Agenda item 7

REPORT TO:	Audit Committee		
DATE:	10 February 2020		
TITLE:	Report of the Cross Party Working Group to review the King's Lynn Innovation Centre (KLIC) project		
TYPE OF REPORT:	Recommendation		
PORTFOLIO(S):	Resources – Cllr Brian Long		
REPORT AUTHOR:	Audit Committee Cross Party Working Group		
OPEN/EXEMPT	Open	WILL BE SUBJECT TO A FUTURE CABINET REPORT:	YES

REPORT SUMMARY

PURPOSE OF REPORT/SUMMARY:
To fulfil the Terms of Reference for a Cross Party Working Group appointed by Audit Committee
~~KEY ISSUES:~~
RECOMMENDATIONS:
Audit Committee consider this report, approve its content and agree its detailed recommendations contained in paragraph 6; Following consideration by Audit Committee the report should be presented for consideration to Cabinet by the Chair of the CPWG
~~REASONS FOR RECOMMENDATIONS:~~

REPORT DETAIL

1. Introduction

At its meeting on 11 March 2019 the Borough Council of King's Lynn and West Norfolk's (Council) Audit Committee set up a Cross Party Working Group (CPWG), following extensive work carried out by its Internal Audit officers, to examine all aspects of the project to create the King's Lynn Innovation Centre (KLIC). The Terms of Reference of the CPWG state 5 clear tasks, all of them originating from the KLIC project, but requiring separate focus. They are attached for reference at Appendix A.

That group met only once before being interrupted by local elections, but it was quickly re-constituted at the first meeting of the Audit Committee after the elections, with the same terms of reference.

Since being constituted the CPWG has met 12 times, with officers providing full support, and has also met with members, and former members, involved with the project. Several CPWG members also visited the Innovation Centre, accompanied by officers, to appreciate the nature of the project.

The KLIC project itself was innovative and a departure from the Council's normal working practices, which attracted negative press towards the end of the project. The partner in this project, Norfolk and Waveney Enterprise Services Ltd, and its wholly owned subsidiary NWES Property Services Ltd (NWES) unfortunately encountered cash flow difficulties resulting in it defaulting on its loan repayments, which culminated in the Council taking ownership of the Innovation Centre. This was the most appropriate course of action for the Council to take to protect its investment in the project.

As the review progressed it became clear that fulfilling the Terms of Reference would be a significant task for members of the CPWG and that it would be difficult to meet the agreed deadline of the October meeting of the Audit Committee. As a result it was decided to deal with the main task, i.e. the items concerning the review of the KLIC project, and report it to a special meeting of the Audit Committee. The remaining tasks would be reviewed and reported on separately. They are not included in this report.

2. <u>Background</u>

In 2009, Morston Assets obtained outline planning permission for the delivery of an Enterprise Centre but was unsuccessful in obtaining funding. Interest in the scheme continued and in 2012 financing was provided by the New Anglia Local Enterprise Partnership's (NALEP) Growing Places Fund to build a high specification building that would attract start-up companies in the budding area of new technology and business ideas with a view to creating more jobs and rejuvenating the local economy as those businesses grew and eventually moved on within the Borough, making space for more new companies.

SUMMARY OF THE BUILD COST OF KING'S LYNN INNOVATION CENTRE			
	COUNCIL	NWES	TOTAL
Council Loan		£2,500,000	£2,500,000
NALEP - Grant		£500,000	£500,000
Infrastructure Costs funded by the Norfolk Business Rates Pool	£450,000		£450,000
Council Grant	£1,000,000		£1,000,000
Groundworks/drainage	£250,000		£250,000
Initial Funding		£500,000	£500,000
Additional Funding		£838,268	£838,268
TOTAL	£1,700,000	£4,338,268	£6,038,268

In addition, the Council lent NWES a further £250k but this was not towards the build cost, it was to cover a shortfall in cash flow, mentioned elsewhere in this report.

KLIC was jointly conceived by the Council and NWES, a private company limited by guarantee. NWES had experience in managing such centres, but not in building them. It is unclear why responsibility for delivering the build was given to NWES, however what is clear is that NALEP expects the relevant local authority to act as a funding intermediary therefore it would not provide funding directly to NWES. As a result Suffolk County Council (SCC), acting as the main accounting body of NALEP, made a loan to the Council for the agreed amount of £2.5m, which would then be released to NWES in stage payments as building progressed, and would then subsequently be repaid by NWES in full, together with accrued interest, on 30 November 2018.

