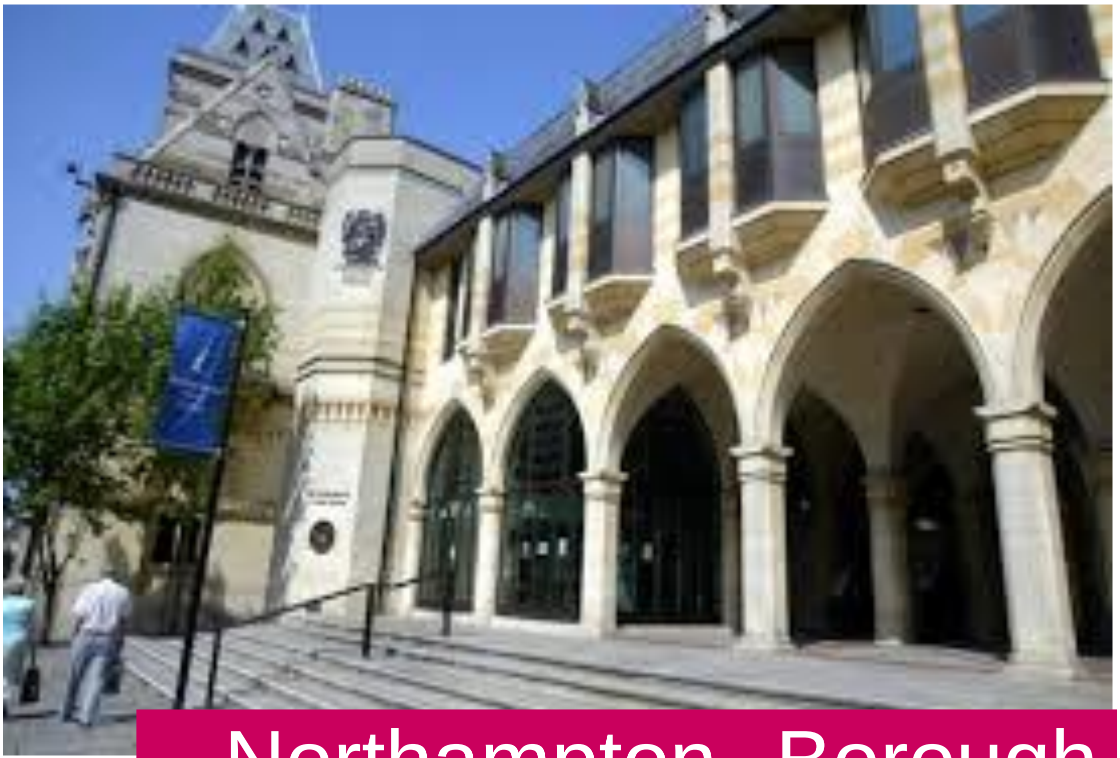

Northampton Borough Council

Review of Housing Development Proposition - Addendum (January 2018)

CAPITA

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1. Introduction

During 2017 Northampton Partnership Homes (NPH) prepared a proposition and draft Development Agreement for the creation of a 10-year new build housing programme.

Capita were appointed by the council to undertake a due diligence review of the NPH proposition. This was completed in October 2017 and a report setting out the advantages and shortcomings associated with the proposition along with alternative solutions was submitted to the Council.

The Council and NPH have since considered the identified shortcomings and NPH have submitted a revised proposition. This paper considers the extent to which the new proposition addresses the identified shortcomings.

2. Original Proposition

The original proposal was that the Council and NPH enter into a non-legally binding development agreement under which sites could be developed to achieve 80 new homes per annum for 10 years. It was based on developments proceeding either on the basis of Model A or Model B:

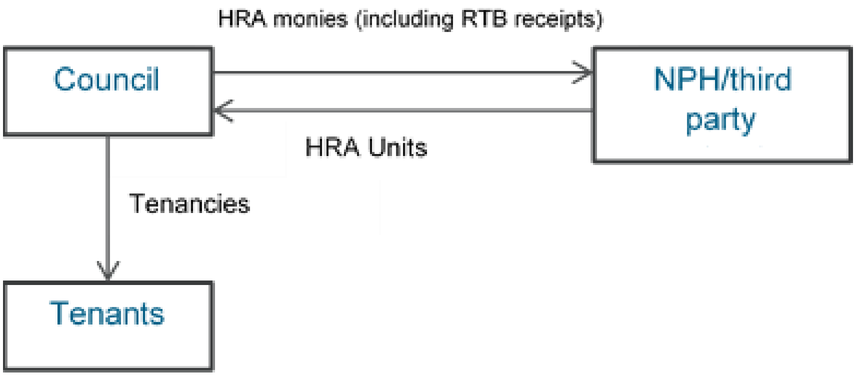
- Model A - Development to be undertaken by NPH as a development agent for NBC on HRA land.

