

This report will be made
public on 29 July 2014

Folkestone

Hythe & Romney Marsh
Shepway District Council



Report number **A/14/16**

To: Extraordinary meeting of the Council
Date: 6 August 2014
Status: Key Decision
Director: Dr Susan Priest, Corporate Director - Economic Regeneration.
Cabinet Member: Councillor Alan Clifton Holt, Cabinet Member for the District Economy; Councillor Keren Belcourt, Cabinet Member for Housing and Environmental Health

SUBJECT: REGENERATION AND HOUSING COMPANY

SUMMARY: This report provides an overview of the detailed Business Plan for the Council's arms-length Regeneration & Housing Company, Oportunitas, and outlines the funding arrangements for the Company's activities, for Council approval.

This report is submitted subject to Cabinet's resolutions on 30 July 2014 (arising from report C/14/21) to recommend that Council approve the funding arrangements for the Company, authorise officers to enter into and sign the loan agreement and update the Council's policy framework as necessary.

REASONS FOR RECOMMENDATION:

Council is asked to agree the recommendations set out below on the basis that:

1. The Company will deliver against Council determined objectives and priorities for regeneration;
2. Core outcomes will be the delivery of more homes; a wider range of housing tenures and rental levels than currently delivered by the Council; more inward investment; and more job opportunities in Shepway;
3. The Company will provide a delivery vehicle for profitable traded services;
4. The Company will supplement existing Council activity in: (a) delivering affordable homes, increasing the provision of affordable family rental units; (b) bringing more empty homes back into use; and (c) providing affordable and appropriate employment / incubation space;
5. The Company will generate new sources of income for the Council in the long term, which may include the New Homes Bonus, increased Business Rates and Council Tax income, along with the prospect of attracting more inward investment into the District, and capital growth through its investments.
6. The Company will provide a vehicle for delivering projects directly utilising additional public sector funding secured from sources such as Local

Growth Funding, Growing Places funding or EU investment funds via the South East LEP once it's Strategic Economic Plan and Growth Deal is approved by Government, expected during summer 2014.

7. The arrangements for financing the Company with 90% loan and 10% shareholder equity investment from Council reserves and capital receipts is based on detailed analysis of financing options and is in accordance with State Aid rules and regulations.
8. The loan:equity split will minimise the Council's exposure to risk.
9. Initial working capital will be made available to the Company, funded by the Council's reserves, to ensure the Company is not at risk of operating insolvently.
10. Subject to the resolutions of Council, a detailed loan agreement(s) will be prepared with external specialist advice and support from Bevan Brittan LLP.

RECOMMENDATIONS:

1. To receive and note report A/14/16.
2. To approve an investment loan up to £2,058,750 and working capital loan up to £300,000 to be made available to support the Business Plan approved by Cabinet on 30 July 2014, drawn from the Council's HRA capital receipt ring fenced for regeneration and affordable housing options in East Folkestone - £91,250; Capital Receipts ring fenced for Asset Development Projects - £1,967,500; and Economic Development Reserve - £300,000, subject to a loan agreement and following Cabinet's recommendation.
3. To approve that equity of £228,750 be made available to support the Business Plan approved by Cabinet on 30 July 2014, drawn from Council's HRA capital receipt ring fenced for regeneration and affordable housing options in East Folkestone.
4. To authorise the Corporate Director, Economic Regeneration, the Solicitor to the Council and the S151 Officer to enter into and sign the loan agreement.
5. To approve that the Council's policy framework is updated as necessary.

1. BACKGROUND

- 1.1 On 16 July 2014, Cabinet considered the Business Case and Indicative Business Plan for the Company and made the following resolutions:

RESOLVED:

