreement has now lapsed.

4.17 Following advice given by Trowers, the Council published a Voluntary Ex-Ante Transparency ("VEAT") notice on 15 June 2018 regarding the lease arrangements for St George's. This was done to mitigate the risk of non-compliance with EU procurement rules, due to there being no competition for Reef's role as developer as part of the St George's transaction. No challenges were received.

4.18 At the time the transaction was finalised in June 2018, the Council had not confirmed the accounting treatment relating to the transaction.

4.19 The Council first discussed the need to consider the accounting treatment in relation to the transaction with Grant Thornton (the Council's external auditors), in November 2018. This formed part of a handover meeting with the outgoing and incoming Grant Thornton Audit Engagement Leads. The Council first shared its proposed accounting treatment with a member of the Grant Thornton audit team on 8 February 2019, which led to some clarifications being sought by Grant Thornton in May 2019 when they were considering the implications for the accounts. The Council responded to these clarifications within three weeks and the then-Audit Engagement Lead accepted these clarifications. The accounts for 2018/19 were presented for audit in May 2019, and they were signed off by Grant Thornton in early August 2019.

4.20 In December 2019, the Council approved the formation of a local authority trading company, Rosherville Limited, whose purpose was to act as developer on the Charter site (formerly known as Eastern Quarter). In February 2020, the Council approved the board and governance arrangements for Rosherville Ltd, with the Council Leader representing the Council as shareholder on the company board. As part of the transaction on St George's, Reef was given exclusivity on related Council developments, and Reef was appointed as a sub-contractor by the trading company.

4.21 Following the departure of the Council's then-Chief Executive on 31 March 2020, the then-Director of Corporate Services was appointed Chief Executive, and the then-Assistant Director of Corporate Services was appointed as the Director of Corporate Services, with both changes taking effect on 1 April 2020.

4.22 On 1 June 2020, the Council's Cabinet agreed to the proposals for the Charter development. It also agreed to delegate authority for the Council's Chief Executive and Director of Corporate Services, in consultation with the then Leader and Chair of Overview and Scrutiny Committee to progress agreed decisions. The Cabinet also agreed to enter into a further project with Reef in relation to the Greenwich Peninsular. However this was not progressed..

4.23 At the start of the external audit of the Council's draft 2019/20 accounts in August/September 2020, Grant Thornton reconsidered its view on the accounting treatment of the transaction and challenged the Council's accounting treatment for the St George's transaction, following a significant write down of the value of St George's in the draft accounts. This related to a revaluation loss for St George's finance lease in the draft 2019/20 accounts. Previously, this had led to an impairment in the 2018/19 accounts. As a result, the 2019/20 audit was paused in Autumn 2020, whilst the Council and Grant Thornton both sough internal and external advice on the correct accounting treatment.

4.24 This is a complex area of accounting treatment and it has taken significant time to work through. By March 2023, a provisional resolution was in place between the Council and Grant Thornton. Due to this resolution, the 2019/20 audit recommenced - including the Value for Money audit which focussed on the St George's transaction, recommencing in February 2023. The work relating to the Value for Money audit forms the basis for the findings set out in this report.

5 KEY FINDINGS

The Council's relationship with Edinburgh House

5.1 The Council had become increasingly concerned over a number of years about the insufficient progress made by Edinburgh House in developing the Heritage Quarter. When Edinburgh House marketed their interest in the site in July 2017, the Council have advised us that Edinburgh House did not inform the Council in advance. This led to a breakdown in relationships between the Council and Edinburgh House.

5.2 On 9 February 2018, Fortress emailed the Council asking the Council to make a decision on their interest in St George's within 4 weeks.

5.3 From our discussions with key Council stakeholders, it is clear that the Council felt under time pressure to identify and agree an alternative to the development agreement with Edinburgh House to avoid the risk of losing control of the site. This is supported by the 21 May 2018 Cabinet report noting the context of needing to meet deadlines imposed by Edinburgh House and Fortress.

5.4 As such, there is evidence that this pressure was a contributing factor to the timing of the decision on the St George's transaction with Reef and Aviva. The Council's ambitions to progress housing development and regeneration of Gravesend town centre had cross-party support, and the Reef and Aviva transaction was therefore viewed as an ideal solution - as alternatives were likely to lead to further delay and an uncertain outcome.

The Council's due diligence

5.5 Our findings in relation to the Council's approach to due diligence are set out below.

Link

5.6 Link were retained treasury management advisors to the Council. The Council has confirmed that the specification was agreed on 10 May 2018, the letter of engagement was dated 15 May 2018. The report was received by the Council on 15 June 2018, with Link providing the Council with high-level sensitivity analysis on 21 May 2018, the day of the Cabinet decision. The report was commissioned informally by the Council 17 days prior to the key Cabinet decision. The engagement was formally agreed 11 days from the Cabinet where the decision was taken. The letter of engagement was signed only 6 days prior to the key Cabinet and Overview Scrutiny Committee meetings on 21 May 2018. The Council understood that it had agreed with Link in commissioning the work, that it would be delivered in relatively short timescale, and the intention was it would be available to feed into the presentation to members on 21 May. However, Link did not deliver the report in time for the meeting.