- Model B – Where RTB 1-4-1 receipts have been exhausted or schemes were to be developed with properties for sale or market rent or where development within the HRA was not viable, land would be transferred from NBC to NPH at minimum cost and the new development undertaken within NPH ownership.

We reported that the Council is entitled to rely on its powers under Section 9 of the Housing Act 1985 to justify the development of housing for housing need within its administrative area. There are no other powers that the Council needs to rely upon in the context of Model A.

From a procurement perspective, we reported that the relationship between NPH and the Council is such that the Teckal exemption could be relied upon in relation to the procurement of NPH's services. The build works, whether contracted for directly by the Council or via NPH would need to be subject to public procurement regulations.

Diagrammatically, Model A looked like this:-



With Model B there were a number of additional legal considerations. These involved the statutory provisions associated with the transfer of land, the provision of financial assistance and state aid rules:

- Subject to state aid compliance, vacant HRA land which is to be developed as privately let accommodation can be transferred to NPH at any price provided the Council is not entitled to manage or maintain the properties under a pre-existing agreement or arrangement; and

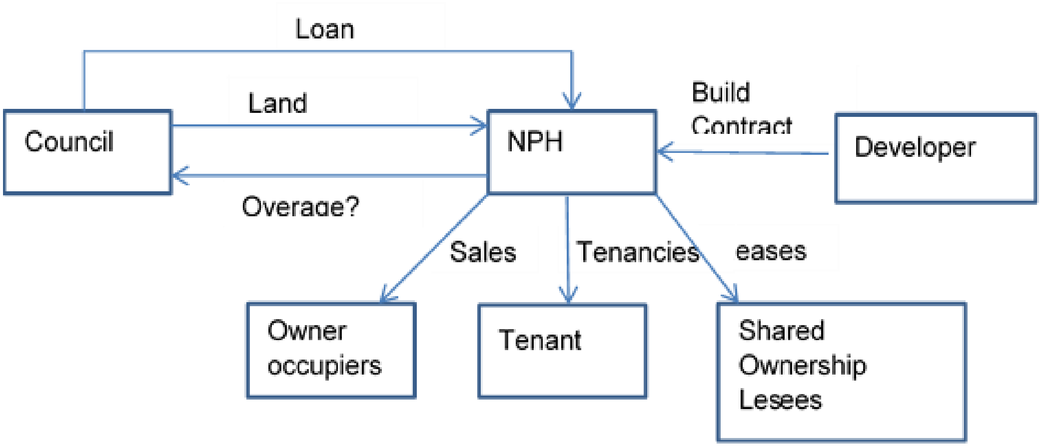
- If the disposal is at an undervalue (as Model B anticipates) and involves general fund land, the recipient of that land must be a registered provider (which NPH is not).

- The council is able to provide financial assistance which takes the form of a loan or a grant for the purposes of (or in connection with) the provision of privately let accommodation.

- Where a local authority is providing financial assistance to a third party, consideration needs to be given to whether it is providing that assistance in compliance with state aid rules. There are two exemptions which are noteworthy within the context of this report and NPH's proposals:

    i. The market economy investor principle. This asserts that a public body is not providing state aid when it is acting like a private investor in the market economy. The test is whether a private investor would invest on comparable terms.
    ii. where the financial assistance is provided to facilitate the provision of assets which are of social or general economic interest (**SGEI**), that assistance may constitute permitted state aid. Social (or affordable) housing is capable of benefitting from this exemption.

Diagrammatically, Model B looks like this:



The reference to “overage?” indicates that some form of contractual arrangement would need to be in place for the Council to benefit from any future uplift in value realised in relation to units developed with the benefit of the Council’s funding – due to NPH’s asset lock.

3. Advantages of Original Proposition

There are approximately 3,600 applications on Northampton’s housing register, of which approximately 2,000 are presenting with an urgent housing need. Our modelling indicates that the council only has capacity to deliver approximately 500 new homes within its HRA over the next 10 years.

