Agenda Item No:

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HERTFORDSHIRE COUNTY COUNCIL

RESOURCES AND PERFORMANCE CABINET PANEL

COMMERCIAL INVESTMENT: SMALL SITE DEVELOPMENT

Report of the Director of Resources

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Local Member: Michael Hearn

1. Purpose of report

1.1 To invite Councillors to consider and make recommendations to Cabinet on a proposed strategy to deliver capital receipts from the sale of small residential sites to Herts Living Limited (HLL) for development; including the establishment of a limit for investments required to facilitate this activity.

1.2 To detail the financing of the proposed strategy and to seek a recommendation from the Panel to for Cabinet for the approval of a loan to be issued to HLL to finance the purchase and development of council land at Shephall Green, Stevenage.

1.3 To enable the Panel to consider whether to recommend to Cabinet that it delegates the approval of future investments, subject to a rolling £5 million limit, for the purposes of implementing the proposed strategy to the Director of Resources, in consultation with the Executive Member for Resources and Performance.

2. Summary

2.1 HLL was incorporated on 5 September 2017 with a target of maximising value from capital receipts from the Council's surplus land portfolio, via innovative approaches to property development.

2.2 To date, much activity has been undertaken by the Council and HLL in relation to the establishment of a Joint Venture in order to deliver developments on substantial sites, however the early proposals and original business case always included the expectation that this would only be one element of HLL's activity.

2.3 This report details and proposes the adoption of a strategy around disposal of small sites for development, via HLL, and the associated authorisations around commercial investments required in order to finance these.

2.4 This report contains detailed proposals for the authorisation of a loan from the Council to HLL to facilitate the development of the first of these sites, at Shephall Green, Stevenage. It is proposed that the commercial investment decision around subsequent sites will be delegated to the Director of Resources, in consultation with the Executive Member for Resources and Performance, within a £5 million limit.

2.5 This report is supported by more detailed information which is exempt under paragraph 3 of Part 1 of Schedule 12A to Local Government Act 1972 (as amended), which is contained in the accompanying Part 2 report.

3. Recommendations

3.1. The Resources and Performance Cabinet Panel is invited to note the information contained within the report and to recommend to Cabinet that it:

i. approves the proposed strategy set out in the report for disposal of small surplus sites directly to Herts Living Limited for development and sale on the open market;

ii. approves the establishment of a loan facility to Herts Living Limited, in order to undertake the strategy referred to in (i) above, from within the Capital Investments budget set in the 2019/20 Integrated Plan to support Herts Living Limited activity; such facility to be subject to a rolling limit of £5 million;

iii. subject to (iv) below, approves the issue of a loan to Herts Living Limited to finance the purchase and development of land at Shephall Green, Stevenage

iv. delegates to the Director of Resources, in consultation with the Executive Member for Resources and Performance, authority to finalise the terms and sum of the loan referred to in (iii) above, subject to the £5 million limit set out in (ii) above;

v. delegates to the Director of Resources, in consultation with the Executive Member for Resources and Performance, authority to take future investment decisions for subsequent commercial investments to Herts Living Limited under the strategy referred to in (i) above, including authority to finalise the terms and sum of any future loan, subject to the £5 million limit set out in (ii) above.

4. Background – Herts Living Ltd (Commercial Investments)

4.1. Cabinet has previously considered a report in relation to the establishment of a wholly owned property company on 13 March 2017 with the remit of entering into a joint venture partnership with a commercial developer to develop sizeable plots of surplus council land, as well as independently pursue additional opportunities to achieve financial returns from other elements of the Council's surplus land and asset portfolio.

4.2. The business case for the establishment of Herts Living Limited (HLL) was approved by Cabinet on 10 July 2017, and also included expectations that HLL would both work with the prospective joint venture partner as well as pursue other projects.

4.3. Cabinet approved a report on 19 March 2018 confirming the appointment of Morgan Sindall as joint venture (JV) partner following the conclusion of a procurement process. The objectives of this joint venture focussed on the development of larger plots of surplus council land. This report also recommended that Cabinet proposed to Council that a limit of £50 million be established within the (then) Capital & Asset Strategy for non-Treasury investments. This limit included Commercial Investments, such as loans to HLL for both joint venture, and direct developments.

