Extraordinary Overview and Scrutiny Committee

7th April 2021

	Response to Call in Request on decision to transfer West Wing and Benwell House Phase 1 from Spelthorne Borough Council to Knowle Green Estates
Purpose of the report	To make any recommendations to Cabinet as considered appropriate by the Committee
Report Author	Terry Collier
Cabinet Member	Cllr Jim McIlroy
Confidential	No
Corporate Priority	Housing Financial Sustainability
Recommendations	**Committee is asked to:** 1.1 **Consider the response made to the points raised in the call-in** request **and whether there are any recommendations it wishes to make to Cabinet**
Reason for Recommendation	**A number of important policy issues have been raised in the Call-In request which the Committee may wish to make recommendations on.**

2. Key issues

2.1 Cabinet on 24th March 2021 considered a report proposing the transfer of West Wing and Benwell House Phase 1 from Spelthorne Borough Council to Knowle Green Estates (the 100% owned housing delivery company of the Council) for Knowle Green Estates (KGE) to hold the assets on a long-term basis and to manage them for the delivery of housing. West Wing to be 100% affordable rental units and Benwell House Phase 1 to be a mixed tenure scheme split roughly 60% affordable, 20% key workers (reserved for designated occupations with a local connection such as health and education workers) and 20% private rental.

2.2 In parallel the KGE Board carefully considered at its Board meeting on 17th March 2021 the proposed transfer and the financial projections to assure itself that the basis on which the schemes were being transferred would be financially viable for KGE and enable it to make the loan interest and principal repayments to the Council.

2.3 Both West Wing and Benwell House Phase 1 (Benwell scheduled Practical Completion 16th April) are due to be completed within the next couple of

months and tenants will shortly be ready to move in. Any delays to completing the transfer between the Council and KGE will have an adverse financial impact for the Council.

3. Options analysis and proposal

3.1 The report will focus on the issues raised in the Call-in report and will cover both West Wing and Benwell House Phase 1 transfers in the following seven sections.

Point of clarification 1: The rationale for the split of affordable, key worker and private rentals and basis on which any choice is made

3.2 Following the Extraordinary Council Meeting on 25th January 2021, the Cabinet set out their broad policy objective of providing **at least** 50% of homes on all its residential developments as affordable housing (defined as up to 80% of market rent), including an element of homes prioritised for local key workers.

Benwell House Phase 1

3.3 This development was always proposed as a mixed tenure scheme, offering a tenure blind approach, meaning no difference in specification between a private rented home and an affordable home. The agreed split of affordable, key worker and private rentals is in line with the publicly stated Cabinet policy objective.

3.4 There is a need to ensure a balanced and sustainable community at Benwell House. As a result of the mix of property sizes in what would have been the 50% private rent element of this scheme, namely the relatively high proportion of studios and one bedroom flats (71%), Officers needed to consider a reasonable tenure mix which would meet the Cabinet's policy objective in relation to the delivery of affordable and key worker homes, be financially sustainable, and offer residents the greatest opportunity to access a one of the homes. The following options were considered:

(a) 50% affordable and 50% private rented – rejected due to financial unsustainability for Knowle Green Estates (KGE) and therefore ultimately for Spelthorne Borough Council (SBC) as the 100% owner of the company) (see para 3X).

(b) 100% affordable – rejected due to the high likelihood of housing management issues arising as a result of the high concentration of one bedrooms and studio flats. Households on the Housing Register eligible for these properties who have a high priority tend to have more support needs.

(c) 80% affordable and 20% private rented – whilst this provided an optimum financial position for KGE, it was rejected for similar reasons provided at (b), in that this would still provide a relatively high concentration of smaller affordable units.

(d) 60% affordable, 20% key worker and 20% private rented – this option has been accepted as it provides a balance between private rented and affordable, whilst also offering a small number of units to trial the operation of a key worker scheme in advance of larger schemes such as Victory Place.

West Wing

3.5 This development will be entirely affordable housing, let to households on the Housing Register. One unit has been fully adapted for disabled use. The Council has been clear from the early days of its Housing Delivery programme that it voluntarily wished to front load the delivery of affordable (planning s106 and "voluntary" affordable) by delivering a relatively high proportion of affordable in the early stages of the programme. 100% affordable rental for West Wing is consistent with the approach taken on Churchill Way and the Bugle Returns site.

Key Worker Policy

3.6 A Key Worker Policy has been drafted and appended to this report at Appendix 1. This policy will initially only apply to the lettings to Benwell House (Phase 1). After twelve months this policy will be comprehensively reviewed, with a view to the creation of a more embedded policy to take effect for future schemes, including Victory Place (which is still subject to planning permission). This policy will be considered by Cabinet at an Extraordinary Cabinet meeting on a date to be decided, with a view to its adoption in advance of the first lettings to Benwell House.