5.7 The Council did not pause to review and approve what was, in terms of the scope of work, the key due diligence report before signing the contracts with Reef and Aviva on 11 June 2018. Senior officers did not share the key findings of the report with Cabinet or Overview Scrutiny Committee prior to signing the contracts. The reasons provided by senior management was that, in their view, the report from Link did not contain any issues that would have been sufficient to pause the decision being made, and this was partly influenced by a perceived lack of trust in Link due to the late receipt of the report. We have been advised that reference was made to senior members that the Link report had been received, but officers have not been able to recollect when this took place.

5.8 The Link report reflects thorough due diligence from the Council's treasury advisors and there were sufficient grounds in the report to have halted the Council's decision until the points raised by Link had been resolved. We understand that a draft was received by senior officers prior to 11 June 2018. The officers' review of the draft formed part of their delegated authority approved by Cabinet on 28 May 2018. We have been advised by officers that they provided a verbal overview of the final Link to the then Leader and the Chair of Overview and Scrutiny Committee.

5.9 that they did not consider the report provided a reason to delay or to change course. We believe this to have been a significant failing in the governance surrounding the transaction.

5.10 We identified some frustrations from some senior officers at the delay in receiving the Link report later than they thought had been agreed which was expressed to us as resulting in a loss of trust in Link on the part of Council officers. This may have impacted officer judgements, which could explain why the risks and challenges identified by Link were not thoroughly considered. We have not found any direct evidence that the Link report was deliberately downplayed or supressed by senior officers, but the timing of the receipt of the draft and final Link report could be interpreted to have potentially jeopardised or at least delayed the planned transaction with Aviva and Reef. At that point, it would have been a difficult call for management to have delayed signing on the back of the findings of the Link report and risk the collapse of the deal. To have raised the issues after the contract was signed would arguably have been even more challenging for management to consider, which provides the context under which the Link report does not seem to have been referenced after this point until its disclosure as part of this audit process.

Grant Thornton

5.11 It is clear that senior officers and members placed importance on the meeting with Grant Thornton in May 2018 as forming part of the Council's due diligence. We believe this to have been an over-reliance because formal advice in respect of the transaction was not sought from (or given by) Grant Thornton. Indeed, such advice would not have been permissible under the terms of the appointment as external auditors. Our understanding from the meeting was that Grant Thornton highlighted some risks and made some suggestions. It is not evidence of advocacy for the transaction from Grant Thornton, or an attempt to provide advice or influence management's decision.

5.12 The high-level nature of the discussion, and the limited information provided to Grant Thornton at this stage (with due diligence and the final terms of the deal not yet complete) means that the Council's suggested reliance on this discussion with Grant Thornton as a primary source of due diligence is misplaced. There was no detailed discussion of accounting treatment until the 2019/20 audit.

5.13 The Council has also placed reliance on Grant Thornton's audit of the Council's 2018/19 accounts and associated VfM audit which were reported after the St George's transaction was finalised. The accounts did not represent Grant Thornton's approval of the transaction or of the Council's accounting treatment. The Council's reliance on these accounts has been retrospective to the transaction being agreed and could not have provided due diligence assurance to the Council prior to the Council's decision to proceed with the signing of the contracts in June 2018.

5.14 The transaction took place in the 2018/19 year, while the audit concluded over a year later. During the course of our review, we identified retrospective confusion from senior officers who initially believed that the discussions with Grant Thornton on the accounting treatment took place prior to the completion of the St George's transaction, which was not the case.

5.15 The Council has placed a high degree of importance in Grant Thornton's sign off of the 2018/19 accounts in particular the Council's accounting treatment of the transaction, and should Grant Thornton have identified the appropriate accounting treatment issue as part of the 2018/19 audit, this might have allowed the Council to resolve the issues raised sooner, however this would not have prevented the Council from entering into the St George's transaction. Grant Thornton's audit could give no assurance about the quality of due diligence undertaken by the Council, and the Council assumed that Grant Thornton would consider the accounting treatment relating to the transaction as part of the audit, albeit the lease payment accounted for in the 2018/19 accounts was not material.

Trowers

5.16 Trowers were engaged by the Council on 28 March 2018 and their advice was provided in two stages. The first stage involved consideration of any legal issues relating to the Reef proposal (such as procurement) and any non-legal matters (such as risk and financial implications). Stage 2 related to reviewing, advising, and assisting the Council in relation to the legal documents relating to the Reef proposal.

5.17 Trowers worked with the legal advisers of other third parties in relation to the legal documents. The Council followed Trowers' advice, which included the publication of a VEAT notice. We note that members were not made aware of the potential consequences of publishing this notice, which could have led to a challenge to the proposed transaction. However, this risk did not materialise.

