Sevenoaks District Council
Affordable Housing Company Business Case

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Contents:

NB: Whilst this report refers to relevant legislation and comments on legal aspects of each option, based on experience and knowledge of existing entities and approaches in other authorities, please note that MBCL does not provide a fully qualified legal advice service; SDC is advised to take specialist legal opinion before taking a formal decision to implement its preferred delivery option.

Executive Summary

This report sets out a business case for the establishment of a local housing company to deliver affordable homes in the Sevenoaks district.

Discussions with SDC identified that the key **purposes** for this programme are:

(a) Making effective use of s106 commuted capital sums.
(b) Securing the long term supply of affordable homes.

The local **context** is characterised by high housing demand and relatively high prices for market rented and market sale homes. The Council currently holds a waiting list of over 600 households. There is a strong political commitment to providing affordable housing and enthusiasm for direct intervention in this space by the Authority.

The **options** of building in-house have been considered, whether creating a new Housing Revenue Account or delivering temporary accommodation in the General Fund, as well as the options of granting funds to Registered Providers or forming a Joint Venture. The preference for establishing a wholly owned not for profit Affordable Housing Company (AHC) offers clear benefits over other options, provided development activity can be demonstrated to be financially viable. The interface between an AHC and the existing Council owned commercial development company Quercus 7 also offers advantages. It is important to note that the establishment of an AHC is recommended as an additional tool to complement the affordable housing provision undertaken in the area by Housing Associations / Registered Providers.

The report discusses a number of **financial assumptions** needed to model development funding options, including rent levels, void and bad debt rates, management and maintenance costs, inflation rates, land values, debt costs, loan periods and gearing (debt:grant ratios).

A series of seven options were modelled using a standard set of assumptions for a typical 10 home development and varying land price and grant rate. The results demonstrate how challenging new build development of affordable housing can be from a baseline without revenue surplus input from an existing property portfolio or capital cross-subsidy from homes built for market sale. An eighth option was modelled to explore the impact of a shorter loan period and the impact of higher rent inflation was tested. The options that work require **discounted land** or an **effective grant rate between 58% and 100%**.

Given the Council currently has around £5 million in s106 commuted sums, if this amount was invested on Council land at an effective 58% to 100% grant rate, then (provided the unit costs suggested are realistic and suitable sites are available) these funds could deliver between **17 and 50 new homes** in the District. Land provided at nil value, whether by the Council or a partner (e.g. a local charity), could increase output and value for money by up to a third. The best options achieve surpluses that could be reinvested in building additional affordable homes in the future.

Governance options include the corporate form and structure to be used, the make-up of the company Board, levels of delegation and decision-making and avoidance of conflicts of interest (e.g. for certain Council members and officers). The AHC is recommended to be a Company Limited by Guarantee with similar Board arrangements to Quercus 7, sitting within the Council's existing Trading Board arrangement.

Funding arrangements focus on the availability of s106 commuted sums and the Council's ability to borrow and then on-lend capital funding to the AHC at below market rates. Due to the focus on delivery of affordable housing in the general economic interest, there is an exemption from **State Aid** rules in this case.

Land can be made available to the AHC by the Council, disposed of at discount under the 2003 General Consent, provided each transaction is not undervalued by more than £2 million.

The report includes a detailed **risk** appraisal which it is recommended be regularly reviewed and updated as new risks arise. Whilst property development is inherently risky, the creation of a subsidiary company limits the Council's liability and ring-fences the commercial risk in the company.

Conclusion:

The evaluation demonstrates that, with use of s106 commuted sums, discounted land and sub-market loan terms, appropriately geared, delivery of affordable rented homes can be made viable.

The report concludes with a suggested **implementation plan**, indicating that the AHC could be registered within a month or so of Member approval and potentially on site with a development scheme within a year.

1. Purpose and Context

Discussions with SDC officers explored a range of objectives, purposes and drivers for a proposed development programme, including to:

- Increase affordable housing supply available for SDC's use.
- Meet housing needs of the most disadvantaged.
- Meet the needs of young people.
- Provide temporary accommodation and avoid the use of Bed & Breakfast.
- Support older people to downsize and free up family homes.
- Meet the needs of working people on lower incomes.
- Provide rented and shared ownership options.
- Make use of available s106 commuted sums.
- Make use of available land opportunities in the public and third sector.
- Invest in assets that deliver a long run financial return to the Council.
- Provide an ownership vehicle for affordable homes built by Quercus 7 where required under s106 Planning agreements.

Having considered relative importance and priorities, the focus was clearly:

- Making effective use of s106 commuted sums.
- Securing a long term supply of affordable homes.

The local context is characterised by an increasing population and ageing population, consequently a high demand for housing of all tenures, summarised well in the Local Housing Needs Study (May 2017).

Sevenoaks District is the least affordable area in Kent, based on median house prices, with a lower quartile house price to income ratio of 13.44 in 2015 (i.e. lower quartile house prices are 13.44 times lower quartile gross earnings). High demand continues to outstrip supply of homes for sale, particularly family houses with gardens.