- 1. To receive and note report C/14/11.**
 - 2. To approve the business case, as set out in appendix 1.**
 - 3. To approve the governance structure set out within the report.**
 - 4. To authorise the Leader of the Council to allocate responsibilities of the Company Secretary to the Council's Principal Solicitor.**
 - 5. To authorise the incorporation of the Company.**
 - 6. To authorise the Solicitor to the Council, in consultation with the Corporate Director Economic Development, the S151 Officer and the Leader of the Council, to complete all the necessary documentation required to give effect to the above recommendations, on behalf of the Council, and enter into the Shareholder's Agreement.**
 - 7. That the Company's business plan is presented to Cabinet for approval, in due course, and in accordance with the process set out in the Shareholder's Agreement, prior to recommendations, relating to the funding of the Company, progressing to Council.**
- 1.2 The development of the detailed Business Plan, as set out in appendix 1, has involved the commissioning of GENECON Ltd.
- 1.3 The Business Plan focuses on the scoping out and delivery of the Company's activity programme and addressing operational matters, including the financial modelling, communications, and associated risk assessment.
- 1.4 External advice has been provided by Bevan Brittan LLP and KPMG on financial matters relating to the detailed Business Plan. This advice has covered State Aid compliance, securing the most tax efficient means of securing an income stream to the Council, and allowing capital appreciation in assets with the Council securing a first charge over properties purchased by the Company using the loan financing provided by the Council.
- 1.5 Following incorporation, the first Board meeting of the Company was held on 25th July 2014 and the Company's Business Plan received unanimous approval for submission to Cabinet and Council.
- 1.6 Following Board approval, The Company's Business Plan setting out the activities of the Company, namely a housing acquisitions and rental programme and Grounds Maintenance trading activity was presented in the appendices of report C/14/21 on 30 July 2014 for Cabinet approval.

2. BUSINESS PLANNING

- 2.1 The Company's Business Plan requires Cabinet approval before it can commence trading. The Company will at all times have a current and up-to-date Business Plan, with written approval of Cabinet being received prior to the Business Plan being adopted, amended, varied or upgraded by the Company.
- 2.2 The Company's Board will be responsible for preparing, reviewing and updating the Business Plan and will be signed off at a meeting of the Board prior to submission to Cabinet for consideration and approval.
- 2.3 The Business Plan will set out the overall strategic delivery plans of the Company for the forthcoming Business Plan Period and will include a detailed revenue and capital expenditure budget. The Plan will identify projects for delivery, provide details of funding and resource commitments associated with the delivery of these projects and any other items requested by Cabinet. A summary of assumptions made in the Business Plan will be included as part of any submission.
- 2.4 The Company's Board will prepare, review and update its Business Plan no less than 90 Business Days before the end of each Financial Year. The Board will report to Cabinet on the progress made on its approved Business Plan activities, as well as any variations to be made.
- 2.5 Robust financial modelling has been undertaken using systems and processes already familiar to the Council, i.e. underlying assumptions and factors, many of which have already been used in the HRA programme, have been used to prepare the housing acquisitions and rental programme. Costs known to the Council in delivering the Grounds Maintenance activity have also been used. Experience of colleagues in other local authorities has also been used to shape proposals.
- 2.6 In the event that the Company wishes to carry out an activity with an annual value in excess of £25,000 that is not included in the current Business Plan, it will submit a discrete business plan for that activity, for Cabinet approval.
- 2.7 As the financial objective of the Company (beyond delivering its specific activities) is to secure an income stream to the Council in the most tax efficient manner, further detailed financial modelling has been undertaken and the detailed Business Plan (appendix 1) has been produced. The Business Plan has been submitted for Cabinet approval at the 30th July meeting, following Cabinet's approval to incorporate the Company at its meeting of 16th July 2014. The Company's Board met on 25th July 2014 and unanimously approved its Business Plan for submission to Cabinet and Council.
- 2.8 The Company's activities are scalable. Its medium term activities may include a broader range of regeneration activities involving employment and housing sites, each assessed on their merits for investment on a case-by-case basis.

- 2.9 In order for the company to be considered as a going concern and to be able to operate and pay suppliers, it needs to ensure that it can demonstrate solvency. The company business model has a substantial front loading of expenditure in the period when the company is establishing itself and the early years. The current level of activity is not sustainable long term and it is acknowledged in the detailed Business Plan that the company will need to carry out additional activity in the medium and longer term.
- 2.10 In order for the company to be able to demonstrate solvency going forward, the Council will need to provide a formal commitment or guarantee to fund any cash shortfall in the Company each year, by way of a working capital facility. Council approval is sought to make this available but with a review as part of the annual approval of the financial business plan and for an initial 5 year period. There will be a funding agreement in place and the Council will charge 1% above the Bank of England base rate to ensure state aid compliance.
- 2.11 The intention is to use the income generated from the Company's initial phase of activity to fund the Company's working capital requirement.
- 2.12 The Shareholder's Agreement specifies that there are some issues, (referred to as material matters) that will need specific approval from the Council regardless of whether they are in the Business Plan.
- 2.13 Officers have considered these matters in detail to ensure that appropriate controls are in place to oversee the activities of the Company and to minimise risks to the Council.