Construction commenced in May 2015 and was completed in June 2016. KLIC had been promoted as a 25,000 sq. ft. facility with not less than 16,000 sq.ft. of rentable office space however, the CPWG has been unable to find evidence as to why the finished project only has 12,595 sq.ft. of rentable space. On inspection, there was a considerable amount of communal space, including conferencing facilities, which would be expected by the type of business it was hoped would be attracted to KLIC. It was noted that there is insufficient car parking to support KLIC's activities as a conference centre and indeed this part of the building has now been converted to rentable office space.

It became clear that NWES was in financial difficulties when its accounts were published and there were multiple resignations of senior staff, and NWES subsequently defaulted on the loan repayment that was due in November 2018. Following extensive legal advice, ownership of the KLIC building has now been formally transferred to the Council but the transfer value of the asset was less than the amount of loan outstanding, including accrued interest. It is also noted that the transfer value recorded of the asset when transferred included the diminution implicit in the annual rent payable to the Council. It is also noted that that valuation of the building is specifically for its ongoing use as an innovation centre with multiple tenants and not as a single user office block. The value of unencumbered freehold asset is the value that this asset is included at on the Council's Balance Sheet, which is higher than the transfer value as the transfer value excluded the value of the land (already owned by the Council).

At this point the CPWG notes that market value of an asset is often way below the cost of construction. The financial return or provision of a public service is usually how the project is measured; however this project was significantly linked to the repayment of a loan, in addition to the Council's own costs relating to construction. The Council owned land had been made available on the basis of a peppercorn rent for the first 5 years of tenure, thereafter at market rate, however, that situation has been superseded by the Council taking back ownership of the building within the peppercorn rental period.

Since taking ownership the Council has allowed NWES to continue to manage the building on a rolling contract, which will not exceed 12 months. This ensured that an uninterrupted service was provided to tenants that the Council itself did not have the resources to provide, neither was it practicable to find an alternative service provider in such a short timescale. The Council is currently considering various options but in the meantime any management fees payable by the Council to NWES are being withheld to offset against the outstanding loan. The CPWG has seen no evidence to suggest that finding a new service provider has been progressed, however reassurance has been received that the process is in its very early stages of evaluation.

Whatever the findings of the CPWG it must be emphasised that the Council currently owns an asset valued at £2,380,000, such valuation having been commissioned by a reputable professional organisation, which is 96% occupied (as at 31 January 2020) and generates an annual net revenue stream of £150,000 by way of rental and other income. This represents an annual rate of return of 6.3% which compares favourably to the rate of return that could be achieved by investing the same sum as a cash investment, currently less than 1%.

The KLIC building is on what was derelict (Council owned) land, which has now become a nascent Enterprise Zone that should see further development in the very near future. KLIC is almost fully tenanted and a number of tenants have been successfully incubated in line with the ethos behind KLIC's construction, however other tenants are perceived to be non-growth businesses that do not fulfil the intended criteria.

Nevertheless, it is reasonable to assert that KLIC was delivered on time and is an operational success story, although it might be argued that the building and its interior finish is designed to a higher, and more expensive, specification than might be expected. There is no comparative evidence to suggest that rent is commensurate with such a high specification and members of the CPWG do not have the expertise to assess this.

3. Project Weaknesses

The CPWG has highlighted many weaknesses, some of which have already been identified by the Audit and Lessons Learnt Reports and which can be summarised as follows:

insufficient background checks on NWES;

the means by which this loan would be repaid;

key documentation was not duly signed;

shortcomings in the process of project management evidenced by lack of control via the specially created Steering Group;

perceived conflict of interest between employees of NWES and the Council and NWES and its project management company Nautilus;

no feedback from the Council's representative on the board of NWES, and latterly, non-attendance on that board;

a naïve view of the value of the completed building being worth more than, or at least as much as, the loan provided;

not securing the loan on the assets of NWES;

a lack of regard of the Council's Treasury Management policies regarding the creditworthiness of counterparties;

granting a further loan for purposes that the CPWG considers inappropriate;

despite the unusual nature, inasmuch as it was an untried and untested method of partnership working, the project was not included in the Council's Risk Register at any point in its duration.

3.1 Issues Regarding the £2.5m Loan to NWES

The underlying issue at the heart of all the problems encountered by this project stem from the loan to NWES, and in part, the loan from SCC. A small part of these concerns can be attributed to hindsight, but the crux of this issue is that the granting of a loan to NWES had no regard to the Council's Treasury Management Strategy. The loan to NWES was not an investment covered by that Strategy, however that Strategy provides a set of rules that might be prudent to follow for any circumstances that include the provision of a loan. Those rules might not be followed to the letter, not least because the circumstances are such that they do not fit any of the criteria however, those rules provide a framework that can be appropriately interpreted to ensure that there is a process of due diligence and that the council's cash is secured by whatever means available.