Estate agents report a buoyant private rental market and high demand for a range of accommodation, with the sector up to almost 13% of households. Given the high price of market rents, many private renters are unable to save towards a deposit, so these households are effectively stuck in the private rented sector and cannot afford to buy a home of their own. The benefit cap is affecting the amount of rent that private landlords receive, making them even less likely to take lower income tenants. This makes it increasingly difficult for those who are benefit- dependent or on low incomes to secure appropriate accommodation privately.

Private rent levels continue to rise in the Sevenoaks district, with the median monthly rent in 2016 at £1,200 pcm and the lower quartile at £975 pcm, both more expensive than in Kent and the South East of England as a whole. While private sector rents remain high and benefits and subsidy levels remain frozen, it will be very difficult to secure the volume of homes needed for low income and benefit-dependent households.

The need for affordable housing in the Housing Needs Study shows a net imbalance of 604 homes each year, of which 77% need to be one and two bedroom general needs and 13% homes for older people (mostly one bedroom). Currently affordable housing (social rented or intermediate) across the Sevenoaks District accounts for 15% of all occupied dwellings.

More affordable housing is needed, across all sizes and tenures, and there is a specific need for more temporary accommodation, particularly in light of the Homelessness Reduction Bill 2017, due to take effect in April 2018.

Financial subsidy support is needed to enable the provision of more social and affordable rented and shared ownership housing. Some flexibility on land use via Planning may be required to find smaller sites for redevelopment and new homes, particularly on the edge of the Green Belt or on open spaces within existing urban areas.

2. Options Appraisal

This section sums up the alternative options for delivery of new affordable homes and evaluates the rationales for selecting a preferred option of setting up an Affordable Housing Company.

Option 1: Housing Revenue Account (HRA)

This would entail creating a new HRA for the small number of homes to be developed by the Council. Although individual local authorities each now have a "self-financing" HRA, there remains a weighty framework of regulation, guidance and reporting arrangements administered by DCLG, which SDC would be required to comply with. All of the relevant accounting rules and restrictions would be time-consuming and likely to create a steep learning curve for Council staff, who have not been involved in HRA accounting practices since the completion of LSVT over twenty years ago.

Rents would need to comply with the national formula rent regime (which currently requires an annual 1% rent reduction, although the Government has recently announced a return to above inflation rent increases from 2020). Tenants would have Secure tenancies under the Housing Act 1985, including the Right To Buy at a large discount on market value.

Financing of new development in a new HRA would be highly restricted by the HRA borrowing headroom provisions – in this case, DCLG would need to set an appropriate debt ceiling for SDC and it is unclear how this would be calculated, presumably based in part on a long term view of the authority's housing capital investment needs, which would be rather hard to estimate when new homes have yet to be built. There is no indication at this stage that the additional debt headroom announced in the November 2017 Budget would be available to SDC.

In light of these challenges and restrictions, this option is not recommended.

Option 2: General Fund (GF)

Properties can be developed or acquired and held within the GF for use as temporary accommodation, let on non-secure tenancies, at affordable rent levels and without eligibility for the Right To Buy. A number of London Boroughs are pursuing this option, given the high levels of homelessness and the associated costs they incur. This approach can generate savings in GF revenue budgets. However, this is not a significant pressure for SDC at present.

There would not be the option of discharging the homelessness duty (by way of a Private Rented Sector Offer under Section 193 of the Housing Act 1996 as amended by Section148 of the Localism Act 2011) as these would not be private tenancies; the homeless duty would only be discharged if the homes were held in an HRA and let on secure tenancies.

This option avoids the restrictions of the HRA borrowing cap, with prudential borrowing in the GF not currently limited in this way. However, it is unlikely that long term temporary accommodation would either meet the Council's strategic objectives for use of s106 commuted sums or the terms of those s106 agreements, which typically are intended to deliver permanent affordable homes in perpetuity.

In light of these challenges and restrictions, this option is not recommended.

Option 3: Grants to Registered Providers (RP)

The Council has the power to grant s106 funds to Registered Providers of social housing (these can operate as either for-profit or not-for-profit entities). This approach would involve entering into a grant agreement, with a range of legally enforceable conditions, to deliver new homes. The Council could also provide land at a discount, again with covenants in place restricting the use of the land for affordable homes. Any such agreement would include long term access arrangements to the new homes for Council nominees.

This approach avoids the time, cost and other resources involved in setting up a new entity. It could be argued that RPs have valuable experience, expertise and financial strength, as well as economies of scale, with many operating across wider areas and in other districts.

However, there may be issues of control and trust with these partners, with their wider geographical spread representing a threat in terms of potentially focusing their attention on other local authority areas and ultimately investing any financial benefits accruing from affordable homes in the Sevenoaks district into meeting the needs of other authorities.

Given these concerns, a delivery option that is locally focused and controlled by the authority is likely to offer greater assurance and security.