3. FUNDING AND ACCOUNTING ARRANGEMENTS

- 3.1 A financial objective for the Council is to secure an income stream from the Company, done so in the most tax efficient manner. Following detailed analysis of financing options, external advice and Business Planning, the officer recommendation is to finance the company with 90% loan and 10% shareholder equity investment from Council reserves and capital receipts. This loan:equity split is in accordance with State Aid rules and regulations in order to minimise risk exposure for the Council. Initial working capital will also be made available to the Company funded by the Council's reserves, again in accordance with State Aid rules and regulations, to ensure the Company is not at risk of operating insolvently. Subject to Council approval, detailed Loan Agreement(s) will be prepared with continued external advice and support from Bevan Brittan.
- 3.2 Although it is not anticipated that the Company will borrow from external sources in the first instance, it will be able to receive grant or loan funding (for example from EKSDC, Regional Growth Fund, Local Growth Funds and EU funding) to resource its approved programme of activity.

- 3.3 Financial modelling included in the detailed Business Plan (appendix 1) has been prepared with external specialist accountancy advice commissioned from KPMG. KPMG advised the Council that a mix of loan and equity financing is the optimum model from a transfer pricing perspective and also the most consistent with the approved arm's length model for the Company. KPMG advised that a 70:30 loan:equity split would be considered to be appropriate by HMRC, but following detailed consideration of this advice the 90:10 loan:equity split is favourable to the Council. The Company will need to accept the 20% reduction in tax deductible interest paid to the Council, from KPMG's recommendation.
- 3.4 The impact on the Council from the operation of the Company will also need to be considered. The Council will provide funding to the Company via three mechanisms: equity, loan and working capital. The projected amount required for the initial business plan (to end March 2016) based on the preferred model of a 50:50 split in delivery of affordable and market rent under the Housing Acquisitions Programme and 90:10 loan:equity funding is set out below:

Loan Funding	£2,058,750
Equity	£ 228,750
Working Capital*	£ 287,211
Total	£2,574,711

* working capital requirements have been planned for an initial 30 month period to cover the first and subsequent business plan periods.

- 3.5 The Council has the following sources of funding available to fund the Company loan funding and equity and it is recommended that the HRA capital receipt is used first where properties are located in East Folkestone, then the Asset Development Projects capital receipts. . The Economic Development Reserve must be used to fund working capital requirements.

HRA capital receipt ring fenced for regeneration and affordable housing options in East Folkestone*	£ 320,000
Asset Development Projects capital receipts **	£ 2,213,000
Economic Development Reserve	£2,000,000

* HRA capital receipts – policy is in place for some of the money received from HRA capital receipts to be ring-fenced for regeneration and affordable housing options in East Folkestone. The amount which is yet to be allocated is £320k. This policy is agreed with Central Government and if the monies are not used for this purpose will need to be repaid. The Council may wish to use the monies for the company activity and if it is felt that East Folkestone is too restrictive, could explore widening the policy to incorporate a district wide approach.

** Asset Development Projects capital receipts – the Medium Term Financial Strategy has previously identified capital receipts allocated to Asset Development Projects primarily for Folkestone Seafront car park development. The Council may now wish to use these monies to earmark for a loan provision to the company. The company will repay principal to the council on loans issued and therefore the capital resource will be available over time for capital re-investment into the Council.

- 3.6 There will be an income stream from the Service Level Agreement between the Company and the Council which includes officer time, facilities and ICT. The Council will also receive interest from the Company for loan provision made with the overriding financial objectives being to secure an income stream to the Council in the most tax efficient manner while allowing for capital appreciation in assets with the Council having secured a first charge over each property that the Company purchases with the loan monies. The Company also has the ability to pay the Council a dividend however this is unlikely in the early years of trading. In addition there is a potential return to the Council from any shareholder equity investment in the Company.
- 3.7 The following table sets out the estimated financial impact on the Council based on a model of 50% LHA rented properties and 50% market rented properties. A 90% loan to the Company will be made at an interest rate of 4% for LHA properties and 4.88% for market properties. It is proposed that the initial 15 properties will be funded from reserves and capital receipts rather than external borrowing. The Council will also generate an income from the interest charged on the working capital loan of 1.5%. This excludes the cash outflow of the loan facilities and the principal repayments of these facilities.

