

Meeting Executive

Portfolio Area Housing, Older People & Health / Resources

Date 3 October 2018



THE FORMATION OF A WHOLLY OWNED HOUSING DEVELOPMENT COMPANY – CONCEPT AND HIGH LEVEL BUSINESS CASE OBJECTIVES APPROVAL

KEY DECISION

AUTHOR – ASH AHMED EXT. 2805
 CONTRIBUTORS – ANITA THOMAS EXT. 2430
 LEAD/CONTACT OFFICERS – AS ABOVE

1 PURPOSE

- 1.1 This report sets out a high level business case for the establishment of a Wholly Owned Company (WOC) that will complement the Council’s existing and future property development activity.
- 1.2 This business case for the WOC is a natural development of the Council’s existing development activity and helps to de-risk development projects that by their nature are affected by wider economic conditions. The proposed WOC is seen as complementing the Council’s existing housing development plans, and in no way will it act as a substitute or provide competition to those plans.
- 1.3 Whilst being a natural addition to the Council’s development practices the creation of the WOC also achieves a number of other purposes. These purposes form the corner stone of the business case for establishing a WOC that members are asked to endorse. Once created, a “housing” WOC will have the ability to purchase, own, develop, sell and rent homes in the private sector at market rents & prices. This is in order to improve the supply of quality homes in the market rent segment in Stevenage. In the first phase of

schemes, the WOC will only purchase homes built out by the Council's Housing Revenue Account (HRA) and General Fund (GF) development arms.

- 1.4 The structure of the WOC will ensure the Council will retain overall control of the WOC's activities as well as setting the WOC's strategic direction (Appendix 1 gives a diagrammatical illustration).

2 RECOMMENDATIONS

- 2.1 That the business case, as outlined in this report, be approved, and that the principle of establishing a Wholly Owned Housing Development Company (WOC), for the purposes detailed in the report, be supported.
- 2.2 That a report be brought to a future Executive comprising a fully costed financial projection of the WOC's operational activities and a Business Plan, prior to the WOC commencing trading.

3 BACKGROUND

- 3.1 Members will be aware that many Councils have set up, or are investigating setting up local housing companies to develop housing. Recent estimates suggest there are as many as 150 local housing companies in England (Delivering the renaissance in council-built homes: the rise of local housing companies, Smith Institute, 2017). However whilst 150 companies may have been set up, there are suggestions that some Councils are unclear about the objectives and the operating parameters of these companies and therefore they are not all operational. Given that no Council or community is the same it is important that Stevenage establishes its own sound reasons for creating a WOC that best serve the Council and local community.
- 3.2 Amid a backdrop of evolving government policy relating to housing, Stevenage Council has sought advice from Solicitors (Trowers & Hamblins), Development experts (Ethixl LLP) as well as Tax experts (Grant Thornton) regarding the viability and most appropriate company proposals for Stevenage Council.
- 3.3 The outcome of the advice and research was that whilst Stevenage Council has the power to directly develop housing for affordable/social rent and in certain circumstance for direct market sale, it cannot develop housing directly for the private rented market as landlord. In order to be able to do this it must first establish a company. It is proposed that in order for the Council to retain control, that this is a wholly owned company or WOC and that the primary purpose behind the Council operating in this market segment is to generate profits through operating a quality service. The profits can then be used by the Council for its own purposes.
- 3.4 This evolution to the Council's approach to housing development has continued since 2015 when targets to build 300 affordable homes by 2021 and 2000 homes over the life of the 30 year HRA business plan were set. In support of this aim, the development programme started by delivering open market acquisitions. The next stage was to acquire new build stock and develop new build housing through the Council's own HRA design and build schemes. Finally, the latest council schemes involve the GF and HRA jointly

(but with segregated and apportioned costs) developing schemes for private sale as well as for affordable and social rent. This forms part of a balanced portfolio that maximises returns, achieves the most affordable housing and is a benchmark for quality in both markets (Social & Private).