4.4. This proposal was approved by County Council as an amendment to the Capital & Asset Strategy on 27 March 2018.

4.5. Following changes in disclosure requirements from Central Government, the Council was required to split out separate Treasury, Capital, and Investment Strategies for the 2019/20 Integrated Plan (IP) process. During this process, the Capital and Investment Strategies were amended to incorporate the £50 million limit on non-treasury investments. The IP, including these strategies, was approved by County Council in February 2019.

4.6. The 2019/20 IP also established a capital budget for loans to HLL in 2019/20 of £10.6m to enable it to undertake development activity (either directly, or via the JV) on surplus council land. These loans were confirmed as capital expenditure within the requirements of the Local Authorities (Capital Finance and Accounting) (England) Regulations

2003, and funded by the capital receipts received from the sale of land being developed.

5. Background – Capital Receipts

5.1. The Council has a capital receipts target of £10 million per annum and the Estates Team is tasked with securing such receipts from the open market.

5.2. Meeting this target can be assisted from securing planning consents on small surplus sites and then selling such land assets for the optimum value. This is the traditional approach regarding capital receipts, however the establishment of HLL enables the opportunity for the group (the County Council and HLL) to retain development profits which would otherwise be inaccessible.

5.3. There is the potential for this work stream to be significant, and the Council has already identified a pipeline of 30 such small sites suitable for development, subject to planning. In some cases, such as Shephall Green, Stevenage, this planning permission has already been secured and approval for its disposal has been agreed by the Director of Resources in consultation with the Executive Member for Resources and Performance under delegated powers. The land value for the site is being agreed and will be reported to the above for final sign off shortly.

5.4. The Council has supported establishment of a Joint Venture vehicle, Chalkdene Developments (a joint venture between HLL and Morgan Sindall), however the nature of this opportunity is too small for this vehicle and this route would offer poor value. The scale and level of risk in this strategy offers an opportunity for HLL to undertake the development directly, thereby securing the full developer’s profit within a council owned company.

6. Small Site Development – Strategy

6.1. It is anticipated that the Council can continue to identify development opportunities within its surplus assets portfolio over the medium to long-term to support a strategy – a pipeline of 30 appropriate sites for development has already been identified – a number of these have been detailed in Appendix A of the accompanying Part 2 Report. The proposal is that the Council will secure planning permission on small sites earmarked for disposal, and sell these to HLL, as well as providing loan financing for the developments. This will take place within a rolling equity envelope of £5 million of loans between the Council and HLL to provide finance for these projects.

6.2. Authorisation for any disposals of land in relation to this strategy will be progressed using the Council’s established processes.

6.3. In respect of the disposal of the land, the Council must meet its duty, under section 123 of the Local Government Act 1972, to secure best consideration reasonably obtainable and valuation advice will be sought to ensure this is the case for each specific disposal to HLL. This is in line with the legal advice and processes around disposal of land in line with best value requirements detailed in section 6.4 of the report to Cabinet in March 2018.

6.4. HLL will undertake the procurement of resources to support the project and appoint suitably experienced and qualified professionals to design, build, and sell the assets.

6.5. With the exception of Shephall Green, where authority for the commercial investment is sought within this paper, it is proposed that authority for the Council to invest in relation to subsequent sites be delegated to the Director of Resources, in consultation with Executive Member for Resources and Performance, following consideration of the detailed financial model of each case.

6.6. Over time, due to retention of development profits, HLL's balance sheet will develop to the point that it can begin to self-finance future developments, and council loans will no longer be required.

6.7. If sites are considered to carry an increased risk in relation to property development, for example listed buildings, the Council will secure planning consent, and sell this land to the open market in the normal way.