	Year 1	Year 2	Year 3
	2014/15	2015/16	2016/17
	£	£	£
Cash inflows from company			
SLA Recharge income	(46,766)	(78,870)	(84,242)
Interest receivable loans	(29,376)	(90,595)	(89,919)
Interest receivable working capital	0	(2,683)	(6,273)
Total	(76,142)	(172,148)	(180,434)
Indirect council impact			
Grounds Maintenance income from General Fund budgets	25,000	30,000	35,000
Loss of interest on reserve balances ~	1,085	11,595	29,344
Net impact to the council	(£50,057)	(£130,553)	(£116,090)

~This is shown for completeness and is the opportunity cost to the Council and will be incurred on whatever the regeneration reserve is used to fund.

- 3.8 The internal rate of return to the Council from investing in the Company is forecast at 7.3% which exceeds the return generated from investment of the reserve balances and capital receipts. It is recommended that the first call on the income generated by the Council from the Company is used to fund the Company's working capital requirements. The Company will repay principal to the Council on loans issued and where this is internally funded by the Council, resources will be available over time for potential re-investment into the Council.
- 3.9 In the future the Council may need to finance the Company by means of the Council's treasury strategy through prudential borrowing. The Council has the power to borrow provided a business case is able to show that the borrowing can be paid within the requirements of CIPFA's prudential code. Essentially this means that the business case provides sufficient income to repay the borrowing costs, both interest and principal, including Minimum Revenue Provision obligations which ensure that the principal element will be repaid.
- 3.10 The Council does not need to borrow externally in order to fund the initial activity. If external borrowing is required going forward, the Council will need to factor in the cost of borrowing when reviewing the interest rate charge to the Company. The Council will need to ensure that interest received from the Company offsets the interest due on the external borrowing, and includes an appropriate mark up to reflect risk. The Council's financing arrangements with the Company also need to take into account movements in interest rates. In the medium to long term these are expected to increase and will impact on both the Council and the Company.
- 3.11 The State Aid requirements are such that the interest charged by the Council must be at a commercial rate which is one that is available in the market place and not subject to subsidy. Therefore, from a State Aid perspective, the rate that the Council borrows at is not relevant to the rate charged. The differential funding requirements of the LHA and market rent units mean that a commercial investor would charge a different rate to reflect the greater risk in respect of market accommodation and therefore the financing arrangements for the loan from the Council have been structured to reflect this with an interest rate of 4% for properties rented at Local Housing Allowance and 4.88% for market rented properties.

4. NEXT STEPS AND TIMESCALE FOR DELIVERY

Subject to Council's approval being received, the next steps are:

- a. The Service Level Agreement is entered into;
- b. Loan documents are finalised and entered into; and
- c. Funding is drawn down and trading commences.

5. RISK MANAGEMENT ISSUES

- 5.1 The Company will have a detailed risk register and risks will be managed on an on-going basis and reported to the Board, to the Corporate Management Team of the Council and to Cabinet as necessary.

Perceived Risk	Likelihood	Seriousness	Preventative Action
LEGAL - The balance between Council control and the Company's ability to deliver against its business plan results in the Council ceding too much control.	Low / Medium	High	Detailed definitions and restrictions / material matters on issues where Cabinet/ Council approval has to be sought are contained within the Shareholder's Agreement, and limit the powers / authority of the Company's Board and therefore mitigate against this risk.
LEGAL/FINANCIAL - Breach of EU state aid rules – Council receives a challenge from the private sector	Low / Medium	High	Legal advice has been commissioned from Bevan Brittan LLP. The approved approach is for shareholder equity investment by the Council in order to deliver a first phase of the Housing Acquisitions programme, with defensible State aid position via market investor principle. Bevan Brittan's advice also highlights the State aid block exemption for aid provided for social housing purposes (under Services of General Economic Interest) being explored further.
FINANCIAL - Adverse impact on General Fund and taxpayer	Low	High	Impact on the General Fund is a key consideration in the work of officers on the most appropriate model for the Council to finance the Company as the single shareholder. This would be controlled via the requirement for approval of the Company's annual Business Plan and the funding process.
FINANCIAL - Proposed investment decision impacting upon the Council's prudential borrowing capacity	Low	Low	Direct investment of shareholder equity is an option for the initial housing acquisitions programme, with prudential borrowing funding subsequent expansion of the Company's activities once it is up and running and delivering its first outputs. Any draw-downs would be managed via approval of changes to the Council's Treasury Management strategy