There is no requirement within SDC s106 agreements that secured commuted sums to make these funds available exclusively to RPs. The SPD does state that "normally" commuted sums will be made available to RPs; however, this is arguably not legally binding in every case, "normally" implies exceptions will arise. If needed for clarity and assurance, it is possible to agree variations to the SPD and s106 agreements to ensure that it is clear that SDC has the legal right to invest these funds via an alternative affordable housing provider, including a company owned directly by the Council.

Option 4: Affordable Housing Company (AHC)

This would entail the Council setting up a limited company (or other corporate entity) as a subsidiary to develop properties for use as affordable housing.

A growing number of local authorities have established trading companies in recent years using the "general power of competence" under the Localism Act 2011, including many housing development and management companies.

Section 1 of the Act provides local authorities with the power to do anything an individual may do subject to a number of limitations. A local authority may exercise the general power for its own purposes and/or for the benefit of others.

Section 2 of the Localism Act 2011 limits the exercise of the new general power where it overlaps with a power which predates it, such as Section 95 of the Local Government Act 2003. Whether the Council relies on the General power and/or Section 95 of the Local Government Act, it is prudent for it to comply with the requirements and limitations to which S.95 is subject. These are set out in Regulation 2 of The Local Government (Best Value Authorities) (Power to Trade) (England) Order 2009 (the Order) which requires a business case to be prepared and approved by the Council before a company starts trading.

Whilst a company solely for the provision of affordable housing could legally be set up on a for-profit or not-for-profit basis, the intention of SDC is likely to emphasise a straightforward social purpose, without any expectation of profits being returned to the Council as shareholder. Rather, any surpluses achieved over time would be reinvested in provision of affordable housing. Given this emphasis, a Company Limited by Guarantee or another not-for-profit style of corporate entity would be preferable to a Company Limited by Shares.

Section 24 of the Local Government Act 1988 provides the Council with the power to provide a wide range of financial assistance to any person for purposes including the acquisition, construction or improvement of “privately let housing” i.e. housing where the immediate landlord is not a local authority. Section 25 of the Act provides that the council must obtain the consent of the Secretary of State to use their powers under S.24. The Secretary of State has set out pre-approved consents in the "General Consents 2010", paragraph C of which allows a local authority to provide financial assistance (other than the disposal of land) in connection with the purposes referred to above.

Most local authorities opt to borrow from the Public Works Loan Board (PWLB) at below market rates and then on-lend to their subsidiary companies. For State Aid compliance reasons, local authority loans to a company for commercial activities must be provided on market terms. This principle applies to Quercus 7. There is an exemption from State Aid compliance for non-commercial purposes, thus in the case of a new affordable housing company, below market rate lending is possible.

Whilst the Government has previously stated that it does not support councils setting up companies in order to provide social housing whilst avoiding the Right To Buy and circumnavigating HRA borrowing constraints, the February 2017 Housing White Paper marked a shift from tacit to open Ministerial support for local authority companies. Although the White Paper indicates a Ministerial desire for these companies to offer affordable housing with the same tenancy rights as within the HRA (notably including the Right To Buy), there has been no indication that the Government will introduce legislation to this effect.

Decisions about management and maintenance arrangements would most likely hinge on the scale of the portfolio and its location. Contracting with an RP partner is likely to be the most realistic option.

Given the analysis above, the option of setting up an affordable housing company is demonstrably preferable to the other options, subject to the detailed business case and financial modelling that follows later in this report.

Option 5: Joint Venture

This option would entail forming a legal partnership or JV company with a private sector or Registered Provider partner, with SDC holding 50% of the shares or decision-making control. The JV would be partly financed by private investment, whether private equity, RP equity, bank or bond finance.

Two key issues arise: firstly, the State Aid question, if the JV partner is a profit-making venture; secondly, the tenure mix - rented affordable housing, which is likely to require a degree of rent restriction that may be unattractive to private equity or bond market funders. There would also be procurement issues around the selection and agreement of terms with a partner.

At this stage, the key objectives for SDC are use of s106 commuted sums and provision of affordable housing. Neither sits particularly well with the motivation of a JV to deliver profits to its private sector partners and funders.

The JV option would be best suited to a development opportunity that offers a mix of market and affordable tenures, with s106 funds contributing to the affordable element and private finance investing in the market element. In the absence of specific opportunities of this kind, there is no immediate incentive to pursue this option, which would raise a number of legal, financial and procurement challenges. If such opportunities arise, a more obvious starting point would be delivery via Quercus 7, with affordable homes then retained by an affordable housing company as above.

Relationship with Quercus 7

There are clear advantages for the Council to create an AHC to complement its commercial subsidiary delivering market homes. On sites where Planning policies require delivery of affordable homes alongside market housing, then Quercus 7 could construct and dispose of the affordable homes into the AHC. There may well be scope for synergies in sharing staffing, jointly procuring consultancy support, professional services, etc. which would result in economies of scale benefiting both companies.

In summary, the proposed AHC vehicle should be seen as a complementary enhancement to the range of affordable housing delivery options locally, rather than an exclusive alternative to use of RP partners.