3.7 In addition to the policy objective of wishing to make a significant difference to residents of the Borough in need of access to affordable housing by delivering a significant proportion of affordable housing, the other important influencing factor is scheme cost, which is touched on more, later in this report. To assist with the planning of the future pipeline of residential schemes, for the benefit of both SBC and KGE, it is suggested that in future greater focus is put on the upfront estimated costs of proposed developments and what those costs mean for KGE's viability on a range of tenure rental mixes. This could be done as a form of "term sheet" at the start of each development as a way of documenting the initial assumptions which can then be monitored and used as a trigger to review transfer and viability projections for a scheme if those assumptions start to look challenging. The Assets Sub-Committee of the Corporate Policy and Resources Committee could review these initial assumptions and at set stages as development projects progress.

Point of clarification 2: Basis of valuation of properties

3.8 A number of valuation options were presented to Cabinet in November 2020 to agree a basis for enabling the transfer of properties from SBC to KGE. Cabinet approved a valuation basis that prioritises the maximisation of S106 affordable housing and occupations whilst ensuring schemes remain financially viable for KGE. This approach requires the Assets team to initially agree an appropriate S106 housing provision through the planning process. When the scheme has been built and all costs are known, a market valuation is undertaken. This establishes the 'profit' locked into the scheme. At this point additional valuation sensitivity analysis is undertaken by incrementally increasing the S106 housing element until the 'profit' has been eroded to a level similar to total costs. Therefore, instead of locking in a 'book value profit', Cabinet have chosen to ensure the Council maximises the provision of S106 affordable housing. Those units which are not S106 will be valued on an open market basis. However this does not preclude them from being let to tenants paying both market and affordable rents. This approach also reduces the transfer value to KGE which minimises its debt and consequent interest and principal repayments and therefore improves its ability to make those financing payments to the Council.

3.9 An illustration of this in practice includes:

(a) Benwell House Phase 1 – From a planning policy perspective, 12 S106 affordable units were agreed as viable. However, as this is ultimately a two-phase project, there is no 'profit' in the first phase and hence no additional S106 units can be provided. Its profitability is reliant on Phase 2 being delivered which is still subject to planning. Notwithstanding this, the model allows us to provide affordable/key worker occupations in the units which are valued at open market sales rates.

(b) West Wing – By contrast, this development was valued at £9.4m on an open market basis as it's a Permitted Development Rights conversion scheme, and not subject to affordable housing policies. However, by applying S106 affordable housing values to all units, the values have been reduced to £5.9m which aligns more closely with total costs. This has resulted in the development providing 100% more affordable than policy requirements.

3.10 To assist both KGE and SBC moving forwards it is suggested that the approach set out in 2.8 is set out as the SBC Policy for Valuation of Transfers and can then be understood and referenced by KGE.

Point of clarification 3: SBC viability expectations

3.11 It is important to understand that KGE is 100% owned by the Council and that its assets and liabilities are fully consolidated into the Council 's financial Group Accounts at the end of the financial year. The Council does not therefore ultimately gain by making a "capital gain" on asset transfer or lose if transfers are at a lower value. SBC is not looking to make a profit on development schemes but ideally is looking to transfer the schemes at a valuation close to the development cost. What is crucial is that KGE as the delivery vehicle is financially viable on a long-term basis and will be able to make the financing payments (and pay for recharged services from the Council) to the Council. As the Cabinet report made clear we do not wish to be in a similar position to Croydon LBC and its housing delivery company Brick by Brick, where that company's inability to meet its loan repayment commitments played a fundamental part in the financial difficulty that Croydon Council recently found itself in.

3.12 The finance team maintain an "integrated" financial model which links together profit and loss, balance sheet and cashflow projections for 50 years for KGE. In terms of the ability to meet future cash commitments there is a particular focus on cashflow, which is key to ensuring the company can meet future liabilities. In contrast, net profit or loss after depreciation is very much impacted by the significant depreciation charges arising from the significant assets the company holds (depreciation is addressed in section 7). Depreciation is a non-cash accounting charge which reduces the net surplus.

3.13 The integrated model has been shared with the Directors of the KGE Board who have assessed the financial viability of different tenure mixes particularly for Benwell Phase 1. As discussed in 2.4, several tenure mixes were rejected because of their adverse impact on viability.

3.14 It should be noted (as commented in the Cabinet report) that where affordable housing units are filled by tenants from the Council's housing register the

Council does make a notional revenue saving on its homelessness budget of roughly £6.5k per household each year.

Point of clarification 4: The way that SBC costs are attributed to developments

3.15 The Council undertakes and manages the development of schemes up to completion before they transfer to KGE. All development costs are treated as capital costs. This includes directly attributable staff costs (for example development manager costs) and includes costs such as security of sites.

3.16 However, it should be noted that whilst all SBC direct costs/fees and interest costs are capitalised, they do remain at risk of being converted to the revenue account if planning permission is not obtained. To minimise the Council's exposure to these risks, the objective is to get robust applications submitted and determined as quickly as possible. Any delay adds to the daily burden of the continuing accrual of interest costs for each project, and unnecessarily increasing costs in return for nothing.