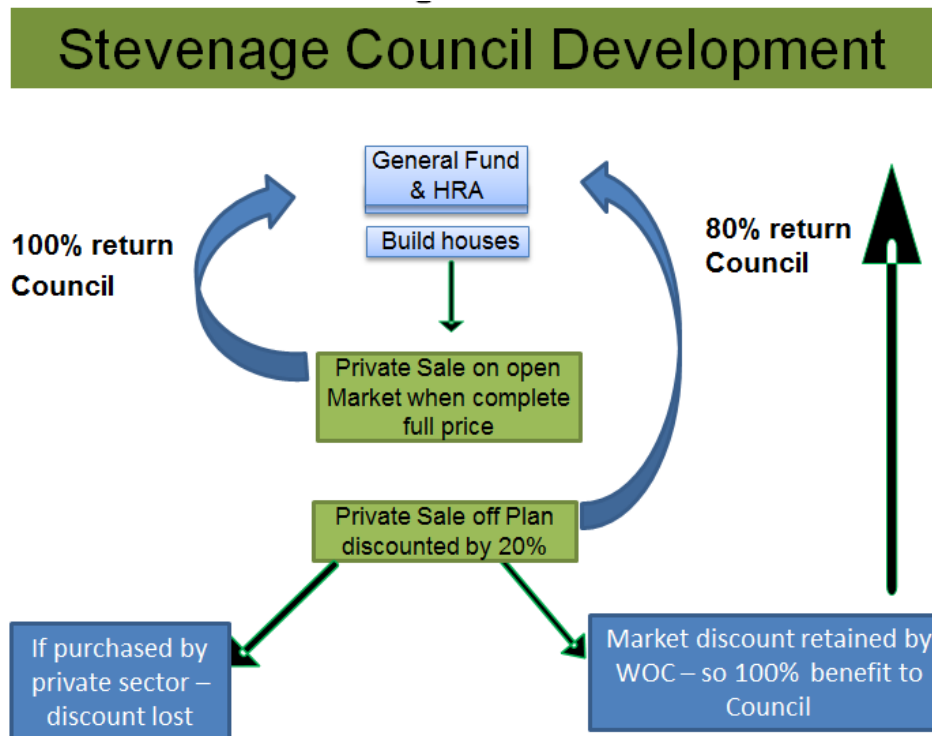
- 3.5 An important point to note is that the Council is already able to develop and sell housing for affordable rent and, provided it is necessary to cross subsidise the social/affordable rent, private sale as well. The Council does not have the power to directly develop and own properties to be let at market rent. This would be regarded as a commercial purpose and would be required to be carried out in a company. The creation of a WOC would therefore allow the Council to develop and purchase property for the specific purpose of renting out at market rates.

Background: Stevenage Local Context & existing development

- 3.6 The Council has a strategic housing duty to provide affordable housing and also to have a view on the supply of housing in the borough. The local plan requires 7,600 homes to be built by 2031 with a need for new housing across all types and tenures, including aspirational homes. The council's Housing Operations team also notes that there is a substantial shortfall in good quality private rented stock. This clearly points to their being gaps in the housing market where Council intervention either at a strategic or operational level is justified.
- 3.7 In response to growing local housing need and also a financial necessity to sustain the HRA Business Plan, the Council has already established an affordable housing development plan (Dec 2014). This has delivered over 140 affordable homes since its inception with a very limited number (thus far only five) being developed for outright homeownership to provide cross subsidy for the HRA's social purpose activities.
- 3.8 Amongst other things, a desire to maximise the return from its assets has prompted the Council to establish an Asset Management Plan (AMP) that tries to make the most of its assets. Where appropriate, this involves trying to generate a developer uplift and the premium that arises from a new build property as part of an array of options that previously simply involved land disposal. Clearly the AMP will always balance the capital needs of the Council and navigate an appropriate split between properties that are developed, and land that is sold.
- 3.9 At present, homes developed in the HRA are considered for possible private sale as a matter of necessity to provide cross subsidy to schemes and programmes that would otherwise not be financially viable. In both of these instances the HRA and GF can only consider homes for private sale as a means of generating additional capital funds.
- 3.10 In developing homes for private sale the General Fund and HRA can utilise the option of *off plan selling*. This is the practise of selling, at a discount on the market price in exchange for a firm commitment to purchase. The market price, in line with market practices, for such purchases is lower than the sale of a home that is agreed when the property is fully built out. At times, *off plan selling* can require a discount of up to 20% of the market price. Developers

weigh up the benefit of a discount against the added development risk of marketing all the homes at once.

- 3.11 At present any home that may be developed by the HRA or the GF that is sold on the open Market as *off plan* would result in a reduced price benefiting the private purchaser. However, through the creation of a WOC the Council's development programmes could ensure that this *off plan* subsidy remains within the WOC (to the benefit of Stevenage Council) and also that properties can be offered at a Market Rent. The graphic below illustrates this principle.