The table below provides a summary of these options for ease of reference.

Table: Summary Evaluation of Options

	Option 1: HRA	**Option 2: GF**	**Option 3: RP**	**Option 4: AHC**	**Option 5: JV**
Debt	HRA borrowing (capped)	GF borrowing	Private finance	GF on-lending	Likely to be private finance
Equity	Not required	Not required	Not required	Land as equity	Land as equity
Tax status	Exempt	Exempt	Depends on type of RP	Yes	Yes
Public procurement rules apply	Yes	Yes	Depends on type of RP	Possibly	Possibly
Tenure options	Secure tenants	Non-secure tenants	Assured short-holds	Assured short-holds	Assured short-holds
Tenants eligible for RTB	Yes	No, but use for TA only	Voluntary RTB now in law	No	No

3. Viability Analysis

This section explores the financial viability of the AHC approach, on the basis of a suggested set of financial assumptions, explaining gearing options, rent/tenure types, and the results of outline financial modelling.

Rent levels

The term "affordable housing" in terms of Planning policy includes a range of rent levels:

- Social rents (the lowest rent levels, set by a Government formula)
- Affordable rents (up to 80% of market rent, usually within LHA levels)
- Intermediate rents (below market rents, may be above LHA levels).

Discussion with SDC officers indicated a preference to deliver rents up to LHA levels. Sevenoaks District incorporates two Broad Market Rental Areas for LHA, namely High Weald BRMA and North West Kent BRMA.

Given that land values are likely to be lower in the North West Kent BRMA and so this area is more likely to offer opportunities for development of affordable housing on Council sites, these LHA levels are recommended for initial modelling of rent levels for the AHC, as follows:

1 bed £124.69 pw or as an annual equivalent £6483.88 pa.
2 bed £153.02 pw or as an annual equivalent £7557.04 pa.
3 bed £174.43 pw or as an annual equivalent £9070.36 pa.

There is also a desire to deliver some shared ownership homes. This tenure can provide some immediate capital receipts to reduce the level of ongoing debt in the company. However, this approach also ties up capital long term, depending on the level of "stair-casing" that can be realistically expected (i.e. purchase of further equity after the initial share). At this stage it is recommended that initial development plans and modelling are focused on 100% rented homes, with shared ownership introduced at a later stage as the company's longer term balance sheet strength is secured.

Financial assumptions

Assumed rent income is calculated using annual rent levels and applying a deduction for a typical average period of vacancy between tenancies (known as a "void" rate) plus an amount for unrecoverable bad debt to be written off.

This modelling study used a benchmark combined void and bad debt rate of 5%.

Whilst rent increases would sit outside the national rent regulation regime, for the purposes of modelling the most prudent assumption advisable is that annual increases will track CPI inflation levels. Assuming a cyclical average CPI of 2%, the modelling used the following inflation rates:

Rent inflation CPI (cyclical average 2%)
Cost inflation CPI (cyclical average 2%)

Modelling of an uplifted above inflation rent increase rate is included later on in this analysis, to mirror the recently confirmed Government position for RPs of CPI+1% post 2020. However, this is not recommended for the base case.

Having considered rent income, the remaining key variables are the costs to be met by this income – namely management, maintenance and debt interest and principal payments.

Management and maintenance costs vary by landlord, property type, scale and geographical spread of homes. For the purposes of modelling, a benchmark assumption of £1750 pa per home was used. This benchmark assumes lifecycle component replacement for new build homes (e.g. boilers, windows, kitchens, roofs, etc.) without including major works that would be needed beyond the assumed initial 40 year loan period. Modelling for refurbishment of older properties rather than new build would need to include a higher level of lifecycle replacement and major works costs.

In relation to the cost of debt, the modelling assumed a discounted loan rate, given the State Aid exemption for affordable housing purposes, with the interest rate matching Public Works Loan Board (PWLB) rates, fixed at c.3% and principal repayments (effectively an additional 2.5% per year) to clear the total sum borrowed over 40 years. The option of shorter term loan finance is explored briefly later in the report.

An alternative option would be to enter an interest-only loan arrangement. However, the requirement for a Minimum Revenue Provision (MRP) for the authority to repay principal amounts to PWLB would need to be covered by the company (otherwise there would be a negative accounting impact on the General Fund revenue position). This is not recommended.

Gearing

In simple terms, the “gearing” of development scheme finance refers to the ratio between debt funding that attracts interest payments and grant or equity that is input without any expectation of a guaranteed return on investment. Most affordable housing developments since the late 1980s have relied on debt finance, thus enabling limited grant funding to go further and deliver a higher output of new homes, offering better value for money to the public purse. In the modelling below the debt/grant gearing ratio also interacts with the question of land value. In essence, there is scope for an additional grant subsidy where the Council provides land at a discounted or even nil value (the legal basis for doing this is explained in a later section of the report).