In the context of this shortfall of social and affordable rented housing the advantages associated with the original proposition were:

- NPH already exists, has a core development team and its leadership is ambitious to pursue a development partnership with the council. It is already managing the existing NBC housing stock and is acting as development agent for the current new build programme

- Unlike the Council’s HRA NPH is not constrained by a debt cap and is able to borrow to fund the cost of new development (Model B) that wouldn’t otherwise be affordable within the HRA

- NPH can build affordable rented and market rented housing, shared ownership and market sale housing

- NPH is not a registered provider. Under current rules the housing it owns will not be covered by the right to buy and will not be subject to HCA rent controls.

- Margin on loan to NPH - The council will be able to generate revenue by charging a higher rate of interest to NPH than it incurs either through its own borrowing or use of balances. Charging NPH interest at a commercial rate means that NPH can deduct its interest charges from taxable profits.

- New Homes Bonus – New affordable rented housing attracts government funding equivalent to the national average band D council tax + £350 per dwelling for each of the four years following construction.

- Land Transfers – Any capital receipt from the disposal of land to NPH would not be subject to capital receipts pooling and would be usable for any legitimate capital purpose. There will need to be a downward adjustment to the HRA capital financing requirement (and a consequent impact on General Fund capital charges) if the receipt from housing land disposals is used for any purpose other than housing or regeneration.

4. Shortcomings of Original Proposition

Our report on the original proposition highlighted that the corporate status of NPH gave rise to a number of adverse financial implications, as follows:

- RTB 141 Receipts - The rules concerning the use of RTB 141 receipts prevent these receipts being used by a body in which the Council has a controlling interest (like NPH). Without an alternative development partner the Council will continue to be required to repay an estimated £11m of 141 receipts and £1.6m of interest (30 years);

- NPH's status as a company limited by guarantee, meaning that the Council is unable to receive profits derived from development activity in the form of distributions which can be received as revenue within the general fund;

- NPH's non charitable status meaning it is unable to obtain relief from corporation tax

- NPH's unregistered status and its status as a company limited by guarantee – meaning that no relevant housing provider or group SDLT relief is available in respect of land disposals from the Council to NPH.

Having regard to these shortcomings NPH have submitted a new proposition.

5. New Proposition

The new proposition incorporates a new independent charity, referred to as a Community Benefit Society (CBS), to work alongside the Council and NPH.

The CBS would be established on terms which permit the Council to have a level of influence, but influence which falls short of constituting a controlling interest.

The intention is that identified development schemes will in the first instance be carried out within the Council's HRA and with NPH acting as the development agent. The council will own these new affordable rented homes and manage them through NPH along with the rest of the Council housing stock. There will be no VAT or corporation tax associated with net rent surpluses and 30% of the development costs will be funded from ring-fenced RTB 141 receipts.

As we highlighted in our main report the capacity of the HRA to support new development is constrained by the HRA debt cap. We have assessed that approximately 500 units could be provided over the next 10 years through the HRA. However, there are not sufficient capital resources to fully exploit all the available RTB 141 receipts. The primary weakness in the original proposition was that NPH, being a Council controlled company, could not access the unused RTB 141 receipts and hence, without an alternative development partner, approximately £11m of funding would be lost.

Under the new proposition the CBS would be able to access the RTB 141 receipts that the HRA would be unable to use. It would therefore become the first alternative to HRA new build. The intention is that it would be established as an 'exempt' charity and would in that case benefit from corporation tax exemptions on its charitable activities, including affordable rented housing, and exemption from Stamp Duty Land Tax (on land acquired for charitable purposes).

The inclusion of the CBS in the development proposition addresses the bulk of the shortcomings identified in respect of the original proposition, namely:

- It allows for the use of RTB 141 receipts that could not otherwise be applied
- As with HRA new build, surpluses generated by the CBS on its sub-market rented housing operation would not be subject to corporation tax
- The CBS would be exempt from SDLT on land transferred or acquired from the council for sub market rented housing development

Being a non-controlled company it should be recognised that the CBS would be legally independent from the Council and at liberty to develop its business as its board sees fit. However, in practice the Council can exert some influence over the future direction of the CBS as follows:

- By careful recruitment of the initial board members of the CBS (meaning that the Council's objectives are likely to be ingrained in the culture of the organisation).
- By imposing clauses in the loan agreement that require the Council to approve the CBS's annual business plan; this is important not only to protect the Council's investment in the CBS but also provides a mechanism for controlling the future direction of the CBS.