6.8. Initial developments set out in 6.1 would entail loans being advanced to HLL to both purchase these sites from the Council, and develop them. For early loans, interest would have to be accrued, and repaid upon sale of the completed homes alongside repayment of the loan. Interest payments to the Council (albeit deferred in cash terms) will provide an income stream to the Council which offsets the cost of the borrowing that the Council incurs on its side of the financing. This will be covered in more detail in Section 8 below, and in the accompanying Part 2 Report, however the overall process is set out below:

- the Council advances an initial tranche of loan to HLL for land value and early costs;
- HLL purchases land from the Council, and commences development. The Council applies this initial capital receipt against its annual target;
- HLL draws further loan sums as and when required to support development cashflows;
- Once development is complete HLL markets properties for sale;
- Once properties are sold, HLL uses proceeds to repays loans to the Council. This repayment represents a second capital

receipt to the Council, which is used to offset borrowing the Council has incurred in order to cashflow the loans to HLL;
- HLL will retain development profit (less corporation tax), which can either be used as a dividend payment to the Council, or reinvested into other projects;
- The Council receives its initial capital receipt for land sale, as well as the difference (spread) between the interest rates of any borrowing required to lend money to HLL, and the interest paid by HLL.

6.9. The scale of this development activity will need to be at a sufficient level to make the strategy meaningful. A rolling limit has been proposed for total loans advanced at any one time to HLL in relation to this activity of £5 million. This will support a staggered programme whereby, once the limit is approached or reached, repayment of loans for earlier sites will, in time, create headroom for new loans – but ensure that the Council's exposure to these loans is managed. The effectiveness of this strategy will be kept under review, as sites move through the development process.

6.10. It is anticipated that, for the size of sites concerned, development work will take around 18-22 months to build and sell, after receipt of planning permission, at which point the loans (and any accrued interest) would be repaid.

6.11. The lead site which could be considered within this strategy is Council land at Shephall Green, Stevenage, which is a surplus site which has been cleared for disposal, by way of delegated approval from the Director of Resources in consultation with the Executive Member for Resources and Performance.

7. Small Site Development – Shephall Green

7.1. The Council's land at Shephall Green represents the first likely site for transfer and development via this process. Detailed financial modelling of this is included within the accompanying Part 2 Report.

7.2. Planning consent has been obtained for development at Shephall Green for two residential dwellings, and associated car parking for a nearby school. The Council will construct the new car park and HLL is fully engaged in the design and programme of such.

8. Financial Implications

8.1. Loans advanced to HLL to support this Strategy fall within the category of non-Treasury investments, and therefore within the £50 million limit established for these by the council as detailed in 4.3 and 4.4. As at 31 March 2019 non-Treasury investments were as follows:

Non-Treasury Investment Category	Balance at 31 March 2019 £000	Notes
Service Investments: Loans	0	Loan facility of up to £260k for Herts at Home
Service Investments: Equity	565	Share capital for Herts Catering, Herts for Learning, Herts at Home and Herts Fullstop
Commercial Investments: Loans	90	Credit Facility of up to £325k for Herts Living Limited
Commercial Investments: Equity	175	Herts Living Limited Share Capital
TOTAL INVESTMENTS	**830**	

8.2. Loans in relation to small site development will fall into the category of Commercial Investments: Loans.

8.3. Budget was identified within the 2019/20 IP for commercial investments in 19/20 of £10.62m, and this is anticipated to be sufficient for current year activity.

8.4. During the 2019/20 IP the capital expenditure for commercial investments was anticipated to be funded in full from the capital receipts released at the point land was sold by the Council, as for Joint Venture projects, elements of the project financing will be input by other parties (both the JV partner's equity contribution, and senior debt taken by the JV itself). In contrast, for small site developments, HLL requires a loan for the full costs of the development, including purchasing the land, and funding the development costs. The initial receipt that the Council would receive for the land when selling to HLL will therefore not provide funding for the whole of the loan.

8.5. It is proposed, therefore, that the initial capital receipt (council land sale to HLL) is taken against the corporate capital receipts target, and used to reduce the capital financing requirement for other, longer term capital expenditure. This represents the overall best value for the Council as it reduces the costs of capital (borrowing and Minimum Revenue Provision costs) on other, longer-term, elements of the capital programme.