Hence the modelling covers the following seven options:

Option A
Land at nil value
Grant (s106 funds) 50%
Debt 50%

Option B
Land at nil value
Grant (s106 funds) 25%
Debt 75%

Option C
Land at 50% of market value
Grant (s106 funds) 50%
Debt 50%

Option D
Land at 50% market value
Grant (s106 funds) 25%
Debt 75%

Option E
Land at full market value
Grant (s106 funds) 50%
Debt 50%

Option F
Land at full market value
Grant (s106 funds) 25%
Debt 75%

Option G
Land at full market value
Grant (s106 funds) 100%
Debt 0%

Scheme scenarios

SDC officers provided outline information on three possible development scheme scenarios, as follows:

Site 1 – Purchase and refurbishment of a Bed and Breakfast hotel.
This would require acquisition most probably at full market value, which means that the options relating to discounted land input by the Council would not be relevant. The costs of conversion and refurbishment should be cheaper than new build, although this will depend on the condition of the building and the degree of internal reconfiguration required. Until a detailed internal survey and design feasibility study has been carried out, it is hard to come up with a set of assumptions for modelling purposes. This opportunity would clearly be attractive in terms of temporary accommodation and/or move on for young single people, whether those who have been accommodated

under a statutory homelessness duty, to prevent homelessness or to assist young people in employment and training.

Site 2 – Land gifted by a local charity for new build development.
This would require a robust legal agreement between the AHC and the charity in relation to the use of the land – whether on a long leasehold or freehold basis, possibly as an equity input by the charity with scope for return, either in terms of ongoing revenue or capital at a future stage. If the charitable asset was being permanently disposed of to the AHC, then covenants in relation to future charitable use may well be required to satisfy regulators such as the Charities Commission. If alongside existing affordable housing provided by the charity, then particular consideration would be needed about the most appropriate use of the new homes, for example this might be ideally suited to enable downsizing moves for older people, freeing up scarce family homes elsewhere.

Site 3 – Land owned by the Council available for new build development.
This scenario is the most straightforward, assuming a clear site ready for development, already in Council ownership. Depending on the site constraints and context, this type of opportunity may be ideal for building houses or flats, maximising the number of homes delivered, most probably aiming to provide a majority of two-bedroom homes, given the need profile. This allows for a range of land input options – the Council putting land in at nil value, a discounted value or seeking full market value from the company. This presents the best opportunity to test out the viability of an AHC new build approach from a standing start and hence was the focus of the modelling exercise described below.

The options below showing nil value land input would work equally well with the Site 2 scenario, if land was gifted by the local charity without any future financial return expectations.

Modelling

The modelling assumed an initial investment in 10 x 2 bedroom homes. To provide the most straightforward illustration, the assumed costs used were £100,000 open market land value per home and £200,000 development costs, totalling £300,000 total scheme costs per home, i.e. £3 million for the scheme of 10 homes when full land value is included.

These broad assumptions will need to be carefully tested in relation to land values and build costs for specific sites, details of which were not available at this stage.

This then translates into the following seven options:

Option A

	£M
Land at nil value	£0
Build cost	£2.0
Total CAPEX	£2.0
Grant (s106 funds) 50% of CAPEX	£1.0
Debt 50% of CAPEX	£1.0
Effective grant rate (including land)	66.6%

Option B

	£M
Land at nil value	£0
Build cost	£2.0
Total CAPEX	£2.0
Grant (s106 funds) 25% of CAPEX	£0.5
Debt 75% of CAPEX	£1.5
Effective grant rate (including land)	50%

Option C

	£M
Land at 50% of market value	£0.5
Build cost	£2.0
Total CAPEX	£2.5
Grant (s106 funds) 50% of CAPEX	£1.25
Debt 50% of CAPEX	£1.25
Effective grant rate (including land)	58.3%

Option D

	£M
Land at 50% of market value	£0.5
Build cost	£2.0
Total CAPEX	£2.5
Grant (s106 funds) 25% of CAPEX	£0.625
Debt 75% of CAPEX	£1.875
Effective grant rate (including land)	37.5%

Option E

	£M
Land at full market value	£1.0
Build cost	£2.0
Total CAPEX	£3.0
Grant (s106 funds) 50% of CAPEX	£1.5
Debt 50% of CAPEX	£1.5
Effective grant rate (including land)	50%

Option F

	£M
Land at full market value	£1.0
Build cost	£2.0
Total CAPEX	£3.0
Grant (s106 funds) 25% of CAPEX	£0.75
Debt 75% of CAPEX	£2.25
Effective grant rate (including land)	25%

Option G

	£M
Land at full market value	£1.0
Build cost	£2.0
Total CAPEX	£3.0
Grant (s106 funds) 100% of CAPEX	£3.0
Debt 0% of CAPEX	£0
Effective grant rate (including land)	100%

In each case a simple spreadsheet was produced calculating the annual surplus or loss and a cumulative aggregated surplus or loss over a 40 year period, assumed to be the term of the loan from the Council to the company.