JLL

5.18 The letter of engagement between the Council and JLL is dated 5 July 2018 and was signed retrospectively to the services having been provided in advance of the completion of the transaction on 11 June 2018. The Council has advised us that this was because of the need for JLL to urgently commence their work, to feed into the Council's due diligence, due to the pressure the Council felt under from Edinburgh House and their funder Fortress to complete the St George's transaction. The Council has advised us that JLL were comfortable to undertake their work in advance of the letter of engagement being signed. The scope of the JLL work was to advise the Council on the financial options presented by Reef, the heads of terms of the head lease, and the occupational leases to support the Council's negotiations.

5.19 The advice from JLL provided independent analysis of the Reef proposal including the financial options. This supported the baseline assumption underpinning future cash flows and rental income, namely that rental income could cover costs over the 50-year lifespan. We note that some provision was made to create funds to manage downside risk (for example, rental guarantees for a limited number of years).

5.20 A letter from JLL to the Council's then-Director of Corporate Services dated 24 May 2018 reports on a further review of the amended Heads of Terms and Deal Structure. This refers to earlier advice given by JLL to the Council on an earlier iteration of the Reef/Aviva proposal. We note that the letter was received after the final Cabinet/Overview Scrutiny/Cabinet meetings on 21 May 2018, but before the transaction was signed on 11 June 2018. This provides evidence that the Council did obtain due diligence from an independent professional adviser on the proposals from Reef / Aviva and that the Council acted upon this advice. JLL's work was, however, restricted to a review of the

Reef/Aviva proposal and the forecast cashflows, and did not cover the accounting and other implications for the Council.

5.21 JLL were able to negotiate on behalf of the Council to secure a lower starting rent, a change to the cap and collar (which provided more certainty to the Council) and additional sinking fund monies which, through financial modelling, would cover anticipated rent shortfalls based on the prevailing and predicted economic conditions at that time. It is reasonable that the downside risk scenarios that were considered at the time, did not anticipate the impact of COVID-19 and global inflationary trends. However, we note that limited consideration took place to determine how the more extreme scenarios that were considered – such as inflation at the capped level of 5% and reduced rental over an extended period – would be dealt with, and the impact that this might have on the Council's wider financial position. In particular, these risks were not adequately set out for members in either of the papers taken to Cabinet in April and May 2018. We have set out our findings in this area in our evaluation of the business case below. Therefore, in our view, while appropriate processional advice was taken to support due diligence on the proposed financial projections, insufficient work was done to fully understand the implications of the more extreme adverse scenarios, how this could be mitigated and what the impact on the Council might be in future years.

Gloucester City Council

5.22 The Council had a telephone call with representatives of Gloucester City Council on 4 January 2018 on the high-level aspects of the Council's proposed transaction with Reef. Gloucester City Council were understood by the Council to be the only council at that time who had entered into a similar transaction (with the business plan agreed in September 2017), and Reef were acting in a similar role for this transaction.

5.23 We believe the Council overly relied on this telephone conversation to provide assurances in respect of the Council's proposed transaction with Reef. This is because the call took place prior to KPMG, Gloucester City Council's external auditors, finalising their audit of the 2017/18 accounts, which were published in July 2018 which was after Gravesham Borough Council's May 2018 decision on the St George's transaction.

5.24 In addition, the nature of the Gloucester City Council transaction was different to that being considered by the Council. The Gloucester City Council transaction was a sale and leaseback whilst the Council's proposed approach was a lease and leaseback arrangement.

5.25 The Council also took assurances from the fact that Grant Thornton's advisory team advised Gloucester City Council in relation to their transaction. However, the Council did not become aware that Grant Thornton had been engaged by Gloucester City Council solely as a result of KPMG requesting an independent view on the accounting treatment. This Grant Thornton advisory engagement was after the Council had taken their May 2018 decision of the Reef proposal, and so provided retrospective assurance to the Council, rather than it forming part of the pre decision due diligence. Furthermore, as a result of the intervention from KPMG and Grant Thornton's advice, the accounting treatment applied by Gloucester City Council changed. The Council was not made aware of this change by Gloucester City Council.

Other due diligence

5.26 The Council undertook their own financial modelling focussing on cash flow and borrowing. There was very limited consideration of the accounting treatment and there was no overarching model that included the balance sheet and income and expenditure statement impact. This resulted in a significant gap in the Council's due diligence. The classification as a finance lease was assumed, but not checked. In addition, the implications of using the effective interest rate ("EIR") were not fully considered.

5.27 A trainee accountant was given responsibility for developing the Council's cash-flow model, reporting to the then-Director of Corporate Services. The assumptions used in the modelling were tested by more senior members of the finance and property teams. We have been advised by the then-Director of Corporate Services that the reason for giving the responsibility to a junior officer was seen as a development opportunity for the trainee concerned. We also note that the cash flow model was checked by the Council's Internal Audit team and considered the Council's own financial projections against those provided by Reef and JLL.

5.28 The Council undertook Companies House checks of companies' interests, for Edinburgh House, Reef and Aviva to check inter-company relationships. A check on the solvency of Reef was also completed. These searches represented basic company due diligence undertaken on the key stakeholders involved in the transaction.