8.6. Loans advanced to HLL will therefore be forward funded (temporarily funded by borrowing) by the Council, until the point that the completed homes are sold, and HLL repays the loans. Usually funding capital expenditure (even in the short term) creates a capital financing cost for the Council (borrowing costs), however this will be more than offset in this situation by the interest costs which HLL will pay to the Council. The detailed financial model is demonstrated in the accompanying Part 2 Report.

8.7. Minimum Revenue Provision (MRP) is the charge that the Council needs to make to its revenue budgets to set aside resources to ultimately repay borrowing required to fund capital expenditure not financed by grant, reserve or capital receipts. The Council's MRP policy, set out within the 2019/20 IP (Capital Strategy – Appendix C), states that for capital expenditure loans to third parties the capital receipt received when the loan is repaid can be regarded as prudent provision – and therefore MRP does not need to be provided. This is on the condition that an annual assessment of the security of the loan is undertaken, and MRP is provided on any impairment to the loan. The capital receipt arising from the repayment of the loan is then offset against the Council's capital financing requirement, in order to clear the initial borrowing implication.

8.8. The annual assessment of the security of loans to HLL will be undertaken as part of International Financial Reporting Standard (IFRS 9) requirements, which require initial impairment of financial assets (such as investments/loans out) on an expected credit loss model, at the point the assets are recognised within an organisations accounts. This will represent an impairment which is a revenue charge to the Council when the loan is recognised, but would be reversed upon repayment. MRP will therefore be made upon this impairment in line with the Council's MRP policy.

8.9. As MRP can be minimised on loans to HLL under this arrangement (as the borrowing requirement that the council incurs will only be temporary, until the repayment of the loan by HLL), it will be more efficient to apply capital receipts that arise as part of the initial land sale to other (traditional) capital expenditure within the Capital Programme where MRP would otherwise be required, and create an ongoing revenue pressure for the Council.

8.10. The financial treatment of these loans has been appraised by the Council's external advisors and confirmed to be appropriate. Arlingclose, the Council's Treasury Management advisors have confirmed MRP, IFRS 9 and borrowing models, whilst Price Waterhouse Cooper have confirmed that property transactions between the Council and HLL directly are exempt from Stamp Duty Land Tax (SDLT) as they fall within the same group.

8.11. Terms of the loans advanced to HLL are proposed under the following principles, although Cabinet is requested to delegate authority to the Director of Resources, in consultation with the Executive Member for Resources and Performance, to confirm final arrangements:

- There will be a rolling limit on total loans advanced of £5 million in relation to direct development of small sites by HLL;
- Individual loans are to be established for each project, under a framework;
- Loans will allow flexible drawdown by HLL in order to match against project cashflows;

- Loan agreements will include maturity dates when it is anticipated that projects will be completed and sales achieved. The agreements will also contain provisions for extension to the term, should sales be delayed;
- Loans will be secured against the land being transferred via legal charge;
- Interest on these loans will be charged at a commercial rate.
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8.12. Detailed financial modelling is included within the Part 2 Report due to sensitivities about anticipated land values and development costs.

9. Risk

9.1. The risks to this strategy are set out in the table below, alongside mitigation measures:

Risk	Mitigation
Property Market Fluctuations	HLL will bear the risk of fluctuations in the property market, however this is the inevitable consequence of seeking to access development profits. Appraisals will be carried out on each investment (i.e. loan) with HLL prior to the Council entering into agreements to sell land and fund development. Where this analysis confirms that profit margins are slim or high risk, the Council is under no obligation to support the development. Where the investment decision has already been made, robust project management undertaken by HLL will ensure that projects are completed to schedule, in order to minimise risk of market fluctuations.
Delays in achieving sales	Loan agreements will contain clauses for extension should HLL experience delays in achieving sales, meaning the initial impact of this would be a reduction of HLL's ultimate profit as it will be incurring interest costs for longer than anticipated. A decision would have to be made on whether to lower asking price in order to achieve a quicker sale, or retain prices and potentially continue to incur interest costs. Depending on the maturity of this Strategy (or others), HLL may have other retained sums available from other projects to repay the loan, and therefore enable it to wait in order to achieve the desired sale proceeds.