Summary Results

The modelling produced the following outputs:

Option	A	B	C	D	E	F	G
Debt	£1m	£1.5m	£1.25m	£1.875m	£1.5m	£2.25m	£0m
Effective grant rate	66.6%	50%	58.3%	37.5%	50%	25%	100%
Breakeven year	Yr2	Yr23	Yr13	Yr34	Yr23	n/a	Yr1
Surplus/loss (Y1-Y40)	£1.08m	-£0.02m	£0.53m	-£0.85m	-£0.02m	-£1.67m	£3.28m

The results demonstrate the importance of both land value and gearing to the viability of developing affordable housing. Only Option A and Option G are clearly viable on this analysis:

- Option A with a substantial 66.6% grant rate including land at nil value.
- Option G with a massive 100% grant rate whilst paying full land value.

Both these options deliver sufficient surplus overtime to reinvest in further development or acquisition opportunities. The table below shows how each of these options performs at snapshot stages during the 40 year business plan.

Option A	Year 1	Year 11	Year 21	Year 31	Year 40
Income	£71,725	£87,432	£106,580	£129,920	£155,266
Debt	£55,000	£55,000	£55,000	£55,000	£55,000
M&M costs	£17,500	£21,332	£26,004	£31,699	£37,883
Surplus/loss	-£775	£11,100	£25,575	£43,221	£62,383

Option G	Year 1	Year 11	Year 21	Year 31	Year 40
Income	£71,725	£87,432	£106,580	£129,920	£155,266
Debt	£0	£0	£0	£0	£0
M&M costs	£17,500	£21,332	£26,004	£31,699	£37,883
Surplus/loss	£54,225	£66,100	£80,575	£98,221	£117,383

Although **Option C** achieves a cumulative surplus over 40 years, the development makes a loss each year for the first 12 years, which would require revenue grant input from SDC, totalling £98,000 over the 12 years. It seems likely that cost savings both at the development stage and in the management and maintenance of the homes during the first 12 years should plausibly enable an earlier breakeven on this option. However, on these assumptions the scheme is very marginal and would need to be considered a real investment risk from the lender perspective.

Clearly the other four options are entirely unviable on this analysis.

Shorter term loan finance

The need for a long term repayment period for debt finance for affordable housing can be illustrated by taking Option A and reducing the loan term from 40 years to 25 years. The modelling then produces the following outputs:

Option	A(25yr)
Debt	£1m
Effective grant rate	66.6%
Breakeven year	Yr14
Surplus/loss (Y1-Y40)	-£0.01m

The table below shows how Option A(25yr) performs at snapshot stages:

Option A(25yr)	Year 1	Year 11	Year 21	Year 25
Income	£71,725	£87,432	£106,580	£129,920
Debt	£70,000	£70,000	£70,000	£70,000
M&M costs	£17,500	£21,332	£26,004	£28,148
Surplus/loss	-£15,775	-£3,900	£10,575	£17,218

Although **Option A(25yr)** almost breaks even in aggregate over 25 years, the development makes a loss each year for the first 13 years, which would require revenue grant input from SDC, totalling £114,000 over the 13 years. It may be possible to find cost savings both at the development stage and in the management and maintenance of the homes during the first 13 years to enable an earlier breakeven on this option. However, on these assumptions the scheme is very marginal and would need to be considered a significant investment risk from the lender perspective.

This demonstrates the sensitivity to loan periods. Clearly this issue does not arise with Option G, which is debt-free, 100% grant funded.

Rent Inflation Sensitivity

As discussed above, the base case was modelled on 2% rent inflation (CPI cyclical average). Given the recent Government announcement heralding a return to CPI+1% rent increases for RPs, modelling of this uplifted rate was carried out to demonstrate the impact on viability of each of the options above. The results were as follows:

- Option A breakeven remains at Yr2 with 40 years surplus increased to £2.15m
- Option B breakeven improves to Yr14 with 40 years surplus increased to £1.05m
- Option C breakeven improves to Yr9 with 40 years surplus increased to £1.60m
- Option D breakeven improves to Yr21 with 40 years surplus increased to £0.23m
- Option E breakeven improves to Yr14 with 40 years surplus increased to £01.05m
  Option F breakeven improves to Yr27 with 40 years loss reduced to -£0.60m
- Option G breakeven remains at Yr1 with 40 years surplus increased to £4.35m
- Option A(25yr) breakeven improves to Yr 9 with 25 years surplus increased to £0.30m

CPI+1% rent increases thus result in broadly similar viability conclusions:

- Option A and G are clearly viable.

- Option C remains marginally viable (a bit less risky, but still right on the edge and needing some GF revenue support in early years).

- Option A(25yr) remains marginally viable, slightly less risky, still needing GF revenue support for several years.

Conclusion of modelling

Substantially more detailed financial appraisal will be needed to check viability of specific development sites and redevelopment schemes as opportunities arise. At this stage, the principles of a viable AHC are illustrated, on the basis of:

- Land input at between 50% of market value and nil value, and/or
- Grant (s106 cash) input at between 58% and 100% of total scheme costs.