The Business Case

5.29 The Council did not produce a full business case in relation to the transaction. Instead, reliance was placed on the reports to Cabinet in April and May 2018. The Council did not follow the best practice HM Treasury Green Book approach to business cases. We would expect (as a minimum) for the five different areas (strategic, economic, financial, management and commercial cases) to have been explored as part of the decision paper to members. Of particular significance is that the reports to Cabinet did not include a properly costed options appraisal as part of the economic case or a full explanation of how the affordability and value for money of the project would continue to be maintained under adverse economic scenarios as part of the financial case. We note that the June 2018 Link report raised both of these areas as needing further development as well as highlighting the importance of the five-case model approach.

5.30 Financial modelling undertaken by the Council was shared with JLL, for JLL to check, including assessing the factors that were most appropriate to consider in a sensitivity analysis. These were considered as part of the risk and opportunities matrix included in the report to members. However, we believe that the consideration of downside risk was limited and not effectively conveyed to decision makers, in particular how the transaction would be afforded in the medium to long term with rental payments inflating at the 5% cap and with rents below those projected in the base case. There is some commentary on project risk in Appendix 4 of the May 2018 report. It covers the risks of parts of the project not progressing, the risks associated with commercial tenants and changes in shopping habits, and how inflationary and other financial risks will be managed.

5.31 The mitigating actions described here amount to high level written management assurances that are in most cases not clearly referenced to robust sources of assurance. Some of the key risks are also alluded to under the heading of ‘Property Considerations’ (although these are not directly identified as risks in this part of the narrative). This section briefly highlights that the annual lease payment may increase by up to 5% (the level of the cap), that this is not linked to the level of actual rent received, and that the rental increases the Council will be able to collect are subject to a number of uncertainties (such as rent increases being demand led and that net income has fallen in previous years and that the loss of major retailers could have a detrimental effect). However, these scenarios are not supported by modelling within the report to clearly quantify the potential financial consequences, which could then be properly considered by members in making the decision. This omission is important, because of the inherent risks that any assumptions about the future economic potential of traditional shopping centres must contain, and that were highlighted to the Council by JLL and Link. There is no narrative content covering what the implications for the General Fund would be if the rental payment becomes much larger than the rental income generated (the risk has been flagged as high likelihood and major Impact). The risks were identified, but the mitigations and actions were not robust, and the information presented to members lacked proper analysis. The fact that the key risks identified (that have ended up crystallising) were not explored in the main cabinet paper narrative or analysis, and their inclusion in a detailed appendix was not conducive to enabling effective scrutiny and challenge. The effect was to downplay the risks to members.

5.32 Consideration of the VfM of the transaction, and in particular the selection of a single option was a limiting factor. The only VfM comparison was to a Public Works Loan Board (“PWLB”) loan of £30m over 50 years, which ostensibly was the least cost-effective option. However, in our view there is strong evidence that this calculation was incorrect, as both the repayment of principal and Minimum Revenue Provision (“MRP”) were added together (resulting in effective double counting of the cost of borrowing). It is standard practice in the public sector to develop a costed options appraisal in a business case on the basis of the discounted Net Present Value (NPV) of projected cashflows. The standard practice for financial options appraisal is laid down by Treasury Green Book and accompanying guidance, and is supported by CIPFA and other professional accounting bodies. MRP is an accounting adjustment to make a provision for the future repayment of debt, and does not reflect an actual cashflow, and therefore it should not have been included in the calculation of comparative cost. If a costed NPV analysis had been undertaken correctly, the PWLB loan could have been shown to be comparable or even a cheaper option over 50 years. Even if it were not, the Council’s own supporting analysis indicated that an equivalent funding package of a £30m loan from PWLB would have cost the Council between £52m and £58m over 50 years, compared to the preferred Income Strip deal which was costed at £131m over the same period.

5.33 This apparent discrepancy was not effectively dealt with in the narrative of the decision paper. The Council’s May 2018 Cabinet report does point out that the PWLB loan would not be a direct comparison, and we infer that there was a cost and risk to delaying that borrowing and in finding a developer that formed part of the consideration to disregard this as a viable alternative option. However, the decision paper did not present a robust case as to why these other non-financial factors justified the differential in cost with the PWLB option. We therefore conclude that the decision papers presented to Members in April and May 2018 did not conclusively evidence the basis for the Income Strip being the preferred option in terms of the economic case. This provides a good example of why the Green Book approach should have been considered, as was recommended by Link in their due diligence report.

5.34 As part of the transaction, Reef had exclusivity on other development sites in the borough. This was not fully explored in the reports to Cabinet and Overview Scrutiny Committee and, in particular, the additional value derived by Reef from this arrangement. We have been advised that the Council at that time did not know what this value would be, but they were confident that in Reef they had a more reliable development partner to bring forward the Council's regeneration plans. Separate negotiations on other sites involving Reef as development partner have subsequently taken place, including a fixed price agreement with Reef for The Charter (Eastern Quarter) and no benefit has been derived by Reef from the Western Quarter because no development has come forward. This exclusivity agreement has expired.

