POLICY AND PROJECTS ADVISORY BOARD

EXECUTIVE DIRECTOR (CUSTOMERS, DIGITAL & RUSHMOOR 2020)

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DEVELOPING THE BUSINESS CASE FOR A LOCAL HOUSING COMPANY – FINANCIAL AND ECONOMIC CASE

1.0 INTRODUCTION

1.1 At the meeting of the Policy and Projects Advisory Board held on 30 August 2018 the PPAB were advised that the Council Plan set out a priority to establish a local housing company as a vehicle to allow the Council to participate directly in the provision of housing.

1.2 Members were advised that a business case was required to underpin any decision to set up a company and that the approach taken to this had been to use the HM Treasury Green Book Five Case Model. Members then considered the strategic, economic and commercial cases and considered a number of issues and questions. The record of this discussion was captured in the note of the meeting.

1.3 This report continues the PPAB's consideration of the business case and sets out the Financial Case and the Management Case for the proposal based on the creation of a wholly owned local housing company (WOC).

2.0 THE FINANCIAL CASE

Introduction

2.1. The Financial Case considers likely funding and affordability issues for both the Council (impact on the general fund) and the company.

2.2 This has been undertaken by building a model based on a set of assumptions set out in section 2.10 below. A 'sample portfolio' of development and rental has then been fed through that model. The 'sample portfolio' is based on a combination of land and existing properties currently in the ownership of the Council.

2.3 The number of units used for the purpose of the Business Case is set out in below.

Number of potential sites	**14**
Number of potential units	**52**

2.4 Members are advised that the actual programme the company delivers could be very different. For example some sites may drop out of the programme and some new sites may be added, the company could sell some existing properties or purchase additional units.

2.5 The initial modelling was based on all units being for private market rent as this was considered the option most likely to provide the best level of financial return to the company. The PPAB identified that they would wish to see the impacts of a range of tenure mix and therefore modelling has been undertaken on a range of tenure mixes to demonstrate the effect of developing some units as affordable and/or social housing.

Developing the model

2.6 The development of the model has involved a range of council officers supported by external advisors with housing development, financial and tax expertise. The assumptions underlying the inputs are detailed below and have been subject to review throughout the preparation of the business case. The key areas considered included annual projected cash flow, corporation tax (at the applicable rate) and accounting implications for the WOC. The cash flow implications for the Council's General Fund have also been modelled alongside the WOC cash flows. Once Members have finished their consideration of the business case and officers have prepared the initial business plan it is intended to test both of these externally with an organisation familiar with the operation of similar companies prior to consideration by Cabinet.

Modelling assumptions and principles

2.7 The model works on the basis that the Council will invest in the WOC by transferring land and a small number of completed homes from its General Fund in return for shares in the WOC. The Council will also loan money to the WOC to finance its development activities.

2.8 It is also important to note that the Council will take security over the WOC's assets (specifically the land) to protect its investment.

2.9 The key commercial aspects are currently reflected in the modelling as follows:

a) The Council will prudentially borrow in order to finance the WOC's development / construction activities. The financing of the WOC activities has been structured (in conjunction with external professional advisors) as a mix of loan finance (WOC Loan) and share equity in order to optimise the equity returns generated by the WOC and to broadly match the capital structure of a typical private sector developer.

b) The WOC will access funding through the Council, likely to be prudentially borrowed and provided to the WOC through a mixture of debt and equity.

c) In order to ensure the commercial structure is state aid compliant, the Council will be required to include a margin over the PWLB interest rate when pricing the WOC loan.

d) The Council will transfer land from its General Fund in return for loan notes or shares in the WOC. The WOC will be constituted as a company limited by shares in which the Council will own the entire share capital.

e) The servicing of the WOC loan is achieved through the generation of net rental income and the receipts arising from potential future sales of the properties by the WOC at the end of the 30 year period. The WOC will rent the houses out in order to repay the debt interest.

f) Net rental income after operating costs will be used to repay interest and the surplus will mainly be returned to the Council by way of interest charged on loan notes.

g) The WOC will act as an investment company, retaining the properties developed by the WOC for letting under new tenures at a mix of affordable and private rents in accordance with the agreed business plan.

h) The WOC will be consolidated into the Council's accounts. Group accounts will have to be prepared for this purpose. The WOC will be recognised in the Council's accounts partly as an investment in company shares, and also as a long-term debtor in relation to the issue of loan notes.

i) The acquisition of equity by the Council and the provision of loans to a third party are both defined as capital expenditure by legislation. They are specifically determined in the statutory instrument SI 2003/3146 (acquisition of equity; paragraph 25(1)(d) and loans; paragraph 25(1)(b)). Because such expenditure is funded by borrowing, there could be a requirement to make prudent provision for the repayment of such debt. However, the assumption has been made that the Council would expect repayment of the loan debt element in full, therefore, there is no requirement to make a provision for repayment of the loan.

