This Report will be made public on 14 February 2023

Folkestone & Hythe District Council

Report Number **C/22/94**

To: Cabinet
Date: 22 February 2023
Status: Key Decision
Responsible Officer: Andy Blaszkowicz, Director- Housing and Operations
Cabinet Member: Councillor David Godfrey, Cabinet Member for Housing and special projects

SUBJECT: HIGHVIEW DEVELOPMENT: PROJECT UPDATE AND NEXT STEPS

SUMMARY: This report informs Members of the progress made since the last report in January 2022. The site now has planning permission for the development of 30 highly energy efficient homes for affordable rent (25) and shared ownership purchase (5). The report provides an update on the tender activity, levels of tenders received and the applications for external funding and the wider financial package for the scheme. The report also now considers the scheme in the wider context of a changed financial environment of higher interest rates, rising costs and the anticipated and competing capital costs of works on the existing stock, including the retrofit programme to raise energy performance levels. The report goes on to consider alternative delivery options and makes recommendations to members on next steps.

REASONS FOR RECOMMENDATIONS:

1. To ensure Members make properly informed decisions as to spending priorities in respect of the Housing Revenue Account and HRA Capital Programme and the many competing demands.

RECOMMENDATIONS:

1. **To receive and note report C/22/94.**
2. **To note the works completed by officers to get the council to this point.**
3. **To note the significant financial implications and impact upon the overall HRA Capital Programme if this new build scheme was to go ahead.**
4. **To approve Option 4: Pause the project and reconsider options when the financial outlook is more positive and market conditions are more favourable.**

5. To approve that if Option 4 is agreed that officers explore Option 5: To sell the site with the benefit of planning permission and demolition / ecology works completed.

6. To note that if Options 4 and 5 are approved then officers will bring back a report following a marketing exercise for further decisions.

7. To note that if Options 4 and 5 are approved then a small revenue budget of £20K per annum will be required for site maintenance and ecology management.

8. To note the award of £465,000 from the Brownfield Land Remediation fund (BLRF) from One Public Estate and the fact that this may need to be repaid should the scheme not progress.

1. BACKGROUND

1.1 Cabinet approved the acquisition of the former Highview School site in Folkestone in April 2017 to enable the development of Council homes for affordable rent and shared ownership purchase. This was carried out.

1.2 Cabinet approved a further report in January 2022 **(C/21/64)** the report approved officers to seek and accept grant funding to support the development. This has been completed and is discussed further in this report.

1.3 The project brief directed that the new homes be as energy efficient as possible and to incorporate features to support the latest standards of achievable carbon reduction. This has been implemented.

1.4 Planning permission has been obtained (02/08/22) which provides 25 homes for affordable rent and 5 homes for shared ownership.

1.5 The scheme design and build contract was tendered via the Ashford BC Framework with tender returns on 30/08/22, resulting in three offers made by Kent based contractors. Two of the tenders are very close in price. Tenders were normalized (adjusted for comparison) with a difference of less than 0.3%. The tender weightings took account of both qualitative and price factors.

1.6 The qualitative assessment means the second lowest price is the lead bidder but by less than 1% overall. Further details are provided in the confidential appendix 1. The proximity of the tender sums and scores indicates a competitive tender action.

1.7 Whilst the above factors are considered to be specific to the Highview project itself and its timeline to date, it is critical that Members now consider this project against challenging financial climate that the HRA Capital Programme finds itself in, given the latest world-wide developments in terms of inflation, borrowing costs and the pressures that HRA Capital Programme will also face given the results of the recent stock condition survey and requirements to achieve Energy Performance Certificate (EPC) C and A by 2030 and 2050 respectively.

2.0 FINANCIAL CONSIDERATIONS AND EXTERNAL GRANT FUNDING

2.1 The Cabinet report C/21/64 of 26 January 2022, used a bespoke financial analysis which lacked the sophistication to analyse the project income and expenditure in a satisfactory manner. The new viability tool used to assess the costs and income (Podplan) overcomes this and in doing so has highlighted some amendments needed to the overall consideration of the scheme. Specifically:

i. The payback period for the financing of the scheme required was not clearly expressed in the previous model. However, note that the payback period is primarily used as a means of appraising projects and differing funding options. Full details of the model are shown in the confidential appendix 2.

ii. Project construction cost was estimated in January 2022 to be £8.2m with a further £450k in contingency. These were reported within a global budget of £10.3m for the scheme. Since the report, the scheme was put out to tender during significant market volatility and high construction inflation rates (11.61% annualized reported by the BCIS).