Given the Council currently has around £5 million in s106 commuted sums, if this amount was invested on Council land at an effective 58% to 100% grant rate, then (provided the unit costs suggested are realistic and suitable sites are available) these funds could deliver between 17 and 50 new homes in the District.

4. Governance

Form of Company

Whilst a company solely for the provision of affordable housing could legally be set up on a for-profit or not-for-profit basis, the intention of SDC is likely to emphasise a straightforward social purpose, without any expectation of profits being returned to the Council as shareholder. Rather, any surpluses achieved over time would be reinvested in provision of affordable housing. Given this emphasis, a Company Limited by Guarantee or another not-for-profit style of corporate entity would be preferable to a Company Limited by Shares. MBCL understands that SDC has obtained more detailed expert legal advice to this effect, which it would be recommended to refresh and confirm.

Shareholders Agreement

A wholly owned company limited by shares would have one shareholder, the Council, and an agreement would set out the powers and authority of the company board and matters reserved for consent by the shareholder. If a Company Limited by Guarantee is preferred, then the Council is the sole member of the company, rather than strictly a shareholder. A similar type of agreement will be needed to set out what type and nature of decisions would be determined by the Council as the member of the company and which matters would be delegated to the Board.

Board membership

A limited company only needs one director by law, but typically a Board comprising several directors would be recommended to ensure a mix of relevant skills and expertise as well as reducing the risk the company cannot operate effectively in the absence of directors from Board meetings. One key consideration for a council is whether the company directors are elected Members, Council officers or independent experts. The relationship between the company and the Council's Executive also needs to be considered, to avoid conflicts of interest and clarify which decisions sit with the company Board and which with the Council. For example, finance (funder) and Planning roles within the Council need to be distinct from decision-making responsibilities as part of the company Board.

Many local housing companies appoint non-executive directors with expert specialist knowledge and experience, for example from the construction industry, private finance, legal, audit or affordable housing management backgrounds. SDC are recommended to consider what skills and expertise would be of value to the AHC and how to recruit suitable people.

Given that SDC has already considered Board membership with regards to Quercus 7, then it seems advisable to approach the AHC from the same starting point, potentially even making use of the same core Board members, at least for the initial set-up of the new corporate entity. Similarly, it would make sense to fit the AHC within the existing Trading Board arrangements for the Council's exercise of its shareholder/member role.

5. Funding

As referred to above, Section 24 of the Local Government Act 1988 provides the Council with the power to provide a wide range of financial assistance to any person for purposes including the acquisition, construction or improvement of “privately let housing” i.e. housing where the immediate landlord is not a local authority. Section 25 of the Act provides that the council must obtain the consent of the Secretary of State to use their powers under S.24. The Secretary of State has set out pre-approved consents in the "General Consents 2010", paragraph C of which allows a local authority to provide financial assistance (other than the disposal of land) in connection with the purposes referred to above.

The Council can borrow capital resources under the Local Government Act 2003 and then lend on to the AHC. Borrowing by the Council must be within prudential borrowing limits. On-lending of funds borrowed by the Council can only fund capital expenditure by the AHC. Any revenue funding support needed by the AHC would need to be met from the Council’s General Fund revenue budgets.

Most local authorities opt to borrow from the Public Works Loan Board (PWLB) at below market rates and then on-lend to their subsidiary companies. For State Aid compliance reasons, local authority loans to a company for commercial activities must be provided on market terms. This principle applies to Quercus 7. There is an exemption from State Aid compliance for non-commercial purposes, thus in the case of a new affordable housing company, below market rate lending is possible.

The Council has a fiduciary duty to consider whether funds they lend to the Company could be better used for the interest of local tax payers and consider the impact on the Council and local tax payers if the Company became insolvent or defaulted on a loan from the Council. The Council should take adequate security over the AHC’s assets in any loan agreement.

Section 106 commuted sums for affordable housing can be provided as a grant from the Council to any organisation providing the affordable homes required under the terms of the agreement. Paragraph 6.11 of the 2011 Supplementary Planning Document approved by SDC states that commuted sums will deliver new homes “normally in partnership with Registered Providers”. The SPD is guidance and so it is arguably not legally binding in every case; “normally” implies exceptions will arise. If needed for clarity and assurance, it is possible to agree variations to the SPD and s106 agreements to ensure that it is clear that SDC has the legal right to invest these funds via an alternative affordable housing provider, including a company owned directly by the Council.

6. Land Disposal

The Council has powers to dispose of land under Section 123 Local Government Act 1972 provided it does not dispose of any land for less than Best Consideration without the consent of the Secretary of State. This generally means that the land is disposed of at full market value, but other considerations may be taken into account.

The Council has the ability to dispose of land for less than Best Consideration within the Local Government Act 1972: General Disposal Consent 2003 where the disposal is intended to help secure the promotion or improvement of the economic, social or environmental well-being of the area, and in each case the under-value of the disposal cannot exceed £2 million.

State Aid considerations can also come into play with disposals of land below market value. However, as stated above, when the AHC is providing affordable housing there is an exemption from State Aid rules as it is acting in the general economic interest in assisting people who are unable to secure accommodation on the open market.