The role of Grant Thornton

5.35 Grant Thornton was made aware of the proposed transaction by the Council when the Council's then-Assistant Director of Corporate Services emailed the then-Grant Thornton Audit Engagement Lead on 27 March 2018. A meeting was held between the Grant Thornton Audit Engagement Lead, members of Grant Thornton's Real Estate and Assets Advisory Team, and the Council's then-Chief Executive, then-Director of Corporate Services, and then-Assistant Director of Resources on 9 May 2018.

5.36 The meeting related to the Council's plans for the Heritage Quarter and enabled Grant Thornton to ask questions on the nature of the transaction, having accessed the Cabinet paper for 30 April 2018 in advance of this meeting. The meeting did not cover detailed financial projections or accounting treatment and the Council noted that the due diligence exercise was still underway.

5.37 From discussions with key Council stakeholders during our current review, it is clear that key officers and members of the Council considered that this meeting formed a key part of their due diligence in respect of the transaction. However, no formal advice was sought from (or given by) Grant Thornton to the Council. Indeed, as noted above, this would not have been possible under the terms of Grant Thornton's appointment as external auditors.

5.38 In June 2018, Grant Thornton published its Audit Findings Report on the 2017/18 audit year. This included a VfM conclusion, which made a reference to the project:

- "We met with senior officers in May with Grant Thornton specialists from our Real Estates team and Government and Infrastructure Team. Officers shared a briefing of the development proposals and through discussions we challenged the arrangements drawing on our knowledge of similar proposals elsewhere. We concluded based on the discussion and without the benefit of a detailed document review, that the Council has engaged appropriate specialist advice, is carrying out due diligence and has taken account of expected risks."

5.39 The Audit Findings Report for 2017/18 VfM conclusion stated that "Based on the work we performed, we concluded that the Council had proper arrangements in all significant respects to ensure it delivered value for money in its use of resources." The Council have confirmed that they placed no reliance on the 2017/18 audit in relation to the decision on St George's.

5.40 In August 2018, Grant Thornton published their Annual Audit Letter for the year ending 31 March 2018 with the report being considered by the Council's Finance and Audit Committee the following month. The report references that: "On the 27 March, senior officers made us aware are of a potential development proposal being considered by the Council. The proposal involves St George's, Western Quarter and Eastern Quarter. In respect of the St George's, the Council would retain the freehold of the development site and grant a long-term lease (150 years) to the developer. Proposals for the development of Eastern Quarter and Western Quarter are still being considered. Given the long-term nature of the proposal and our lack of understanding of the Council's arrangements, we undertook some work to understand the proposals."

5.41 Following the 2017/18 audit year, Grant Thornton changed their Audit Engagement Lead for the Council. The new Audit Engagement Lead had been a senior member of the audit team for 2017/18, providing continuity between audit years.

5.42 In February 2019, the Council provided a paper to Grant Thornton on the proposed accounting treatment relating to the St George's transaction. On 17 May 2019, Grant Thornton's then-Audit Engagement Lead emailed the Council's then Assistant Director (Corporate Services) in relation to VfM and the accounting treatment. The Council provided a response on 5 June 2019 including asset valuation information, cashflow forecasts, copies of legal agreements (including lease agreements) and reports relating to the Council's decision to proceed with the transaction. We have confirmed that there was no further dialogue between the Council and Grant Thornton's then-Audit Engagement Lead.

5.43 In July 2019, Grant Thornton published its Audit Findings Report for the year ending 31 March 2019. The report included references to St George's transaction:

a) "We have reviewed the valuation methodology for St George's Centre and the accounting treatment to move to a finance lease. Our audit work has not identified any other issues in respect of the valuation of property, plant and equipment."

b) "The Council has reviewed the fair value of the finance assets as part of the IFRS 9 assessment in preparing the draft accounts and concluded that the Finance Lease for St George's is level 3. Fair value hierarchy level 3 financial assets are hard to value as they have unobservable inputs for the asset or liability. By their very nature, level 3 assets require a particularly high degree of judgement. There is a risk to reach an appropriate valuation at year end, as well as ensuring the asset is classified correctly in line with the new accounting requirements of IFRS 9". The report noted Grant Thornton had challenged management about the disclosure of the level 3 financial asset, and that "our audit work has not identified any issues in respect of the finance lease classification as level 3 asset. However, the draft accounts did not include the required disclosure in accordance with IFRS 9. The accounts have been amended to disclose the valuation methodology used to prepare the accounts and the sensitivity analysis of holding such as financial asset."

c) In relation to VfM work for 2018/19 the report noted that "We also considered your proposals for the St George's Centre development project. The governance arrangements for decision making about the project's viability included reporting all information to Cabinet and Overview Scrutiny Committee to ensure proper challenge was provided. The Council has used experts for all elements of the proposal and obtained appropriate support to plan the St George's Centre development. We are satisfied the Council has put in place the required governance arrangements for the project."

5.44 In August 2019, Grant Thornton published its Annual Audit Letter for the year ending 31 March 2019. This included a VfM conclusion which noted that: "We are satisfied that in all significant respects the Council put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources for the year ending 31 March 2019." The letter also confirmed that Grant Thornton had completed its audit of the financial statements of the Council in accordance with the requirements of the Code of Audit Practice. The only reference to St George's was that the St George's valuation had been excluded from Grant Thornton's materiality calculation.