2.2 These factors and the uplift in construction costs evidenced by the tender action has resulted in the global scheme costs rising to approximately £11.028m including contingency. This represents an uplift of £0.728m since Jan 2022 of which the majority relates to the inflationary rise in construction costs.

2.3 The Podplan model produces a series of financial metrics which give a view to overall scheme viability. The four measures that are used are:

1) NPV – (Net Present Value)
2) IRR – (Internal Rate of Return)
3) CTV – (Cost to Value)
4) Loan Repayment Period

2.4 Whilst the NPV and the IRR are both positive for the tendered scheme the cost to value ratio is 125%. This means that the scheme costs 25% more than it is worth on the open market. This raises concerns around the Value for Money (VFM) of the scheme and the best use of the HRA capital reserves. Approximately 9% of the total scheme cost is due to high abnormal costs relating to the topography of the site and the requirement for piled foundations and retaining walls.

2.5 Other options explored have positive NPV's and IRR's but also have negative CTV's ranging from 111.5% - 115.5%.

2.6 To help mitigate the cost impact of this, affordable housing grant funding from Homes England is being sought at a higher level than previously anticipated. A bid was submitted for £1.793M and has been supported through a detailed scrutiny process by Homes England. A decision was expected on November 24th 2022, but was subject to confirmation of support from Members on a capital contribution from Folkestone & Hythe. The scheme will be presented to Homes England Investment Committee if Members decide to proceed with the scheme with the council letting the building contract.

2.7 An application for Brownfield Land Release Fund (BRLF) has been successful and the Council has been awarded £0.465M. This award is subject to a contractual commitment to construct the development being made before 31/03/2023. Discussions have taken place with One Public Estate regarding extending this deadline which will be further explored if necessary. There is a risk that the grant will need to be paid back should the scheme not progress.

2.8 Although the scheme costs have risen since the last agreed budget position in January 2022, the external grant funding from BLRF and Homes England will clearly assist the existing financial pressures on the Housing Revenue Account than would have arisen previously. However its now critical to note that the capital sums required to be spent on the existing stock including, Decent Homes standards and improving energy performance have now been accurately estimated, and allied to the recent substantial rises in interest rates from the Public Sector Works Loan Board(PWLB), requires Members to identify their preferred spending priorities. Members need to be satisfied that prudent decisions are being made in respect of the capital resources available.

3. PROJECT REVIEW – FURTHER OPTIONS FOR CONSIDERATION

3.1 Members will be aware that due to current financial crisis resulting from raising of interest rates, the war in Ukraine, fuel prices and high inflation the Council is carrying out a review of all of its major capital projects.

3.2 It should also be noted that the Housing Revenue Account (HRA) 30 year Business Plan is currently being rewritten and this document will provide the financial framework for all investment in the existing and future housing stock. There are many demands on the HRA capital reserves including; Tenant health and safety and property compliance, Decent Homes standards, other capital investment, retrofit of the existing stock and the new build programme. Any decision on one part of this should not be considered in isolation.

3.3 Following discussions with the portfolio holders, officers were asked to consider other options for delivering the scheme using different financial and planning configurations. These are discussed in more detail below. These options produce proposals with estimated total scheme costs of between £10.2m and £11.33m. Further detail around the financial metrics of each option is shown in confidential appendix 2.

Option 1: Continue with existing NZC scheme. Award contract to winning bidder and maximise value engineering to reduce cost post award. Bidders have committed to holding their prices submitted in August 2022 until the end of February 2023.

Option 2: Re-procure scheme with existing planning consent to current building regulations plus 10% uplift in efficiency measures as per local planning conditions.

Option 3: Re-design scheme with higher density (possibly 33 units) to National Design Space Standards sizes, submit new planning application and retender scheme to current building regulations plus 10% uplift in efficiency measures as per local planning conditions.

Option 4: Pause the project and reconsider options when the financial outlook is more positive and market conditions are more favourable.

Option 5: Sell the site with the benefit of planning permission and demolition / ecology works completed.

3.4 All of the options listed above carry varying degrees of risk. The main risk factors are based around, time, inflation, planning, procurement and possible loss of available grant. These risk factors are explored further in section 4. A substantial amount of work underpins the summary analysis below which is detailed further in confidential appendix 2.

4. OPTIONS DETAIL

4.1 For the sake of comparison all options include the same level of HRA reserve funding and external grant contributions. There is the possibility that grant levels may diminish depending on the option chosen. All options are also considered at today's prices and do not factor in inflationary price increases. This is a further risk depending on the time taken to deliver the options. The main variable in each option is the amount of private finance required to deliver the scheme.

4.2 **Option 1:** Continue with existing NZC scheme. Award contract to winning bidder and maximise value engineering to reduce cost post award. Bidders have committed to holding their prices submitted in August 2022 until the end of February 2023.