2.10 The key financial assumptions underlying programme modelling are shown in the following table. The assumptions have been based on information provided by property and financial consultants utilising industry benchmarking and data.

Item	**Assumption**
Funding rate/term	*30 years, 2.7%*
WOC Funding rate	*30 years, 4.5%*
Land cost	*Based upon estimate of unserviced plots*
Construction costs	*Based upon estimated tender prices in the market and applied to the entire programme.*
Rents/ letting profile	*Rents are based upon current market rents, uplifted to the letting date and then uplifted at 2% per annum* *Letting profile is based upon industry advice received and benchmark data.*
Tenure mix	*Market rent*
Annual maintenance/ operating costs	*Management, maintenance, client management and lifecycle costs reflect analysis of Council/local Registered provider costs and benchmarked data, uplifted at 2.0% per annum.*
Void Rate/ Bad debts	*4% of gross rental per annum. Based upon benchmark information.*
Management fee	*10% of gross rental income per annum. Based upon benchmark information.*
Maintenance charge	*£400 per unit plus service costs per annum. (RPI indexed). Based upon benchmark information.*

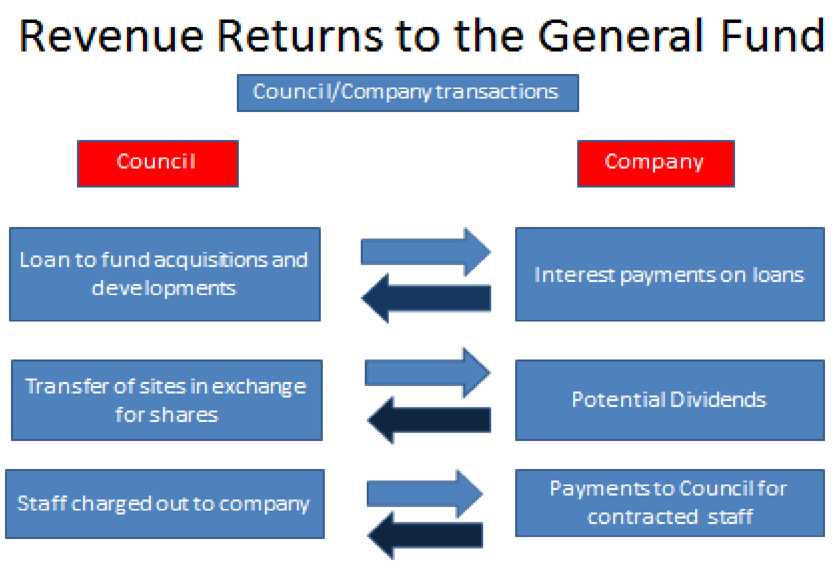
Item	Assumption
WOC operating costs	*Initial set up staff time charge £38K from RBC and then annually £18K staff time charge indexed. RBC staff time charged to projects as part of 12% fees, which may be RBC or external consultants*
House Price inflation	n/a as no disposals planned

2.11 Assumptions contained within the modelling relating to the General Fund are:

- Any net positive cash flows arising from rental income generated by the WOC in the first 3 years are recycled to fund construction where possible
- Distributions from the WOC to the General Fund in the form of dividends are restricted where the WOC continues to be funded mainly by loan note capital.

Impact on the Council's General Fund

2.12 The General Fund will receive three different types of revenue return from the Housing Company



Dividends

2.13 In some cases the financial modelling for the Housing Company demonstrates, on the current assumptions, that the initial loan debt can be repaid and that the Company is able to make both all interest payments on the total loan values as they fall due. The company could provide the Council with an annual dividend from year 4 whilst generating a surplus position for the company.