5.45 For the 2017/18 audit year, the then-Grant Thornton Audit Engagement Lead noted the transaction had occurred post year end and had considered the high-level briefing with Council officers. Grant Thornton noted the issue briefly in the audit findings report, but did not draw a direct conclusion on the arrangements supporting the transaction as they did not directly impact on the VFM conclusion for the financial year 2017/18. The then-Grant Thornton Audit Engagement Lead had therefore acted appropriately in regard to 2017/18. For the 2018/19 audit year (the year the transaction took place), the Council's arrangements were considered adequate, based on a high-level review, on the basis that a due diligence exercise had taken place to support the decision by members and external advice had been sought by the Council to support this. At that stage, the auditor did not find or act upon any indications of heightened risk associated with the governance arrangements surrounding the decision, which may have triggered a more detailed investigation. This was in line with the code of audit practice in force at the time. which had come into force following parliamentary approval, in April 2015..

5.46 In June/July 2020, the external audit process commenced. There was a further change to the Grant Thornton Audit Engagement Lead for the 2019/20 audit, due the person in this role for the 2018/19 audit having left Grant Thornton in February 2020.

5.47 In August 2020, the Grant Thornton audit team raised initial concerns with the Council's finance team regarding the accounting treatment relating to St George's. This related to a revaluation in relation to the St George's finance lease in the draft 2019/20 accounts. This had led to an impairment in the 2018/19 accounts. On 9 September 2020, the Grant Thornton Audit Engagement Lead formally raised the issue with the Council's Director of Corporate Services. The Council was asked to re-examine the accounting treatment of the transaction, in particular:

a) Reconsider whether the arrangement constituted a loan and not a finance lease.

b) Clarify the principal and interest components of the various transactions and assess the implicit interest rate.

c) Consider whether there were any embedded derivative arrangements that needed to be separately accounted for.

5.48 Discussions have been ongoing between the Council and Grant Thornton since Autumn 2020 to resolve this issue and to agree what adjustments, if any, need to be made to the Council's financial statements for 2018/19 and subsequent years. The complex nature of the transaction included the involvement of various parties, a series of lengthy and detailed legal documents setting out the arrangements, considerations over appropriate interest rates and asset accounting. Both the Council and Grant Thornton have sought external advice during this period.

The Substance of the St George's transaction

5.49 The June 2018, transaction in relation to St George's involved the following:

a) The Council terminating an existing 150-year lease with Queenridge Properties and Edinburgh House dating back to the 1980's.

b) The Council then entering into a new 150-year lease for St George's with the Aviva for a peppercorn rent of £1 per year, with a break clause after 50 years. Simultaneously, Aviva were to lease it back to the Council for 50 years, with annual rent of £1.15m due from the Council to Aviva in year one, which would increase in line with inflation (capped at 5% per annum with a floor of 0%). Payments from the Council to Aviva were projected to total £131 million over the first 50 years before discounting for net present value. This type of transaction is known as an income strip deal and was comparatively rare/innovative for local government at this time.

c) The Council entering into a development agreement with Reef Estates Regen 1 Ltd, who would undertake the onsite improvement work at St George's. Reef Estates Regen 1 Ltd was an SPV incorporated in April 2017 and was owned by Reef Estates. We understand the SPV was established by Reef Estates to deliver the development agreement agreed with the Council.

d) The Council would receive various income from Aviva to cover the cost of lost rental from St George's over the first three years of development, the risk of future rental losses, a sinking fund for future reinvestment and the initial capital investment for the development, totalling approximately £23.5m. The Council would also receive benefit from Reef / Aviva having purchased the development rights from Edinburgh House (estimated to be £10-25m), effectively unlocking the development rights and enabling the project to proceed.

e) Aviva paying Reef for development works and reimbursing any other costs and expenses.

f) At the end of the lease period, the unencumbered freehold of St George's would revert to the Council for no additional consideration.

The accounting treatment of the St George's transaction

5.50 The Council did not establish the accounting treatment before the St George's transaction was approved, nor did the Council take independent external advice on what the accounting treatment should be. The Council was therefore unable to confirm if the transaction was affordable. In our view, represents a significant omission in the governance process. It should be noted that the Link due diligence report did highlight to the Council that the transaction was likely to have the substance of a loan rather than a lease. Although the Link report was received later than expected, the advice was correct in substance, but was disregarded by management. In our view, the late receipt of the Link report does not undermine the validity of the advice which was received before the transaction was signed. Irrespective of any 'lack of trust' in Link by the management of the Council, that the delay had caused.

5.51 We consider that the Council then accounted for the transaction incorrectly. When the accounting treatment was corrected, the charge to its Income and Expenditure account was much higher than planned and could not be covered from the rental income being received.

5.52 Whilst the full financial position is still being finalised, the Council has had to identify additional revenue funding for the difference, impacting on the Council's long-term financial position. This also undermines the key premise of the original expectation that the transaction would be self-funding. If members had been aware that it would require a subsidy from the General Fund, they may not have approved the transaction.