This produces a 47 year Loan Payback Period

HRA Capital Contribution **-** £3.18M

Capital financing requirement **-** £5.09M

Total Scheme Costs approx. £11.03m

1. Procurement advice is that the contract award must be made prior to any dialogue with the lead tenderer, in respect of clarifications on optimizing and balancing performance specification against outturn costs.

2. The tender award would therefore be at the tendered figure, with an expectation that the contracting tender figure will examine opportunities for Value Engineering and reductions in costed risk items to reduce the contracting sum.

3. Contract could be let in Summer 2023. Practical Completion Late 2024

4.3 **Option 2:** Re-procure scheme with existing planning consent to current building regulations plus 10% uplift in efficiency measures as per local planning conditions.

This produces a 35 year Loan Payback Period

HRA Capital Contribution - £3.18M

Capital financing requirement - £4.24M

Total Scheme Costs approx. £10.18M

1. Lower energy performance than original scheme, but would still be highly energy efficient and conform to current Building Regulations.
2. Would require retender of scheme, crystallise some abortive costs and delay timetable by approximately 8 months.
3. Would be lowest cost option in respect of letting a building contract to existing planning consent.
4. Contract would could be let late 2023 . Practical Completion Mid 2025.
5. Assumptions around build costs could add risk.

6. Inflation not factored in.
7. Could be risk of lower grant levels.

4.4 **Option 3:** Re-design scheme with higher density (poss 33 units) to NDSS sizes, submit new planning application and retender scheme to current building regulations plus 10% uplift in efficiency measures as per local planning conditions.

This produces a 34 year Loan Payback Period

HRA Capital Contribution - £3.18M

Capital financing requirement - £4.55M

Total Scheme Costs approx. £10.75M

1. Would require new planning permission. Time related to scheme redesign and new planning permission allied to abortive costs from previous scheme would affect some of the additional value from increased density.
2. Lower energy performance than original scheme, but would still be highly energy efficient and conform to current Building Regulations.
3. Would require retender of scheme, crystallise some abortive costs and delay timetable.
4. Contract would be let mid 2024 . Practical Completion late 2025
5. Assumptions around build costs could add risk.
6. Inflation not factored in.
7. Could be risk of lower HE grant levels and potential loss of BLRF funding due to timescale.
8. Planning risk associated with higher density.

4.5 **Option 4:** Pause the project and reconsider options when the financial outlook is more positive and market conditions are more favourable.

1. Evidence that this scenario will evolve is inevitably speculative, uncertain and subject to macro events and factors that by their nature are unpredictable.
2. Would be some (limited) costs in securing, maintaining the site and managing the ecology were this scenario to be adopted – Estimated at £20K PA.
3. Loss of grant available at this time.

4.6 **Option 5: Sell the site with the benefit of planning permission and demolition / ecology works completed.**

1. Would enable prioritisation of capital programme to existing stock.
2. Loss of exemplar scheme opportunity to FHDC.
3. Would require a budget and procurement exercise to attract bids.
4. Not certain that costs to date, c.£1.5m would be recouped.
5. Loss of Homes England funding.
6. Likely loss of BLRF grant although officers would make the case that we have enabled development of a brownfield site and would seek to keep the funding.
7. Would enable another developer to take on the site and deliver the homes.

4.7 Further detailed financial information on each option is included in confidential appendix 2.

5. HRA reserves and impact on HRA Business Plan

5.1 Cabinet approved the draft HRA revenue and capital budget for 2023/24 at its meeting on 25 January 2023. This shows the HRA has a reserve balance of £5.8m at 1 April 2023. The Highview development, if approved, will consume £3.18m of these reserves (representing a 54%reduction), leaving a balance of just £2.6m after allowing for other HRA commitments in 2023/24.

5.2 Prioritising a £3.18m (54%) reduction in HRA reserves for the build of the Highview properties will significantly impact on future HRA spending plans (as part of the 30-year business plan) represent a significant reduction in HRA Reserves – impacting on both the capital and revenue budget position in the medium term. The 4 year capital programme projections in Section 7 below which highlights the impact of this over a 4 year period.

5.3 Right to Buy implications; The 25 affordable rent properties potentially qualify under Right to Buy (RTB) rules – however if a new property was purchased under the Right to Buy there is a cost floor (which essentially the build cost). If the tenant's RTB discount exceeds the cost floor, then it would not apply.
The HRA would however lose the rental income if the property is sold, whilst still having to maintain the capital financing costs in the revenue account. There will be a capital receipt generated from the sale.