Other returns

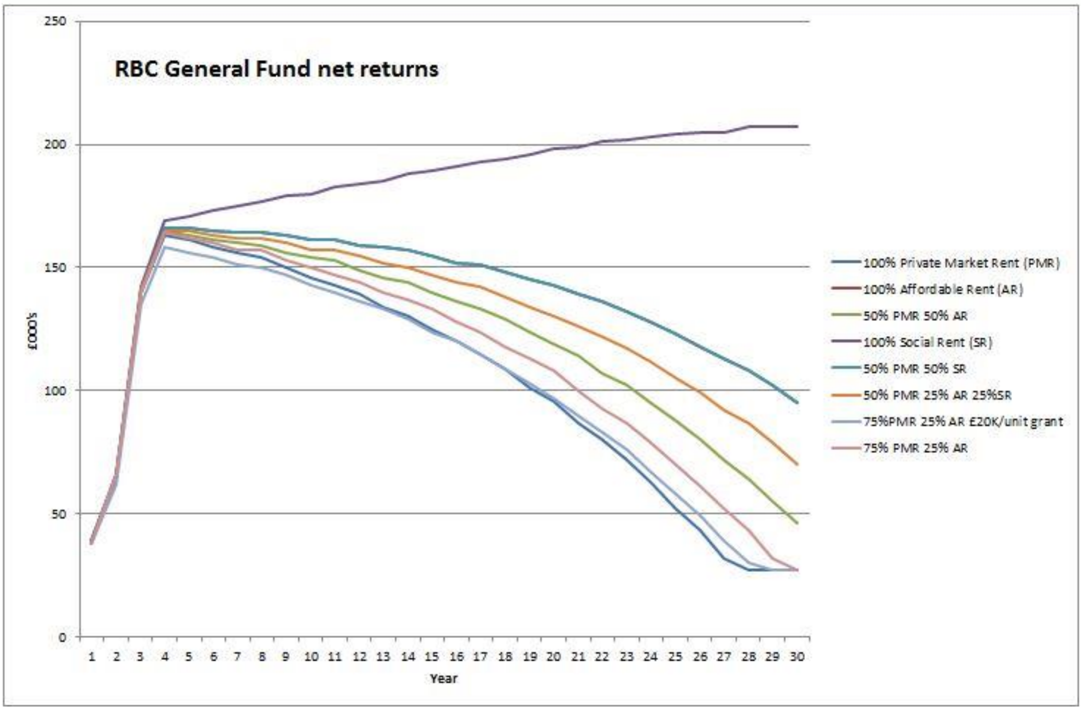
2.14 In addition to the returns to the General Fund as set out above, the Council will benefit from additional income through Council Tax generated from dwellings and from New Homes Bonus. The potential to generate income will also result from the provision of Council services and by contracting staff to the Housing Company subject to available capacity.

Options modelled

2.15 A total of eight options of tenure mix have now been run through the model.

Option 1	100% Private Market Rent (PMR)
Option 2	100% Affordable Rent (AR)
Option 3	50% PMR 50% AR
Option 4	100% Social Housing (SR)
Option 5	50% PMR 50% SR
Option 6	50% PMR 25% AR 25% SR
Option 7	75% PMR 25% AR
Option 8	75% PMR 25% AR £20K/unit grant e.g. commuted sums

2.16 All options deliver a return to the Council. All options excluding option 4 indicate the WOC would operate with a decreasing debt over the 30 year period modelled. However, only options 1,7 and 8 demonstrate full/nearly full repayment of debt over the 30 year period. This is shown graphically below and the supporting financial tables (exempt) will be available for consideration by members at the meeting along with the theoretical balance sheet and profit and loss information for the Company and the Council balance sheet and General Fund impact.



2.17 The performance indicator that was chosen for the purposes of the financial model was that the company could repay its loans in 30 years. The elimination of debt within this target period is a good indicator of company financial health and helps the company eventually to generate cash toward the end of the modelled period that could be used to pay dividends.

Risks and sensitivities

2.18 The current financial modelling indicates that, based on the initial 52 unit model for the Company, the Council would make a return on its investment in the Housing Company and the housing company could be considered a going concern for all options excluding Option 4 - 100% social housing.

2.19 However, although the business case demonstrates that the Housing Company is viable, there remains a risk that the principal sums transferred to the Housing Company by the General Fund are not returned in full. This would require adverse movements in a number of the assumptions used in the business plan, but is nevertheless a risk. This risk is significant during the first 5 years of the Company and at times when its asset base is below or close to its debt liabilities.