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- By drafting appropriate clauses in lease documentation where land is to be transferred from the Council to the CBS.

Expected New Build dwelling numbers (HRA and CBS)

Estimates of numbers of new homes that could be funded are very much dependent upon the accuracy of our development cost projections. For the purpose of this assessment we have assumed approximately £143k per unit (2017/18 price base and including a land component). If actual unit costs come in below this rate then the number of units that will be deliverable will grow.

Under the new proposition, with the CBS receiving the unused RTB 141 receipts and borrowing from the Council to fund the remaining 70% of development costs, we estimate that the cumulative number of new homes that could be funded between the Council and the CBS over the next 10 years would rise to 619 (see table below). However, it is important to note that over the same period we are projecting 940 RTB sales.

	New Provision - Number of Dwellings						
	Existing schemes	**Residual Capacity in HRA**	**HRA Total**	**CBS (using spare 141 receipts + 70% match funding)**	**Total CBS + HRA**		**RTB Projection**
2017.18	24		24		**24**		**104**
2018.19	68	38	106		**106**		**99**
2019.20	100	41	141		**141**		**99**
2020.21		41	41	2	**43**		**94**
2021.22		39	39	8	**47**		**94**
2022.23		39	39	18	**57**		**90**
2023.24		38	38	15	**53**		**90**
2024.25		24	24	27	**51**		**90**
2025.26		24	24	24	**48**		**90**
2026.27		24	24	24	**48**		**90**
	192	308	500	119	**619**		**940**

The new proposition then provides for any additional housing to be developed, owned and managed by NPH.

We have already identified the advantages of working with NPH. In particular, compared with the CBS or another alternative entity, the Council would ultimately retain control of the housing through its wholly owned subsidiary. In respect of the identified shortcomings of working with NPH these are mitigated as follows:

- RTB 141 Receipts – The primary concern under the original proposition was that NPH was not able to receive RTB 141 receipts. Under the new proposition this is no longer a concern because any unused RTB 141 receipts can be channelled towards CBS development;

- NPH's status as a company limited by guarantee (rather than limited by shares), meaning that the Council is unable to receive profits derived from development activity in the form of dividends - In respect of the new proposition the council would also not be in a position to receive distributable profits from the CBS or any another for-profit entity in which it didn't hold an equity stake. An alternative would be to establish a new housing development company, limited by shares, which would be able to distribute dividends to the council. However, given that:

  - our modelling indicates that distributable surpluses are unlikely to be available for a considerable time (approximately 30 years)
  - that the Council ultimately owns the assets and balances of NPH and is therefore able to influence their use (through the agreeing of NPH's delivery plan in accordance with the management contract between the Council and NPH)

  we would conclude that the status of NPH as a company limited by guarantee should not preclude it as a development partner as envisaged within the new proposition;

In practice we would recommend that the agreement with NPH should ultimately give the Council the flexibility step outside the framework described in the new proposition and allow it to select an alternative development partner where it considers a better outcome may be achievable, whether that be working with NPH, the CBS, or another entity (such as an existing housing association). In these circumstances the selection of a partner (and indeed the decision to proceed or not), particularly where no further RTB 141 receipts are available, should be based on scheme appraisals, taking into account:

1. The cashflows associated with the scheme – do they represent good value for money?

2. NPH's non charitable status meaning it is unable to obtain relief from corporation tax and stamp duty land tax (SDLT) - It may well be the case that the cashflows can be managed to minimise the corporation tax implications of a scheme to such a degree that ownership of the housing through NPH is preferable to ownership by the CBS

3. The availability of additional funding or other resources specific to the delivery partner. For example:
   a. It might in some instances be advantageous to work with a housing association or other third party developer where they are able to offer specific advantages, such as greater development efficiency, the scope

to apply RCGF monies towards the scheme or cross subsidy from market sale or market rent schemes and/or land

b. NBC may be offered grant or a relaxation of its HRA debt cap making additional development within the HRA viable

c. The tax savings available from the charitable CBS may be considered to be of greater value than the benefit available from indirect ownership through the Council's wholly owned subsidiary

The arrangement arising from this new proposition should therefore incorporate provision for the Council to make its own assessment concerning the viability and delivery mechanism of individual schemes.