5.53 When the additional impact of inflation and the Covid-19 pandemic on rental costs and income are then factored in, the transaction shifts from placing a significant unplanned budget pressure on the General Fund to being wholly unaffordable. It is acknowledged that these factors were outside the scenarios considered at the time of the transaction.

5.54 Due to the non-viability of the transaction, the Council is seeking early termination with Aviva and Reef.

Other observations

5.55 In our work we have found no evidence to suggest that the motivation of officers or members was being driven by personal gain or the desire to protect personal reputations by covering an error and stopping the transaction decision. Rather it was to drive forward the Gravesend town centre development.

5.56 During the course of our review, we established that the Council's then-Director of Corporate Services was on paternity leave during the week of the May 2018 Cabinet decision. This implies that this senior officer was not able to fully participate and engage with the final decision process. The officer was one of three key senior officers invested in the transaction and associated due diligence. This may have impacted on how the Link report was considered and there being no discussion on the option to pause the Council's decision.

5.57 The Council's then-Chief Executive, then-Director of Corporate Services (Section 151 Officer) and then-Assistant Director of Corporate Services (Deputy Section 151 Officer) were the three key officers involved in the transaction, in consultation with the then Leader, Deputy Leader and Chair of Overview and Scrutiny. The latter officers are still employed by the Council (both in more senior roles as noted at paragraph 4.21) and they have been involved in this review, but we have not spoken to the former Chief Executive.

5.58 Other senior Council officers involved in the transaction were the Monitoring Officer, Deputy Monitoring Officer, Director for Regeneration and senior officers in the Council's finance and property teams. Progress on the transaction was discussed at the weekly Management Team meeting which involved the then-Chief Executive, Directors, and the deputy Monitoring Officer. We have not spoken to the then Monitoring Officer, then-Director of Regeneration or then-Deputy Monitoring officer who are no longer at the Council.

5.59 In October 2019, the Council's Internal Audit team reported on a review of the Council's property acquisitions which noted that they were properly managed, and the report was rated green. In June 2020, the Council's Internal Audit team reported on a review of asset management processes which were also rated green. These reports indicate that the Council's property acquisition and asset management processes were operating effectively in the period following the St George's transaction taking place.

The strategic case vs reality

5.60 The Council proceeded with the St George's transaction on the understanding it was financially viable. It was a large-scale commercial transaction in proportion to the size of the Council, utilising what was then a novel and innovative structure for the local government sector. The Council's annual net revenue expenditure in 2018/19 was £15.1m and the transaction represented a £131m outlay over 50 years.

5.61 The intention of the Council's transaction (the strategic case) was to:

a) Lease back its own asset, with a substantially reduced value as an operational asset compared to its value as an operational asset.

b) Gain access to increased value from commercial rents and the capital investment to achieve this (provided by Aviva), alongside a ready-made asset manager who would facilitate the development (Reef).

c) Accelerate the improvement of St George's via the injection of funding from Aviva, which was a Council policy priority, following a long period of frustration and delay on the part of the Council and its members.

d) Ensure that the cost of lost rental while the development took place would be covered from funds provided by Aviva.

e) Use the arrangement would also be catalyst for other development projects, such as housing and to regenerate the town centre, enabling the Council to progress its housing targets.

f) Ensure that the proposed plans included a leisure element at the rear of St George's which included a cinema, restaurants and an experimental hub (including virtual reality and a panic room) to increase dwell time, footfall and spend in the town centre, boosting the local economy and providing social benefits.

g) Remove the Council from what was considered to be an ineffective partnership with Edinburgh House.

5.62 The intention of the Council was never to generate financial surpluses. The Council intended for rental income to cover the cost of development paid to Reef/Aviva, so it would have an effective cost neutral impact.

5.63 The reality of the transaction has been:

a) Downside risk has been compounded by the Covid-19 pandemic and pressure on interest rates that could not have been predicted.

b) Rental income achieved is significantly below the cost of payments due to Aviva over the 50 years.

c) Work continuing on the financial implications, but under the proposed new accounting treatment it is now estimated to be a net c £700k per annum of unbudgeted revenue pressure, when the correct effective interest rate is applied to the loan. This relates to the start of the period of the transaction, but not the full 50-year term and operates on a reducing basis.

d) That the upfront monies received from Aviva that were expected to offset the cost of lost rental income and manage risk, were effectively borrowed at a very high interest rate.

e) That the St George's capital development has stalled, and the upfront monies received to cover lost rent have now been fully consumed.

f) There was inherent risk in the original plan with a significant reliance being placed by the Council on the shopping centre's resilience of tenant base and the ability to break even under worst case conditions.

g) Insufficient consideration of affordability in the Council's original plan including headroom to manage risk to enable the Council to continue to afford the rental payment.

5.64 The planned leisure element at the rear of the St George's site has to date not progressed due to the impact of the pandemic on the retail, hospitality and leisure sectors. £6.9m was included in the construction costs sum deposited from Aviva with the Council to bring forward the leisure element, alongside other contributions to incentivise potential tenants. These remain unspent. In the first year of full operation the leisure element was expected to provide additional rental income of £550k which has not been realised, impacting on funds available to the Council to cover the rental payments to Aviva over the 50-year term.