In support of that assertion, the most recent internal audit of the Treasury Management activities of the Council contains the following statement: "Treasury management is described by the Chartered Institute of Public Finance and Accountancy (CIPFA) as the management of the organisation's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. **This definition is intended to apply to all public service organisations in their use of capital and project financings, borrowings and all investments."** The relevant Code of Practice has been in place since 2003 and was therefore in place when the financing of KLIC was agreed.

The CPWG understands that it is standard working practice for the NALEP to expect the Council to act as an intermediary in terms of handling the loan facility, i.e. handing the capital sum over to the Council at the outset and the Council then releasing it in stage payments to NWES. It is also standard working practice for the NALEP to specify terms for the loan to be repaid by the Council to the NALEP and for those terms to be replicated in the loan agreement between the Council and the project deliverer. The end result would be that the loan would be repaid by NWES on the same day as it was due to be repaid to SCC, with neither lender being any worse off. Unfortunately there was nothing in the loan terms that made one specifically dependent on the other, therefore creating two independent liabilities.

We have not found any evidence of criticism of NALEP/SCC for imposing unreasonable conditions on the granting of the loan by placing the liability of repayment on the Council. The security of the loan from the SCC's perspective was 100% guaranteed by the principle that "Loans to local authorities are automatically secured by statute on the revenues of the authority rather than by reference to specific revenues, assets or collateral." i.e. loan repayments have first call on sums collected by way of Council Tax, etc. Section 13 of the Local Government Act 2003 refers.

Early reports to Council indicated that the loan would be secured on the KLIC building but that factor did not go forward into the loan agreement. There are a number of options that could have been applied to protect the council's interest, such as including a floating charge over the whole business or personal/corporate guarantees but none of these, or any other, options were exercised. The only security was that the ownership of the building would revert to the Council in the event that the loan was not repaid, which has happened. In making this condition no consideration of the value of the building was taken into account. Given that the Council already owned the land that KLIC was built on, and continues to own the land, it should have been considered at the time that such a building, with its high level of finish, might not have been worth its build cost on the open market. Given that the site is derelict, and in parts contaminated, it would have been many years into the future, when the Enterprise Zone has been fully developed, for KLIC to be valued at anywhere near its build cost.

3.2 Further Loan of £250k

The reason for granting this loan is that NWES was experiencing cash flow problems specific to KLIC inasmuch as it was unable to pay the contractor and needed a short term loan as a counter measure. NWES was expecting EU funding, which was slow in arriving, hence the cash flow shortfall, however the EU funding was not in respect of KLIC and it's unclear why the Council should have provided a basic banking service to a company that had ongoing projects with other clients in addition to the Council. This loan was specifically made in accordance with the extant Treasury Management Strategy, as minuted by Cabinet on 14 September 2016 but it is worrying that such an investment was made without taking into account either the counterparty's creditworthiness or any other form of security to ensure repayment would be made, except by virtue of the value of the building, which we now know to be insufficient.

We understand that NWES was experiencing financial difficulties and the CPWG has made the perceived assumption that granting this loan would prevent NWES from sinking into further difficulties, i.e. potential liquidation, and that the granting of this further sum would also go some way to protect the Council's original loan but this was not the case. We have seen no details of what evidence was taken into account before granting this loan.

Throughout the duration of this project, the loans given to NWES have been included in routine progress reports to Audit Committee on Treasury Management activities, but the NWES loans were excluded from the most recent reports. Given Audit Committee's specific interest in the KLIC project it requires reporting on these loans to be restored. It is also recommended that any future loans taken out or given under any power that enables the council so to do be reported to Audit Committee at the outset to establish risk and be monitored on a regular basis.