6. Ownership and Control of the CBS

NPH's proposition envisages:-

- the CBS' board comprising of 4 board members; and
- the initial board comprising of one officer of NBC and three appointees of NPH (involving a mix of NPH officers and board members).

No assumption is made regarding the shareholders in the CBS. Given that the CBS would be established as a charity, the rules of the CBS will not allow the distribution of any surpluses to its shareholders.

We make the following observations in the context of this aspect of NPH's proposition:-

(a) the size of the CBS board should reflect the level of activity anticipated; a board of four may, therefore, be adequate at the outset.

(b) if it is to be four, we would recommend that the Chair of the CBS is afforded a casting vote;

(c) the Chair ought to be someone who can objectively be seen to be independent of NPH and the Council – given the imperative, from the Council's perspective, that there is no question over the CBS' independence from the Council (and the implications in terms of RTB 1-4-1 monies if the Council is held to have control over the CBS).

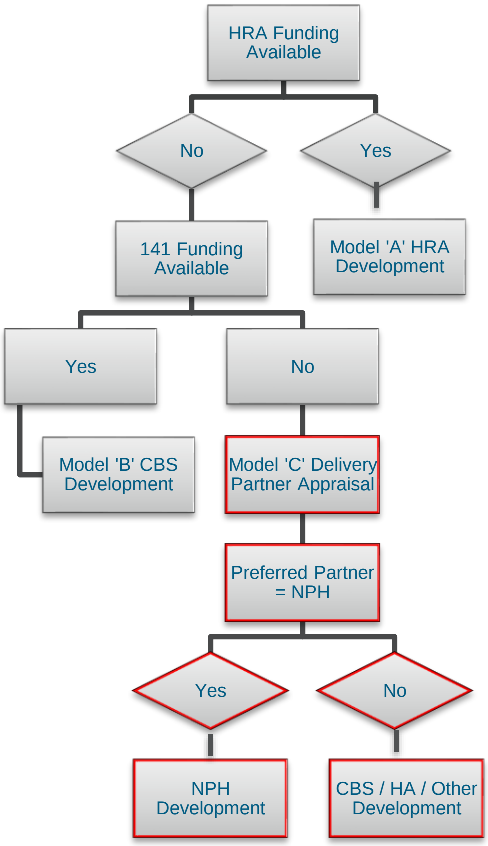
(d) NPH's proposition assumes a number of the CBS' board members are officers or board members of NPH. We take the view that care should be taken in this regard (given the independence imperative referred to above) and the assumption made about the role that NPH will play in the provision of services to the CBS. The CBS' board will need to approve entry into contracts with the Council and NPH and will need to monitor performance. Any individuals on the board that are connected to the Council or NPH will have an interest in that matter and there is scope, in certain circumstances, for that interest to constitute a conflict.

(e) In our view, therefore, ideally, a board of four would involve no more than one board member that is also connected to the Council and one that is connected with NPH; that would leave two board members that are independent of both organisations. If the quorum for board meetings were to be set at two, the board would remain able to attend to any business relating to transactions with the Council and /or NPH where those individuals step aside from those board items.

(f) We would envisage the board members (from time to time) being the shareholders of the CBS (a commonly adopted structure on CBSs in the housing sector). Given the not-for-profit status of the CBS, the role of shareholders will be limited; their main function being to act as the guardians of the CBS' constitution.

7. Conclusions

The new proposition document prepared by NPH incorporated a filter diagram to illustrate the process for deciding which entity (the Council, the CBS or NPH) should undertake a development. We have reproduced that diagram below but added (highlighted in red) an evaluation process in respect of schemes for which no RTB 141 funding is available.



The mechanism illustrated above is broadly in line with NPH's new proposition but includes provision for the council to assess the relative merits of alternative development partners where it considers better outcomes may be obtainable. This should be a fairly straight forward process of examining the tax, level of council control and specific funding implications of the alternative arrangements.

The selection of the board of CBS should reflect the imperative that there is no question over the CBS' independence from the Council. We suggest that with a four person board this could be achieved by:

1. Having no more than one board member that is also connected to the Council and one that is connected with NPH;

2. Appointing a Chair who can objectively be seen to be independent of NPH and the Council