- 3.12 It is not permissible for either the GF or the HRA to develop homes that are for market rent because that would be regarded as pursuit of a commercial purpose. As this can only be done through a company, the creation of a WOC is seen as essential in retaining the *off plan* market discount. Furthermore, the creation of a WOC will allow the diversification of the Council's exposure to housing development to more market segments which helps to mitigate development market risk.
- 3.13 It has been confirmed, through independent legal advice, that local authorities have the power to create WOC's for this purpose under the Localism Act 2011 and are required to do so for activity which is undertaken for commercial purposes.

Objectives of the WOC – The Business Case

- 3.14 In addition to complementing the Council's existing development practises and reducing the development risk there are other reasons and objectives for the Council to develop housing outside of the HRA/GF. These principally center around the external financial pressures on the Council to be more commercial and maximise alternative sources of income.

3.15 Therefore the purposes of creating a WOC will be as follows:

1. The WOC will increase the supply of market rented housing in the sector.
2. It will maximise the Council's financial returns including interest payments on loans made to the Company and the payment of dividends. The Council also expects the Company to repay the initial debt and any equity investments.
3. It will maintain the design, upkeep and look of the schemes that are central to the regeneration priorities for the Council's administrative area.
4. It will encourage economic activity and regeneration in local areas that result from construction activity in the local economy and offer a stable market tenure providing longevity, certainty over management and therefore security.
5. Diversify the Council's development portfolio to allow it, through a WOC to hold stock that is other than social or affordable rented.

The objectives set out in 3.15 are clear and will correspond with the Business Plan for the schemes that will be brought before this committee for approval at a later date.

3.16 It should also be noted that the WOC will give the Council a separate legal entity that can be flexed in alternative routes in the future should the business case or need arise as a result of new opportunities or challenges the Council is facing.

3.17 As a separate legal entity the WOC's structure and operating behaviour needs to be clearly set out. Furthermore, the control the Council would have over it also needs to be considered. Following legal advice, it is proposed that the WOC is a limited company, with all shares owned by the Council. This would give the Council complete control on the strategic direction of the WOC and who its key personnel are.

3.18 The WOC would likely operate with a small board of 2 or 3 Directors, comprising existing Council officers to be appointed by the Chief Executive. The WOC would not employ staff directly, as its operational requirements would be met through a series of contracted out arrangements (service level agreements) with existing Council services, or external providers. The Council's Development team would support the WOC on a time charged basis. This will allow the WOC to operate a low cost and efficient structure; this is further explained in 3.23.

3.19 Given that the identified schemes for the WOC's operations will be schemes where there is a GF and HRA investment lead, the Council should be assured that oversight on aspects such as programme, design and tenure would have already been exercised by members through the Housing Development Committee or member consultation, and the Capital Strategy approval process. However members would have additional scrutiny and control on decision making through the appointment of a Shareholders

representative as an addition to the Board of Directors referred to above in 3.18.

Stevenage Council Control over the WOC

- 3.20 Where the WOC (as a separate entity) will need its own policies and procedures it is proposed that the WOC adopt the Council's policies and this would therefore avoid any potential reputational risk or divergence and possible conflicts. This, along with the fact that Members will have influence via the appointment of a Shareholder representative, ensures the Council will retain full control over the WOC. The CEO will bring forward governance proposals with the full Business Plan as it is essential that there is complete confidence in the WOC to operate as per its objectives.
- 3.21 Whilst Directors of the WOC have a duty to act in the interests of the Company, even if there is a conflict with the Council, given the manner in which development schemes will arise, the approval process and the ethos of what is proposed it is unlikely that any conflicts will exist. However this is something that would need to be kept under review and appropriate measures will need to be put in place to ensure that any conflicts which do arise are managed appropriately. As the sole shareholder of the WOC the Council will be able to protect its interests by changing and adding to the Directors as it sees fit.
- 3.22 The WOC will require its own Articles of Association (constitution of the WOC) and a Shareholder Agreement (protecting the Council's interest as sole shareholder of the WOC) and if the Business Case for the WOC is approved it is proposed that delegated authority be given to the Chief Executive to instruct legal advisors Trowers & Hamlins to prepare these in draft form for the Executive's approval before the Company is established and begins trading. A budget of £25,000 had already been established in the 2018/19 capital programme to facilitate costs incurred in company research and set up this may be added to as the need arises.
- 3.23 At this stage it is envisaged that the WOC will in the first instance seek to procure the majority of the services it requires through internal departments. Specifically this includes Accountancy Support, Repairs, Maintenance and Housing Management. The only mandatory external service will be the lettings service, so as to clearly define a separation of the Council's affordable duties through the HRA and its commercial lettings arm operating through the WOC. Appendix 2 lists the services to be utilised by the WOC, subject to procurement process and any exceptions on service standards that may apply.
- 3.24 The WOC would be subject to corporation tax on the profits it generates from trading, the financial modelling for the business plan would seek to legitimately minimise any tax incurred by the WOC.