Consequences and the current position

5.65 Failure to correctly calculate effective interest rate resulted in an under charge to Income and Expenditure for interest, in comparison to the real cash flow which was lower. An additional General Fund impact an initial net c £700k per annum that is unfunded either from rental income or monies received from Reef (loss of rental agreement). This has resulted in approximately £3m General Fund cost pressure than the Council originally forecast. This is the cumulative position over the period 2018/19 to 2022/23. This affordability gap increases over the 50-year term and is compounded by higher-than-expected inflation and lower than forecast rental yields.

5.66 The interest rate change noted above could have been managed by the Council by the use of reserves up to the present time. However, there are further charges that are set out below which means that the transaction is now unaffordable in the short to medium term.

5.67 The Council is engaged in dialogue with Aviva and Reef over an early termination of the arrangement, which will require a premature debt repayment premium, amortised over the lifetime of the loan. Whilst this has not yet been confirmed it is expected to be significant and could be between £5m and £10m.

5.68 A complicating factor relates to payments by Reef to Aviva and others which were originally funded by Aviva and where the accounting treatment has not yet been resolved. The worst-case scenario is a further £15m charge to the Council's General Fund in 2018/19, albeit this would reduce the annual additional interest charge to the General Fund in subsequent years.

5.69 The St George's transaction will have a long-term financial impact on the Council.

6 CONCLUSION AND RECOMMENDATIONS

Conclusions

6.1 In engaging external advisers, the Council recognised there were experience gaps in-house. However, in our view and as set out in this report, there were significant weaknesses and limitations in the level of independent advice and due diligence that were undertaken to support the Council's decision to progress the St George's transaction in May 2018.

6.2 It is likely that this was a result of a lack of capacity and experience from senior Council officers in fully appreciating what was required prior to such a strategically significant decision taking place. In particular, the decision of officers to proceed with signing the deal before the key piece of due diligence from their treasury management advisers (Link) had been properly considered, in the context of significant pressure from third parties as perceived by the Council (Fortress and Edinburgh House), was a key failure of governance.

6.3 In addition, the failure to fully communicate to members the financial consequences of adverse economic scenarios and mitigating actions made the Council more vulnerable to financial risk than it would otherwise have been, notwithstanding the fact that the extreme adverse scenarios that crystallised as a result of the Covid-19 pandemic and global inflation could not reasonably have predicted at the time.

6.4 The Council's failure to obtain professional advice on the accounting treatment of the transaction, and to properly understand the impact on the Council's Statement of Income and Expenditure, budget and Medium-Term Financial Strategy, prior to entering into the arrangement, were also a significant failures of governance. This meant that the Council entered into the deal without a full understanding of the risks and financial impact.

6.5 It could be argued that there was a general lack of challenge and or constructive curiosity from members, around the lack of detail provided within the decision papers., Therefore an opportunity may have been missed to pause the transaction while a full business case, full options appraisal or a more detailed analysis of the downside risk was developed. We note that questions were able to be asked at Cabinet and at the Overview and Scrutiny meetings , and that members were entitled to accept the assurances given by officers at the time or in supporting briefing sessions. In addition, members could not necessarily have been expected to bring with them knowledge of what a business case should contain. Nevertheless, the indications are that a cross party consensus had developed among Council members, who understandably wanted to see progress made on the St George's development. This may have undermined the level of effective scrutiny and challenge that may otherwise have been present.

6.6 Regardless of how effective the scrutiny of the decision was or was not, members were not provided with the information they needed to make an informed and appropriate decision. This was the responsibility of the senior officers involved.

6.7 Having sequential Cabinet, Overview Scrutiny Committee, and Cabinet meetings on the same evening provided no time or space to reflect or seek further detail and advice between these meetings, which was driven by the Council's view of the time pressure being placed on it by Edinburgh House.

6.8 The Cabinet's 21 May 2018 decision to delegate the final decision of the St George's transaction to senior officers, in consultation with the then Leader, Deputy Leader and Chair of Overview and Scrutiny, provided some additional time for officers to consider matters such as the Link report. However, it removed the potential for further member scrutiny, including member sight of the Link report - which was a key part of the professional advice and due diligence obtained, and the Council officers' response to it. Again, it is likely that this was caused by the time pressure that senior officers felt the Council was under to secure an alternate development partner to Edinburgh House.

6.9 Ultimately, the Council's arrangements relating to the St George's transaction have not secured value for money through economy, efficiency, and effectiveness in the use of resources.

Recommendations

6.10 The Council should carefully consider this report to ensure all members understand the events and conditions that led to the issues set out in this report, so that lessons are learnt, and assurances are provided that arrangements are in place that would mitigate or avoid such a situation happening again.

6.11 The Council should finalise the changes planned to accounting treatment and the early termination of the Aviva/Reef deal, confirm the overall financial impact and the consequences for the Council's financial sustainability, and put in place appropriate plans and arrangements to mitigate financial sustainability risks.

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