10. Legal Considerations

10.1. In accordance with the previous reports to Cabinet, the Council created HLL using its powers under section 1 of the Localism Act 2011, which provides the "general power of competence" (GPOC) which permits the Council to do any activity which an individual may do, for a commercial purpose subject to such being through a company. The implementation of the strategy set out in this report is within the Council's powers under GPOC.

10.2. In respect of the disposal of the land, the Council remains obliged to ensure that it meets its duty under section 123 of the Local Government Act 1972, in securing best consideration.

10.3. The Council is empowered to provide a loan to HLL by virtue of its powers of investment under s12 Local Government Act 2003 and the general power of competence under s1 of the Localism Act 2011. S12 of the Local Government Act 2003 permits the Council to make investments (in this case by way of a loan) for the purpose of the prudential management of its financial affairs. Such investments are controlled within the Council under the Investment Strategy (Appendix E to the Capital Strategy), approved by the Council as part of the Integrated Plan. Para 1.2 of that strategy sets out that:

"The Council Invests its money for three broad purposes:

- ***Treasury Management***
  Because it has surplus cash as a result of its day-to-day activities, for example where income is received in advance of expenditure
- ***Service Investments***
  Supporting local public services by lending to or buying shares in other organisations
- ***Commercial Investments***
  Where the main purpose is to earn investment income or generate enhanced capital receipts"

Loans in relation to this proposal come under the category of Commercial Investments, and Para 4.5.1 and 4.5.5 of the Investment Strategy respectively set out that:

"Commercial investments will be evaluated and appraised on an individual basis following development of a robust business case which will be subject to established Officer and Member sign off protocols."

And:

“The majority of commercial investments are capital expenditure, therefore will be subject to further scrutiny and approval as part of the capital programme.”

Such loans and investments will be subject to the Authority’s normal approval process for revenue and capital expenditure and need not comply with this TMSS.”

10.4. In determining the provision of loans, the Council has taken into account the requirements with regards to State Aid, ensuring that any financing it makes to HLL is done on an arm’s-length, commercial terms and in line with market practice. There will be no State aid where it can be demonstrated that the terms are in line with what would be expected under normal market economy conditions: the so-called Market Economy Operator Principle (MEOP).

11. Equalities Implications

11.1. When considering proposals placed before Members it is important that they are fully aware of, and have themselves rigorously considered the Equality implications of the decision that they are making.

11.2. Rigorous consideration will ensure that there is a proper appreciation of any potential impact of that decision on the county council’s statutory obligations under the Public Sector Equality Duty. As a minimum this requires decision makers to read and carefully consider the content of any Equality Impact Assessment (EqIA) produced by officers.

11.3. The Equality Act 2010 requires the council, when exercising its functions, to have due regard to the need to: (a) eliminate discrimination, harassment, victimisation and other conduct prohibited under the Act; (b) advance equality of opportunity between persons who share a relevant protected characteristic and persons who do not share it and (c) foster good relations between persons who share a relevant protected characteristic and persons who do not share it. The protected characteristics under the Equality Act 2010 are age; disability; gender reassignment; marriage and civil partnership; pregnancy and maternity; race; religion and belief, sex and sexual orientation.

11.4. As property developments come forward full equality implications of the decisions are taken account of through local planning policy compliance.

Background Information:

Cabinet – 10 July 2017
https://democracy.hertfordshire.gov.uk/CeListDocuments.aspx?CommitteeId=146&MeetingId=415&DF=10%2f07%2f2017&Ver=2

Cabinet – 19 March 2018
https://democracy.hertfordshire.gov.uk/CeListDocuments.aspx?CommitteeId=146&MeetingId=423&DF=19%2f03%2f2018&Ver=2

County Council – 27 March 2018
https://democracy.hertfordshire.gov.uk/CeListDocuments.aspx?CommitteeId=216&MeetingId=524&DF=27%2f03%2f2018&Ver=2

County Council – 19 February 2019

https://democracy.hertfordshire.gov.uk/mgAi.aspx?ID=1299#mgDocuments