4 THE BUSINESS PLAN AND POST DECISION IMPLEMENTATION

- 4.1 A full detailed business plan with financial projections and cash flow implications is being prepared to be brought to a future meeting of the

Executive. At this juncture it is important to explain some key aspects about how the WOC will be financed and how the Council's returns will arise.

- 4.2 The proposal is to fund the WOC through a mixture of loan debt and equity investment from the General Fund. From both a taxation and State Aid perspective the mix of debt and equity needs to reflect a commercial approach. The WOC will then trade by purchasing housing schemes to rent at market rate levels. The types of returns generated are detailed below in para 4.5 General Fund Returns, however the priority of these returns, in the first instance, is to satisfy the costs and liabilities the GF has encountered in set up, rather than these being spent on new activities.
- 4.3 The WOC will be created as a new Council owned legal entity and Council officers will work with the consultant team of experts to devise the best legal and operational structure for the company to lawfully minimise liabilities and risk. These will be demonstrated in the Business Plan.

Three potential projects have already been identified as possible intervention projects for the WOC to enable modelling. These include the Council led schemes at Ditchmore Lane, 12 North Road (Subject to Planning) and a further Local Plan (STP). Rather than the full allocation of the private sale units on these schemes being sold to the private market it is proposed that the WOC would purchase a total of 25 apartments from these three schemes to let at market rents.

General Fund Returns

- 4.4 The General Fund is anticipated to receive three different types of return from the WOC and some ancillary benefits through increased business opportunities for its in-house services :

Interest on the loan to the WOC - This will generate a surplus for the General Fund of the difference between the rate it borrows the money for and the mandatory commercial rate it charges the WOC.

Dividends - These are entirely dependent on the profitability of the WOC. Should the WOC have surpluses it would be in a position to pay these to the Council after the WOC had properly accounted for any corporation tax payable on those profits.

The return/repayment of the initial debt and equity investments –At any given point the WOC would be able to sell the properties it holds and rely on the equity generated to pay the initial debt back along with any rise in capital value.

Ancillary business opportunities: Service commissioning or tendering

The WOC will operate in the new build private rentals market. The services it commissions to administer, repair and manage these properties will need to be procured. It is the intention that to begin with existing council services will bid for this work on a commercial basis and therefore make a small but reasonable return for the Council on the fees that they charge the WOC.

4.5 The Council will make a return on its investment in the WOC. However, there may be periods where the impact on the General Fund bottom line is negative as costs are greater than revenues. Further detailed work is required on this to identify the years in which this situation may arise and what mitigation can be placed on this, including the use of allocated reserves.

5 RISK MATRIX

5.1 Clearly the establishment of the WOC and operating in the Private Rented Housing Market brings new risks that the Council's Housing delivery teams will need to manage. However if the operation of the WOC is not seen in isolation to the Council's existing plan for developing in the HRA and the General Fund, then the diversified portfolio of housing development operations can be seen as a measure that more evenly spreads the council's exposure to major development risks such as market slow down.

5.2 The WOC will operate a risk register which will be reported regularly to the Board of Directors and annually to the Council. The risk register will include mitigation measures as part of the operational processes of the WOC's business.

The following risk categories have been compiled using Treasury Guidance (Public Sector Business Case, using the Five Case Model, Green Book Supplementary Guidance on Delivering Public Value from Spending proposals) and are likely to form the basis upon which the WOC's risk register will be compiled. Not all elements may be regarded as necessary as to begin with the WOC will only purchase off plan, pre designed homes from Stevenage Council.