6. RISK MANAGEMENT ISSUES

6.1 The risks associated with bringing the Highview scheme forward at this time are shown in the table below.

Risk	Seriousness	Likelihood	Preventative action
Scheme exceeds budget costs and does not represent positive VFM	High	High	Tenders have been received that exceed the previously agreed budget. Members should consider options 4 and 5 detailed in the report.
Unacceptable pressure put on HRA finances and other capital priorities by	High	High	Members should consider options 4 and 5 detailed in the report.

proceeding with scheme at this time			
If members are minded to consider option 5 of selling the site offers received do not fully recoup costs	High	Medi um	Officers will instruct agents to fully test the market to achieve offers for a private developer or other Registered Provider to bring the development forward. Offers will liaise with One Public Estate to see if the BLRF grant can be retained.
Loss of BLRF grant should the scheme not progress	High	High	Officers will make the case to One Public Estate that the works undertaken to date including site demolition, ecology, scheme design and planning consent will have enabled the site to be sold for development and the grant funding should be retained.

7. LEGAL/FINANCIAL AND OTHER CONTROLS/POLICY MATTERS

7.1 Legal Officer's Comments (AK)

There are no specific legal comments arising directly from this report. Having said this, legal advice should be sought throughout this project.

7.2 Finance Officer's Comments (JS)

<u>HRA Capital programme implications – 4 year capital programme</u>

1) The Council's HRA Capital Programme has had to be recast for years 2023/24 through to 2026/27 to accommodate the anticipated capital costs that arise from the recent stock condition survey and capital expenditure required for Energy Performance Certificate (EPC) C work by 2030 and the decent homes standard plus by 2025. These costs are substantial.

2) Not all of these costs had previously been factored into the HRA and the Chief Housing Officer has worked with Finance officers to provide updated capital scheme costings on a scheme by scheme basis. Finance officers have also challenged and reviewed these numbers with housing to ensure they are robust and are satisfied they are accurate. Furthermore, The Council's Finance Team have also prepared a separate 4 year capital programme for adoption and this is included in the HRA Revenue and Capital Budget report also being considered at the Cabinet meeting on 22 February 2022; for comparison, the summary capital programme which includes Highview is outlined below at paragraph 6).

3) Given the scale and size of the capital costs, the Finance Team asked the Chief Housing Officer to provide a "critical" (bare minimum) works costing and also an essential works costing (desirable) to give options for the four year capital programme. Given the significant draw on HRA Capital resources (as shown in the table at 6 below), it has only been possible to accommodate (and fund) the "critical works list" as the HRA simply cannot afford anything further over the four year period.

4) Given the size and scale of the HRA Capital Programme including the new build costs for Highview (included in the main body of this report) would result in a draw on HRA reserves that would reduce balances to the bare minimum of £2m over the four year period and a 38% increase in prudential borrowing would be required to fund the overall capital programme spend of £49m over the four year period.

5) This position, whilst arguably fundable, is not considered sustainable as overall HRA borrowing required will increase by £18m (from £47m to £65m) just to cover the next four year period. The cost of this additional borrowing would therefore add £822,000 to HRA revenue costs of the HRA every year for 50 years plus. The Finance Team have prudently profiled the funding of the capital programme to maximise the use of the Revenue to Capital Contributions (RCCO) to minimise this borrowing where possible, even after allowing the Homes England grant funding to be included for Highview alongside the BLRF funding.

6) The Table below outlines at high level, the costs and funding required in the HRA capital programme over the period 2023/24 to 2026/27 including Highview. The Orange bar at the top of the table highlights the significant amount of expenditure (only at critical level) of what will be required to fund the Decent Homes standard work that arises from the stock condition survey requirement and energy performance certificate related expenditure.

1. Capital Programme		Original 2023/24	2023/24	2024/25	2025/26	2026/27
Capital Schemes						
	Decent/Non Decent Homes Standard	7,199,150	9,065,150	7,341,227	6,945,276	6,413,236
	New Builds	3,454,000	3,204,000	0	0	0
	High view	3,450,000	3,700,000	5,700,000	168,000	0
	Ship Street					
	Biggins Wood			2,600,000	2,600,000	
	Env/Estates Improvement	89,500	0	416,380	529,080	426,130
	Other schemes	28,000	28,000	0	0	0
	Sub Total	14,220,650	15,997,150	16,057,607	10,242,356	6,839,366
Financed by						
	MRR	3,084,000	3,084,000	3,084,000	3,084,000	3,084,000
	1-4-1 Capital Receipts	600,000	600,000	600,000	600,000	600,000
	Prudential Borrowing	3,454,000	3,454,000	9,228,785	4,261,283	1,324,668
	Revenue contribution (bal. fig) / RCCO	5,275,150	5,943,650	2,112,322	1,714,573	1,830,698
	BLRF	465,000	465,000	582,500	582,500	
	Homes England	1,342,500	1,342,500	450,000		
	Carry forwards (22/23)		1,108,000			
	Sub Total	14,220,650	15,997,150	16,057,607	10,242,356	6,839,366
	Check	0	0	0	0	0
3,HRA Reserves						
	Opening balance	-5,867,227	-5,867,227	-2,128,949	-2,011,103	-2,009,781
	Requirements / usage	3,069,778	3,738,278	117,846	1,323	-30,790
	Closing Balance (Surplus) / Deficit	**-2,797,449**	**-2,128,949**	**-2,011,103**	**-2,009,781**	**-2,040,570**