			<p>with approval required by both Cabinet and full Council.</p> <p>This can be managed on an annual basis utilising the requirement for approval of the Company's annual Business Plan within which to identify the financing proposals for the Company.</p>
FINANCIAL - The balance between the financial imperative to keep operational costs to a minimum whilst adequately resourcing the Company is not managed effectively	Low	Medium	Company resourcing has been carefully considered and costs associated with the resourcing have been included in the financial model for the Company.
FINANCIAL - The Company fails to adhere to loan repayment obligations	Low	Medium	The repayment schedule will be set out within the Company's business plan, which will return annually to the Council for approval.
FINANCIAL - Company defaults on its financial obligations to the Council	Low	High	The Council will see and approve the Company's annual business plan. Security can be taken on shareholder equity or loan funding provided by the Council to the Company by a first charge on each property acquired by the Company.
FINANCIAL – the Company fails and any losses made fall back to the Council	Low	High	The Council will see and approve the Company's annual business plan and will take early action if failure of the company was likely. The legal agreement will ensure that the council has the ability to enforce disposal of properties.
FINANCIAL – the valuation of the properties reduce to below the value of the Council's loan to the Company resulting in an impairment cost which could fall to the Council's revenue account.	Low/ Medium	Medium	The properties will be valued annually as part of the year end accounting process and trends in property prices will be closely monitored. This risk could also be mitigated by the Company selling properties.
OTHER - The Council reputation and public perception suffering in the event of the Company's failure	Low	High	Risk assessment regularly reviewed. Communications plan will be developed and maintained to ensure the Company contributes towards a positive view of the Council's services.
OTHER – The potential for negative publicity associated with challenges from private sector landlords	Low	Medium	The Council's marketing team will carefully manage press releases and media engagement in relation to the launch of the Company.

OTHER – The Council's reputation and public perception suffer in the event of the Company's failure.	High	Low	GENECON commissioned to assist in the preparation of the Company's business plan. Legal advice provided by Ashford Borough Council, drawing on their experiences setting up an arms-length local authority company. Legal advice commissioned from Bevan Brittan LLP.
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6. LEGAL/FINANCIAL AND OTHER CONTROLS/POLICY MATTERS

6.1 Legal officer's comments (EC)

Officers have taken specialist legal advice from a Company/Commercial Solicitor who works for Ashford Borough Council on the governance arrangements for the company. She has advised on the drafting of the company documents. Officers have also taken advice from Bevan Brittan on the implications of State Aid. That advice is summarised throughout this report.

Officers will continue to work with these external legal advisers for the next steps outlined in 4 above.

6.2 Finance officer's comments (OCW Deputy S151)

Finance has been consulted on and has been part of the preparation process for the Cabinet report and detailed Business Plan. The financial considerations for the Council are set out in Sections 2 and 3 of the report. There are also financial risks identified in the risk matrix in Section 5.

External advice has been sought on state aid, tax issues and financial modeling for the company which has been used to inform the Business Case and Business Plan.

Key areas for financial consideration include the Company's requirement to demonstrate solvency which is set out in 2.10, the impact on the Council which is covered in Section 3 and the requisite of the Council to enter into detailed loan agreement(s) before loan funding is made available to the Company. It is recommended that any loan made to the Company by the Council is on an annuity basis as oppose to interest only which will enable the Council to meet any Minimum Revenue Provision obligations arising.

It is essential that the Company assesses each potential activity to establish its financial viability as well as looking at the impact on the overall Company position. This will also need to be a key consideration for the Council in respect of decision making on whether to lend to the Company.

The Council needs to ensure that the Company has adequate financial management arrangements in place and that statutory obligations are met. The Business Case presented to Cabinet on 16 July in report C/14/11

included Financial Regulations for the Company and Scheme of Delegation and Financial Thresholds.

6.3 Diversities and equalities implications (SP)

There are no diversities and equalities implications arising out of this report.

CONTACT OFFICERS AND BACKGROUND DOCUMENTS

Councillors with any questions arising out of this report should contact the following officers prior to the meeting

Susan Priest, Corporate Director (Economic Regeneration)
Telephone: 01303 853315
Email: susan.priest@shepway.gov.uk

Alexander Kalorkoti, Economic Development Project Officer
Telephone: 01303 853402
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The following background documents have been relied upon in the preparation of this report.

None

Appendices:

Appendix 1: Regeneration & Housing Company – Detailed Business Plan (exempt from publication by virtue of paragraph 3 of part 1 of schedule 12A of the Local Government Act 1972).