Risk Area	Risk	Mitigation
Business risk	The risk that the WOC cannot meet its business imperatives.	The Business Plan will be scenario tested for resilience
Construction risk	The risk that the construction of properties is not completed on time, to budget and to specification thus impacting on, amongst other things, repayment obligations.	Resilience to Business Planning and good project management will be key to accurate forecasting
Decant risk	The risk arising in circumstances where occupants of properties need to decant.	An appropriate form of tenancy will be used to protect the Council's possession rights.
Demand risk	The risk that demand for the properties does not match the levels planned, projected or assumed and thus adversely impacting on cash flow projections.	A small number of homes in high demand locations are being proposed

Design risk	The risk that design cannot deliver the housing to the required performance or quality standards.	Reputable consultant team appointments along with sound project management
Economic risk	Where the project outcomes are sensitive to economic influences. For example, where actual inflation differs from assumed inflation rates.	Stress testing the business plan to varying economic changes and building in resilience
Environment risk	Where the nature of the project has a major impact on its adjacent area and there is a strong likelihood of objection from the general public.	Pre-application planning advice and careful stakeholder engagement
Funding risk	Where project delays or changes in scope occur as a result of the availability of funding. Also, where finance is unavailable on suitable terms.	The programme proposed for the Business Plan will have identified funding
Legislative risk	The risk that changes in legislation increase costs. This can be sub-divided into general risks such as changes in corporate tax rates and specific ones which may affect a particular project.	Horizon scanning and financial resilience to such changes will be incorporated in to financial modelling
Maintenance risk	The risk that the costs of keeping the properties in good condition vary from budget.	Historical data and professional forecasting will improve accuracy
Occupancy risk	The risk that a property will remain untenanted and thus adversely impact generally on cash flow projections and loan repayment terms in particular.	A robust and active marketing strategy with high demand property selection
Operational risk	The risk that operating costs vary from budget, that performance standards slip or that services cannot be provided. Also, the risk that unforeseen events impeded the ability of the WOC to function. This could include natural disasters or crime such as computer hacking.	Appropriate corporate governance and resilience management frameworks will be applied
Planning risk	The risk that the implementation of a project fails to adhere to the terms of planning permission or that detailed planning cannot be obtained, or if obtained, can only be implemented at costs greater than in the	Sound project management and use of professional services will be used

	original budget.	
Policy risk	The risk of changes of policy direction not involving legislation – local or central.	Risk areas will be identified and managed
Procurement risk	Where a contractor or service provider is engaged, risk can arise from the contract between the two parties, the capabilities of the contractor, and when a dispute occurs.	A procurement strategy that minimises risk will be used in line with SBC protocols
Regulatory risk	Changes in the regulatory environment impose costs which have not been foreseen and accounted for in the Business Plan.	A contingency budget will be planned for
Reputational risk	The risk that there will be an undermining of customer/media perception of the organisations ability to fulfil its business requirements e.g. adverse publicity concerning an operational problem.	An active media, including social media marketing strategy will be implemented
Residual Value risk	The risk relating to the uncertainty of the value of the properties.	Qualified valuations and professional forecasting will be used
Technology risk	The risk that changes in technology result in services being provided using non-optimal technology.	This is unlikely to apply to the residential lettings market

6 REASONS FOR RECOMMENDED COURSE OF ACTION AND OTHER OPTIONS

- 6.1 Whilst there is a recognised need to increase the supply of all housing types in Stevenage to meet the growing needs of the circa 85,000 households the Council could adopt a risk free, do nothing approach and leave the situation to the private housing market and housing associations to resolve. However, it is clear that this would result in higher house prices, lower standards of quality and choice as well as a shortage in supply. The council would also miss out on a commercialisation opportunity to generate income and offset delivery risk in its other housing programmes.
- 6.2 The creation of the WOC is seen as a measured risk initiative that if delivered correctly and in phased approaches, will ensure that the Council's overall risk positioning in respect to housing development is better balanced rather than worsened.

- 6.3 Consultation at this stage has been informally with Portfolio Holders and Members of the Housing Executive. Full public consultation will take place on all development schemes as part of the planning process and separated development consultation.

7 IMPLICATIONS

Financial Implications

- 7.1 There are clear financial implications. Some of the proposed schemes that will form part of the business plan and development pipeline have already been allowed for in the Capital strategy. However, agreement to deliver new schemes and take on additional Council borrowing will need to be measured against the returns generated and balanced with other Council priorities.