7) In short, the HRA faces <u>an extremely challenging</u> four year period and at 2027 the HRA revenue reserves and Revenue Contribution to Capital Outlay contribution to fund capital will be reduced to just £1.8m.

8) The HRA can still borrow money as technically it has no specific credit ceiling, however the Prudential Borrowing can only be utilised if the HRA can afford to pay for the borrowing costs from its revenue account.

9) The Finance Team calculate that a maximum of £28m could be borrowed at the 2027 point. However this reflects the total HRA borrowing for all future periods (at that point in time) which would mean that the HRA capital and revenue resources would be stretched to maximum strain level.

Future HRA Capital Funding pressures

10) To give some context the future HRA capital requirements, the Housing Team have provided finance with a list of known future critical capital commitments for the HRA :-

<u>Other potential borrowing requirements (estimates)</u>	£
EPC A by 2050 (net carbon zero)	
Estimate 10k per property (3000 stock):	30,000,000
If unsuccessful SHDF Wave 2 (EPC C):	2,500,000
Independent Living (not covered by current EPC work)	2,000,000

The above commitments exclude any costs at this stage for additional New Builds or acquisitions.

11) In summary it is clear that the costs resulting from the recent stock condition survey and EPC C and A will require significant capital funding in the four year period to 2027. Many of these costs have not been factored into the HRA over this period previously.

12) It is clear that the recent increases in price inflation, borrowing costs, energy costs and costs of raw materials and the war in Ukraine have been a factor in the increasing pressure on the HRA capital and revenue costs. These factors have also impacted on the cost of new build schemes such as HV.

13) If the HRA capital programme outlined above (including the critical items) is agreed, then minimal reserves and balances will be available by 2027 and HRA borrowing will have to be increased by £18m to £65m by 2027.

14) Capital Headroom will be available at 2027, and £28m and is affordable, however this all that will be available to fund capital schemes into the future and after this, the HRA will have no capital spending power unless future government support is available or significant increases in income in rents become available. At these levels of borrowing the HRA capital and revenue account will be at maximum strain levels in terms of funding capacity.

15) Careful consideration is required for future spending plans for the HRA in light of the factors identified in this report and before any new project is considered and for schemes such as the HV development, any future new build project, at such a high cost to value (see paragraph 2.4 above and metrics in Appendix 2 below) would probably be un-sustainable given current HRA level resource levels and stock related spending pressures.

16) If the HRA capital financing becomes strained at these levels, this could attract criticism from the External Auditor and could lead to a poor value for money conclusion in its annual audit report.

7.3 Diversities and Equalities Implications (AB)

There are no diversity and equalities implications arising directly from this report.

7.4 Climate Change Implications (AT)

The climate change impacts will depend on the option chosen. Option one would deliver 30 new affordable homes for rent and shared ownership purchase. All of the homes would be delivered to Zero Carbon in Use standards. The homes would have vastly reduced carbon outputs due to the heating technology and will also produce lower heating bills compared with previously constructed Council Homes. Redesigning the scheme would require the submission of a new planning application, which would need to meet the standards set out in local plan policies. These options are likely to be less beneficial in terms of carbon emissions, although still above national standards. If the project is paused (option 4) for a significant period, any new scheme may have to conform to future standards set by the Government’s proposed National

Development Management Policies, or by new local plan policies that the council will need to adopt following the enactment of the Levelling Up and Regeneration Bill.

8. CONTACT OFFICERS AND BACKGROUND DOCUMENTS

Councilors with any questions arising out of this report should contact the following officer prior to the meeting.

Simon Baxter – Chief Officer – Development
Telephone: 07518299621
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The following background documents have been relied upon in the preparation of this report:

None

Appendices:

Confidential Appendix 1: Tender Evaluation

Confidential Appendix 2: Podplan Financial Metrics for options 1-3