2.20 Sensitivity analysis has been undertaken in relation to the financial projections. The analysis considers changes in some of the key financial assumptions on which the model is based. These sensitivities consider largely the impact of downside movements on key input variables against the key metrics of the base case.

2.21 Whilst the WOC is an investment vehicle, the drivers behind a number of key metrics are centred on various capital elements such as development costs, sale values and house price Inflation (HPI). To reflect this point the impact of reducing rental income inflation to zero for a period of 6 years does have a materially adverse effect as the reduction in rental income results in lower company performance impacts on the Council’s ability to achieve a buoyant financial return.

2.22 However, an increase in rental income inflation to 2% provides a significant increase on the rate of return. The business case assumptions on rental income inflation and HPI can be considered prudent given current housing market trends.

2.23 A balance will need to be struck between financial advantage to the Council and the risks for the company . Because the company is wholly owned by the Council any adverse effects on the Company could cause difficulties for the Council and it will be the responsibility of the Company Board to run the WOC prudently and within the expectations and requirements of the Companies Act.

3.0 MANAGEMENT CASE

Introduction

3.1 The Management Case covers Governance Arrangements for the Company It also shows how Council will undertake the project, detailing the decision-making process, staffing arrangements, consultancy support, and budgets.

Governance Arrangements

3.2 The company will be set up and governed as a Wholly Owned Company (WOC) of the Council. An appropriate governance structure is required to ensure sound and robust management of the company alongside protection of the Council’s financial and reputational investment in the company. The governance must not hinder the company and must allow it to act swiftly and pro-actively as a separate legal entity.

Council’s role as Shareholder

3.3 The Council will own 100% of the shares in the company. As shareholder the Council will among other things, agree and approve the company’s annual business plan and funding arrangements and monitoring progress against the business plan on behalf of the Council.

3.4 There will be a range of matters reserved to the Council which means the company must have the Council's consent to actions relating to these matters. Outside of this the management of the company will be the responsibility of its board of directors.

3.5 Examples of matters that would require Council consent are:

- Borrowing outside the funding agreements entered into with the Council,
- Creation of a subsidiary
- Adoption or amendment of the Business Plan
- Acquisition of land or dwellings above a given value
- Entering into contracts above a certain value

These and other items requiring consent will be contained in a shareholder agreement.

3.6 A decision will be required on how the Council will exercise its role as shareholder. Possibilities are Licencing, Audit and General Purposes Committee acting as shareholder or a subgroup of LAGP Committee. Both of these would require powers to deal with the decisions required. Consideration will need to be given to whether some matters will still need Cabinet approval.

3.7 The need for the Shareholder to allow the company to react quickly in a commercial way will be a critical factor when considering the best structure.

3.8 Legal advice provided by Freeths recommends that a member of the Shareholder committee or sub group should not also be a director of the company

The Board of Directors

3.9 It is proposed that the company will have up to five directors, appointed by the Council, who may be members, officers or independent persons. They will need training to explain the extent of their formal duties under the Companies Act 2006 and their need to disclose their interests. There are a number of combinations that can be considered but it is recommended that one or two independent directors are appointed to add to the expertise of the board. No decisions have yet been made on the recommendation as to potential members of the WOC board as the Council is currently appointing a number of new heads of service who may be able to bring relevant experience and skills which would be beneficial.

3.10 The Council will need to provide indemnity insurance cover for officers of the Council serving on the board.

3.11 Although the company is wholly owned by the Council, as far as company law is concerned, the directors have duties to exercise independent judgement in the governance of the company and are accountable in terms of their duties under the Companies Act 2006. For example, they have to:

- act within their powers;
- carry out their role for a proper purpose;
- have a duty to promote the success of the company; and
- exercise independent judgement / exercise reasonable care, skill and diligence/ avoid conflicts of interest / declare an interest on any proposed transaction / to declare interests in existing arrangements.

3.12 This means, for example, that if members of the Board were also Councillors they would need to formally to disclose their role as company directors to the Council's Monitoring Officer and to notify other directors/company secretary of their role as members of the Council even though this might be known. If the company were to be trading whilst insolvent they could, in certain circumstances, become personally liable and open to investigation by Companies House.