Legal Implications

The Council has powers to form a WOC under section 1 of the Localism Act 2011. This provides that the Council can do anything that an individual can do, provided it is not otherwise prohibited by any existing law. If a local authority uses this power for a commercial purpose, as is proposed here, section 4 of the Localism Act requires the council to use a company. The creation of the WOC to hold the market rent housing would satisfy this requirement. Regulation 2 of The Local Government (Best Value Authorities) (Power to Trade) (England) Order 2009 is also potentially relevant here as the establishment of a company to let market rented dwellings is likely to be regarded as trading. The 2009 Order requires that the council must prepare and approve a business case before establishing a trading company. This report sets out the business case for approval.

The report confirms that it is the intention for the Council to borrow with a view to on-lending to the WOC to facilitate the purchase of the properties once developed and that this will be a mixture of debt and equity. The Council has power to borrow for the prudent management of its affairs or in furtherance of its functions under section 1 of the Local Government Act 2003 and has a power to invest (for the same purposes) under s12 of the same act. When undertaking borrowing and investment the Council must have regard to the statutory guidance on investments issued by the Secretary of State. Amongst other things, this guidance prohibits a local authority borrowing in advance of need purely to make a profit. It also requires that a local authority consider the place making and service delivery objectives associated with the borrowing and investment.

Legal implications arising as a result of State Aid, the duty to obtain best consideration for land transfers, and procurement protocols will need to be addressed as part of the advice from Trowers & Hamlin that will accompany the Business Plan.

Planning Implications

- 7.2 The WOC will be in the first phase of its operation purchasing off plan homes. It is unlikely therefore that any adverse planning issues will arise.

Other Implications

- 7.3 **Constitutional:** responsibilities and functions of the WOC relating to policy and governance arrangements will be reported as part of the final Business Plan

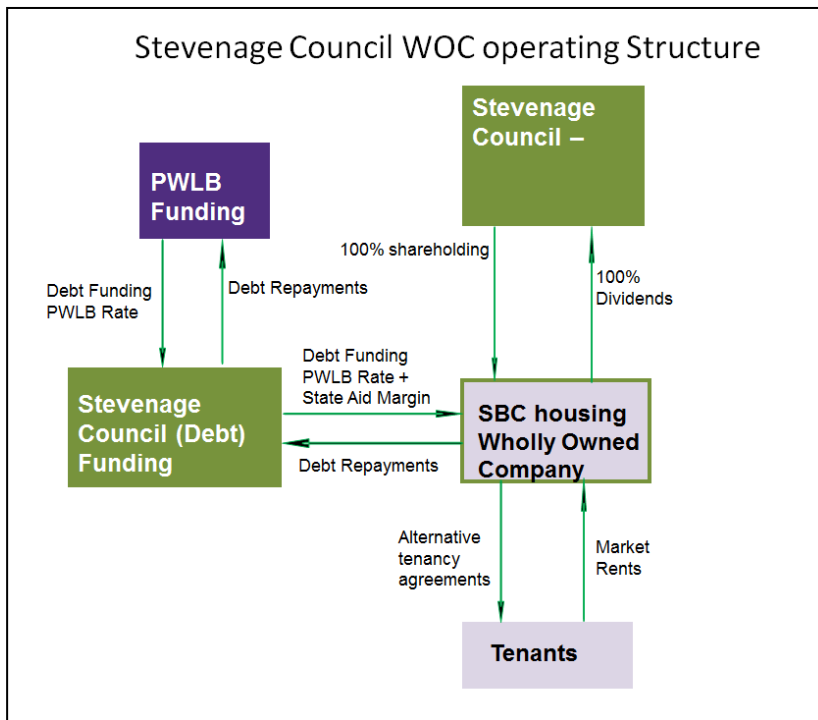
Equalities and Diversity Implications

- 7.4 The proposals in this report anticipate a positive impact from residents and do not raise any negative equalities issues because the creation of a housing WOC will add to the supply of housing available to our residents that live in and are from diverse communities. A full EIA will be completed for the Business Plan and on a scheme by scheme basis for the development programme.

APPENDICES

- 1 Stevenage Council WOC Operating Structure.
- 2 Stevenage Council WOC Operating Structure – Service Level Agreements.

Appendix 1



Appendix 2