3.3 Warning Signs of NWES's viability

NWES was significantly funded by European monies, which was potentially jeopardised by the Brexit Vote in July 2016, and therefore the future of its funding was at risk;

NWES's 2017 accounts, which had not been filed until April 2018, stated that the auditors had identified circumstances regarding the company's future viability as a going concern. In dealing with a private sector partner the CPWG considers that there should be adequate and regular monitoring of its status;

The request for cash flow funding is mentioned elsewhere. That and other evidence of the company and its partner company NWES Property Services Ltd experiencing difficulties should have caused concern but the Council did not carry out any additional credit checks until after NWES had defaulted on the loan repayment;

At no point does it appear that NWES was asked, by Council members of the Steering Group or others in direct contact, whether it could repay the loan, and from which source it intended to do so, whether, for example, from EU grant funding, from capital receipts or business centre income. NWES was not asked to provide a cash flow forecast or business plan to demonstrate its ability to repay. Overall, there was a failure to monitor the performance of NWES and its subsidiary NWES Property Services Ltd and there was no evidence that the Council carried out any financial review until after NWES had defaulted on the loan repayment. Also the CPWG has been unable to see any evidence that any financial reviews were carried out before the commencement of the loans.

Overall there is a sense of misplaced trust inasmuch as NWES had been the major player in its market of delivering innovative public sector projects and was perceived as not being subject to failure.

3.4 <u>Activities of the Steering Group and Conflicts of Interest</u>

A Steering Group was created to project manage the KLIC build. It comprised an equal number of officers from each organisation, however the minutes are implicit in suggesting that there was a personality dominance inherent in NWES's officers.

The only evidence of the Steering Group's activities is a file of paper records, which has been scrutinised by several members of the CPWG. It is apparent from the content that certain designated members of the group were routinely absent and that some records are missing.

The Steering Group included members of staff from Nautilus Associates Limited (Nautilus), a project management company appointed by NWES. A director of NWES, who was also a director and shareholder of Nautilus, served as a senior member of the Steering Group. This may have caused a conflict of interest as the minutes show that Nautilus employees may have had undue influence. However this is the CPWG's opinion arising from the status of those attending in their parent organisation. The then Chief Executive of the Council, as the most senior member of the Steering Group, should have conferred a strong hold on such a new way of working, especially in the early days of the project, but it is the CPWG's opinion that the then Chief Executive's regular absence weakened the Council's position.

There were several conflicts of interest in the partnership between the Council and NWES from the start, which led to what might be perceived as an imbalance of power alluded to above, and because the records are incomplete, the line of accountability and transparency is difficult to demonstrate.

Nautilus, the company appointed to project manage the building of the KLIC, was appointed by NWES, as per the Heads of Terms Agreement and not by the Council. It is apparent that the appointment of a project manager was not conducted under an open procurement process.

The NALEP's Loan Agreement stipulated that Public Procurement Rules should apply for the appointment of a contractor to carry out the build, but the CPWG has seen a document which suggests that NWES were of the opinion that those rules were not relevant because NWES was a company and as such was not obliged to follow public sector rules. However, according to documentary evidence in the Steering Group file, the then Chief Executive pointed out that NWES's proposed Procurement Strategy would have breached the Council's Standing Orders for Contracts as well as the terms of the NALEP's Loan Agreement, and his insistence ensured that the Public Procurement Rules were eventually adhered to.

Nautilus had a Director who was also a Director of NWES and Nautilus also had a representative on the NALEP that awarded the original funding for the project, such funding being effectively guaranteed by the Council, an unrepresented third party in this instance.

There was no elected member appointed to the Steering Group until very late on in the life of the project, and by the time a member was appointed the Steering Group had ceased to meet.

The NALEP was asked to provide an impartial Chair for the Steering Group but declined.

The NALEP was also invited to attend meetings of the Steering Group but there was no NALEP representative at any meeting of the Steering Group.

The then Leader of the Council, previously employed by NWES, was appointed to the board as a director of NWES. Legal advice has recently been provided to the effect that anyone so appointed must, first and foremost, consider the interests of the company. This then potentially causes an elected member NOT to prioritise the interests of the Council.

Regardless of the above, there is no record of that Director reporting back to the Council, although that member did declare an interest at appropriate times. When that member stood down as Leader of the Council, the new Leader did not take up a place on the board. In light of the legal advice provided, the CPWG acknowledges the difficulty and inherent conflict that arises from such an appointment and is not able to quantify the advantages and disadvantages thereof.

In accordance with the NALEP's requirements there would be no restrictions on NWES's future use of the KLIC building beyond the scheduled date of the loan repayment.

The CPWG can see that within the Partnership Agreement, a provision was included that required NWES to obtain the Council's consent to dispose of the building, or change its use, for a period of 2 years from repayment of the loan.

The CPWG's conclusion is that 2 years was not a long enough period to protect the Council's interest and was contrary to protecting the purpose of the building. However when NWES's position was seen to be vulnerable in mid-2018, the Council drew up and entered into a lease agreement with NWES restricting the use of the building for the duration of the lease.