3.13 Advice from the Council's legal advisers is that Members of the Council's Executive (Cabinet) could be on the board of directors but they would need to declare an interest and they should not hold the portfolios related to the business of the company e.g. Major Projects and Property.

Controlled Regulated Companies

3.14 The Local Government and Housing Act 1989 deals with companies under the control of local authorities and subject to local authority influence. The Housing Company is likely to fall within one of these categories and will therefore be required to comply with the relevant provisions of the Local Authority (Companies) Order 1995, in terms of accounting for debts etc.

The Council's Fiduciary duties

3.15 The Council's fiduciary duties can be briefly summarised as acting as a trustee of tax and public sector income on behalf of its rates and taxpayers. The Council in effect holds money but does not own it and spends that money on behalf of its business rate and council taxpayers. Taking these fiduciary duties into consideration, the Council's primary objectives when making investments/loans are the repayment of the principal and interest on time, then ensuring adequate liquidity, with investment return being the final objective. The Council therefore will need to ensure that that it has minimised the risks and potential costs to it if the Housing Company becomes insolvent and/or defaults on any loans and then ensure that it achieves an appropriate return for the lending it provides.

State Aid Compliance

3.16 If the Council is acting in a way that a private lender and/or investor would not act in similar circumstances in a market economy, for example, by providing a loan on uncommercial terms and at an uncommercial interest rate, and/or was making an equity investment on the terms and for the return which a private investor would not, then such activity could constitute unlawful State Aid within the meaning of Article 107 of the Treaty on Function of European Union (TFEU).

3.17 When the Council establishes the detailed loan arrangements with the Housing Company it will need to ensure that an analysis of the relevant risk in relation to the loan is undertaken and also confirm that the interest rate applied is consistent with that which a private lender would require in the same circumstances and that the non-financial element of the loan complies with the terms and conditions which a private lender is likely to require, so not to constitute unlawful state aid.

3.18 State Aid will need to be continually kept under review to ensure that the support from the Council is able to continue to be provided throughout the loan period.

3.19 It is also important that any services provided by the Council to the Housing Company are provided at "arm's length" on a commercial basis.

Staffing

3.20 In the initial set up stage, council staff will be contracted to the company to carry out the work necessary to deliver and review the company's business plan. Formal contractual agreements will be entered into between the Council and the Housing Company in relation to such staff. The contracted staff team would run the day to day management of the company. Working as a team, they would need to oversee the design, planning, procurement and construction process through strong project management processes and monitoring the performance of contracts such as letting and management agents.

3.21 The staff team would commission specialist consultants and contractors to undertake the detailed design, planning and implementations work ensuring that such matters conform to the company's procurement requirements.

3.22 The Housing Company will contract with the Council through a series of service level agreements for HR, finance and legal advice etc. The company will meet the cost of staff and specialist support. The Council will charge the company for contracted staff including VAT at the appropriate rate. It is unlikely that the company will be able to recover the VAT charged in these circumstances.

Proposed Accounting arrangements

3.23 Due to the relatively limited volume of transactions within the company for the initial years, it would be practical to maintain and complete the accounts within a spreadsheet. The alternatives are to (1) utilise capacity in Rushmoor Integra 2 system (setting up a new company within), or (2) the company purchases a software package. The company will require its own bank account.

Project Management

3.24 Subject to Cabinet and Full Council approval to set up a housing company it is currently proposed that this will be treated as a project as part of the Council's regeneration programme and will be managed and governed in accordance with the processes set up for that programme

4.0 CONCLUSION AND NEXT STEPS

4.1 Consideration of the desired outcomes against the delivery vehicle options has led officers to the conclusion that a wholly owned company limited by shares is the best vehicle to assist the Council in meeting its housing objectives. Examination of this option has established that the Council has powers to create a company and to provide funding. Financial modelling demonstrates the potential to make a return on investment in the company from three principle sources: dividends deriving from surpluses, interest on loans to the company, and charges for services provided to the company by Council staff. A company will give the Council the freedom to participate in the housing market to meet housing needs and to achieve greater financial sustainability.

4.2 The PPAB are invited to consider this report and further information they might require. At the conclusion of PPAB discussions members are invited to set out any comments or recommendations they would wish to be passed on to the Cabinet when the decision to set up a Housing Company is to be considered.

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