3.17 It is hoped that the new Corporate Policy and Resources Sub-Committee will assist in ensuring schemes do not continue to be used for conflicting political motivations. For example, Ashford Victory Place, Thameside House and Benwell Phase 2 have stagnated in the planning process whilst cross party support for the new leisure centre has enabled the application to progress (so far) within statutory timescales. The same can be said for Harper House and the White House Hostel, West Wing and Benwell House Phase 1, although these last two were office to residential conversions allowed under permitted development rights.

Point of clarification 5: The rate of interest charged for loans to KGE

3.18 The Cabinet report attempted to explain the policy drivers to explain the interest rates used. These are:

(a) for affordable units provided the Council will charge the same financing rates as it can access through the Public Works Loan Board (PWLB) and

(b) for private rental units, following legal and expert advice, the Council will charge a proxy market rate (currently 5%) this minimises the risk of the Council and the Company being challenged on state aid grounds.

3.19 To make the above more transparent, we will express the Interest Rates Policy as follows:

(a) Financing of affordable rental units (including key worker units where the same twenty percent discount on market rental applies). The Council will charge KGE at the same rates as it is able to access through the Public Works Loan Board. This shall be expressed as being at a rate of plus or minus twenty basis points of the prevailing fifty-year PWLB Annuity rate (or equivalent) on the day of the transfer.

(b) Financing of market rental units. The Council will charge the Company a proxy market rate of the prevailing PWLB 50-year annuity prevailing on the day of the transfer plus two hundred and fifty to three hundred fifty basis points. This range will annually be reviewed in consultation with the Council's treasury management advisers.

Point of clarification 6: Potential sale of SBC developed housing

3.20 The recent independent Local Government Association Corporate Finance Peer Review commented in one of its recommendations on the challenges of ensuring that the Councils ambitious housing delivery programme remains financially viable if it only delivers rental units, as currently is the case. The Peer Review suggested (as quoted in the Cabinet report) that the Council explores the option of having the option of some sales of residential units in the future, which would reduce the amount of debt finance required for the programme.

3.21 It needs to be made clear that the current policy of the Council, and the parameters within which KGE are operating, is that *all* developments are being delivered solely on a rental basis. Unit sales are not being proposed for Benwell House Phase 1 nor West Wing. Cabinet was however flagging this as a matter for future consideration and stating it need to be kept under review if the KGE future years viability modelling projections become more challenging. It is suggested that this could be taken forward through the Community Wellbeing and Housing Committee and Corporate Policy and Resources Community, in partnership with the KGE Board.

Point of clarification 7: Depreciation and asset valuation

3.22 In updating the 50-year model to date, a fairly high-level approach to depreciation has been undertaken. However, at the next KGE Board there will be a paper setting out a draft Depreciation Policy addressing a componentisation approach. This is designed to aid the consolidation of KGE accounts into the SBC accounts. By componentising each property, the Directors would be looking to establish the relevant life expectancy and therefore a depreciation rate for each component listed above using a straight-line methodology to calculate the figure, for example:

(a) Land would not be depreciated. This is in line with generally accepted accounting principles,

(b) Building structure - 50-100 year (between 1 & 2% p.a.)

(c) Bathrooms – 20 years

(d) Lifts – 20 years

(e) Heating Electric – 15 years

(f) Heating Gas – 15 years

(g) Kitchen – 20 years

(h) Roof (Pitched) – 60 years

(i) Roof (Flat) – 2 years

(j) Windows – 10 years

3.23 In the 50-year projections we used a 50-year life expectancy on the whole cost of the property, including land, i.e. 2% per annum straight line, so that we could assess the impact on profitability.

3.24 The projections indicate that the cumulative profit and loss account would be in the region of £104 million after 50 years and therefore, would be able to meet a major refurbishment across all properties on at least one occasion and provide for a healthy level of annual repairs and maintenance and would still allow KGE to meet its financing payments and other liabilities.

4. Financial implications

4.1 As set out in the Cabinet report, any delays to finalising the transfers will add to the costs the Council is incurring before KGE starts to generate a rental income stream and is able to start making financing payments to SBC. It is therefore in the Council's financial interests to ensure that the transfer dates do not slip.

5. Other considerations

5.1 By delivering a significant proportion of affordable housing units the Council is helping to provide opportunity for more of its residents to live-in high-quality accommodation in the local area that is affordable.

6. Sustainability/Climate Change Implications

6.1 Not raised as an issue in the Call-In request.

7. Timetable for implementation

7.1 An Extraordinary Cabinet has been scheduled for 14th April to consider and respond to any recommendations that the Overview & Scrutiny Committee may wish to make. The Cabinet will also consider the adoption of the Key Worker Policy mentioned within this report.

7.2 Anticipated practical completion for Benwell House Phase 1 is 16th April, and for West Wing is 25th May.

Background papers:

Appendices:

Appendix 1: Exempt Cabinet report and appendices on transfer of Benwell Phase 1 to KGE

Appendix 2: Additional supporting information with respect to key worker approach – draft Key Worker Policy