4. Cross Party Working Group Activities

The Group has met frequently, 12 times since inception. Individual members of the Group have submitted questions and requested a significant amount of evidence, both of which have been made available to all members of the Group. In addition members of the Group have visited the Council's offices to view documentary evidence that could not easily be made available either as a hard copy or electronically.

Members of the CPWG were given a tour of the KLIC building in order to familiarise themselves with its facilities and whether, in their view, such facilities were commensurate with the Centre's stated purpose.

Thanks go to the officers who have gone to great lengths to answer the Group's questions and provide documentary evidence not only directly connected to the review but also in support of the review, thus helping members gain a better understanding of the wider picture as information has been gathered from many service areas.

5. Conclusions

- Whilst the project appeared to be a good concept there was a lack of due diligence. There was a degree of naïveté demonstrated by both officers, who had no experience of partnership working on a high profile project, and elected members, nearly 40% of whom were newly elected when the project was in its infancy;
- There are some design failings. The specification was at a level to attract incubating businesses but there is no evidence to suggest that there was an adequate market for such businesses requiring premises with such a high specification. However, no-one can deny that a landmark building has been created at a prominent location at one of the main access points to King's Lynn;
- The Council has an asset that is generating income and the rate of interest being charged on the outstanding loan is now at a commercial rate, more than offsetting the investment interest lost by the loan not being repaid on the due date;
- The loans were not adequately secured on the asset as required by Council minutes. Stipulating that the asset would revert to Council ownership in the event that the loan was not repaid might not have been secure if NWES had gone into liquidation as preferential creditors would have had first call on the company's assets;

- The Council did not follow its own policy/strategy vis à vis creditworthiness of counterparties it invests with, irrespective of what powers such investments are made under;
- The Council did not challenge the NALEP regarding the imposition of terms on the loan to NWES. It would generally be considered unacceptable for a third party to make such impositions on a transaction that was between the Council and NWES;
- There was no covenant or other restriction placed on NWES in the Partnership Agreement that lasted for longer than 2 years after the loan repayment, or its successors to maintain the building as an Innovation Centre;
- Component parts of the project were not considered as a single scheme and to some extent the Council was not made fully aware of all the implications such as the cost of providing infrastructure;
- The loan of £250k is of special concern. Its authorisation was not considered by Council as the value was within the authority delegated to Cabinet, however, it was wrong to divorce this expenditure from the overall project, the value of which was in excess of Cabinet's delegated authority. Any naïveté should have dissipated by that stage of the project;
- The Steering Group should have continued to meet until the loan was repaid as that factor should have been the final element of delivering the project.

Overall the Council should move forward and not discount projects because they do not follow usual working practices. There is always room for innovation and in an economic climate where local authorities see Government funding diminish to the extent that it is non-existent, other ways of working need to be considered. The key points are to maintain control at all times, evaluate all aspects of what is being proposed and have adequate controls in place to ensure a positive outcome.

All large value projects need to be properly managed by a designated officer and the Council has put in place both an officer and a member Major Projects Board to monitor activity, both Boards being subject to review by the CPWG culminating in a future report. The final element of the CPWG's purpose is to review elected members' activity as an appointed representative to an outside body, especially with regard to public companies.

6. **Recommendations** (subject to the CPWG's completion of its remaining Terms of Reference)

- Notwithstanding the requirements of the Major Projects Boards, all major projects should have a designated Project Manager of sufficient seniority in the Council's hierarchy to make appropriate decisions;

- In the event that a major project involves a third party in order to bring it to fruition the Chief Executive Officer or appropriate Assistant Director should oversee the project's management;

- If a loan is granted or investment made under any statutory power that in ordinary circumstances would fall within the Treasury Management Procedures it should be governed by those Procedures, especially as regards to the 3 principal elements, i.e. risk/security, liquidity and return;

- Any joint venture with a third party must undergo rigorous examination before being entered into to ensure as far as reasonably practicable the third party's financial viability for a period exceeding the life of the project;

- If a loan is entered into with a third party that does not fulfil the Council's requirements for creditworthiness such a loan must be secured on a tangible asset wholly owned by the third party that is not otherwise secured elsewhere;

- Each and every project involving a third party should be included in the Council's Risk Register following a risk assessment;

- The loans to NWES should immediately be either reinstated to the half yearly reports on Treasury Management to Audit Committee or be reported on separately to Audit Committee at a shorter frequency;

- All legal documents should be signed off before funds are released.