7. Risk Appraisal

This section evaluates risk levels and mitigation measures across the range of governance, finance, planning, development and management risks that would need to be managed in setting up and developing homes in an AHC.

Risk	Level	Mitigation
Failure to set up company in compliance with the relevant legislation	Low	Appoint specialist external legal advisers to assist with company documentation and set-up.
Ultra vires	Low	Clear rationales for establishment and activity under the General Power of Competence (Localism Act). Check no conflict with other legislation restricting the Council's power to act.
Failure to comply with tax legislation	Medium	External specialist tax advice.
State Aid challenge	Low	Clear rationales for exemption for affordable housing purpose in general economic interest.
Lack of suitable development sites identified.	High	To engage someone specifically tasked with assessing and identifying suitable sites.
Site opportunities do not reflect need or strategic objectives	Medium	Site review and approvals process to ensure resources are not expended pursuing inappropriate sites.
Challenge to use of s106 funds in AHC	Medium	Consider amendments to s106 agreements and/or SPD to specifically refer to granting funds to AHC.
Planning consent not obtained	High	Regular review of design adviser's progress during pre-application process; amendments to Planning submission to address issues raised to ensure policy compliance; re-submit amended application.
Procurement fails to secure constructor	High	Consider using framework agreements, target small and medium-sized local builders, soft market test ahead of formal tendering processes.
Construction difficulties during build period	High	Site surveys to identify risks in the ground; design and build contracts to transfer risk; contingency sums.
The properties don't achieve the anticipated yield.	Medium	Detailed financial modelling to be undertaken with sensitivity testing to determine the impact of changes in rent levels, LHA levels, void and bad debt rates.
Homes are hard to let	Low	Ensure properties snagged, ready for viewing, attractive marketing materials, targeted advertising, pre-letting process, advice and assistance; broaden target group of tenants.
Maintenance costs are higher than anticipated	High	Maintenance and operating costs monitored and reviewed for variations to ensure the yield is positive with additional movement in costs.

Risk	Level	Mitigation
Company makes a loss	Medium	Regular forecasting and monitoring, awareness of fixed and variable costs, scope reduce variable costs, short term overdraft facility from the Council.
Rent inflation	Low	Allow for CPI + 1% (3%) which is in line with the long term indexation for registered providers and therefore a good indication of inflation on sub-market rents.
Demand falls	Low	The need for accommodation due to the increasing population, increasing private sector rents and increasing housing prices mean supply is unlikely to outstrip demand; however, should this happen surplus/vacant property could be sold on the open market.
Governance failures	Low	The Council will be able to influence the performance of the AHC through conditions on use of the grant, the terms of the loan agreement and restrictive covenants on land assets passed to the company. The Council will have powers to change the members of the Board.
Legislation introduces RTB for AHC tenants	Medium	Although the Housing White Paper in Spring 2017 indicated that Ministers would like to see tenants of local housing companies afforded equivalent rights to Council tenants, including the Right To Buy, there is no indication of any intention to introduce legislation to this effect. Were legislation to be introduced to Parliament, the Council would have several options to consider in relation to the AHC such as disposal of assets to an RP or independent charity, or exploring a financial mechanism to enable the RTB to take effect without critical impact on the company's business plan.

8. Implementation Programme

Experience elsewhere suggests the following key tasks and likely timescales for completion of implementation of the preferred option, once agreed:

Task	Responsible	Timescale
Prepare briefs for specialist advisers	SDC/MBCL	Dec 2017
Appoint specialist legal advisers	SDC Legal	Jan 2018
Draft legal documentation	Legal advisers	Jan 2018
Approve Company documentation	Cabinet	Jan 2018
Appoint Board Members	Cabinet	Jan 2018
Register Company	SDC Legal	Jan 2018
Agree AHC policies and procedures	AHC Board	Feb 2018
Research development site opportunities	SDC Housing	Jan 2018
Appoint specialist design advisers	SDC Housing	Jan 2018
Site design feasibility appraisal	Design advisers	Feb 2018
Appoint specialist financial advisers	SDC Finance	Jan 2018
Detailed financial modelling on specific sites	Financial advisers	Feb 2018
Draft loan facility agreement	Legal advisers	Feb 2018
AHC loan facility approved	SDC Finance	Mar 2018
S106 grant agreement approved	SDC Finance	Mar 2018
Land disposal(s) approved	Cabinet	Apr 2018
Pre-application process on specific sites	Design advisers	Apr 2018
Planning application(s)	AHC	July 2018
Planning approval(s)	SDC Planning	Sep 2018
Procure constructor(s)	AHC	Oct 2018
Start on site	AHC	Jan 2019

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NB: Whilst this report refers to relevant legislation and comments on legal aspects of each option, based on experience and knowledge of existing entities and approaches in other authorities, please note that MBCL does not provide a fully qualified legal advice service; SDC is advised to take specialist legal opinion before taking a formal decision to implement its preferred delivery option.