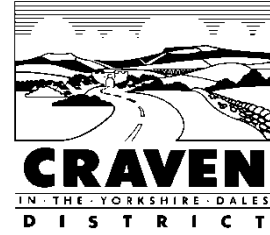


## Policy Committee – 12<sup>th</sup> April 2016

### ESTABLISHMENT OF COUNCIL OWNED TRADING COMPANY



Report of Director of Services

Lead Member; Councillor P Mulligan

Ward(s) affected: All

#### **1 Purpose of the Report**

To seek approval to the establishment of a wholly owned arms' length company of the Council to manage assets that generate a revenue stream for the Council.

#### **2 Recommendations**

Members are recommended to:

- 2.1 Approve the incorporation of a company limited by shares wholly owned by the Council.
- 2.2 Approve the trading company's objective as 'To manage assets that generate a revenue stream for the Council'.
- 2.3 Approve the company's governance arrangements as those set out in section 7 of this report and give delegated authority to the Chief Executive in consultation with the Section 151 and Monitoring Officers to finalise the detailed arrangements establishing the company.
- 2.4 Recommend to Council the appointment of the Members and Officers set out in para 7.3.
- 2.5 Recommend the Articles of Association as set out at Appendix A to Council and give delegated authority to the Director of Services in consultation with the Monitoring and Section 151 Officers to make any minor amendments.
- 2.6 Agree in principle to provide to the company funding through state aid compliant loans subject to such funding being in line with the Council's financial strategy and delegate authority to the Council's Section 151 Officer in consultation with the Leader of the Council, Lead Member for Financial Resilience and Council's Monitoring Officer to agree the Heads of Terms of loan agreements.
- 2.7 Request a business case for each acquisition, housing development and any other trading activity identified that would lead to Council assets and/or resources being transferred to the trading company to be submitted to the Council's Policy Committee for approval.

# AGENDA ITEM 6

## **3 Background**

- 3.1 There is increasing pressure on the public sector to strategically manage and operate property assets and act commercially when making property investment decisions. At the same time there is pressure to continue to provide front line local services whilst operating under financial constraints. Many Councils, including Craven, are now acting to reduce reliance on Government grant by trading commercially for financial returns. According to CIPFA around 90% of Councils now own a trading company and of those Councils that actively trade property development is the second highest income generator above income generated from education, parking for example.
- 3.2 This Council approved an Acquisition Regeneration and Investment Strategy (ARIS) at its meeting on 25<sup>th</sup> February 2016, the purpose of which is to acquire assets to promote or improve either the economic, social or environmental well-being of Craven and/or as investments to generate revenue.
- 3.3 The 'general power of competence' contained in the Localism Act 2011 gives the Council the power to acquire property for investment. However, where the general power of competence is used for a commercial purpose, it must be done through a company. Council of 25<sup>th</sup> February 2016 therefore requested a report be submitted to a future Policy Committee setting out proposals on the financial and legal implications associated with establishing a trading company, together with the resourcing and governance arrangements.
- 3.4 In addition to the ARIS the Council has also been assessing other options for generating sustainable additional revenue streams to offset reducing Central Government grant. One such opportunity for the Council is the potential from the development of market rent homes to generate a financial return as well as improving the local housing supply. Once the houses are built it would then be in the Council's best interests to lease the properties to a third party trading company to protect the Council from right to buy implications.
- 3.5 This report therefore sets out the business case for establishing a Council owned trading company, proposed governance arrangements, company's objectives, resources required by the company to deliver these objectives, risks and expected financial results.

## **Business Case**

### **4 Strategic Objectives of the Trading Company**

- 4.1 Financial resilience is a key Council priority. With the ever decreasing grant funding and uncertainties about future funding levels it is Craven District Council's aspiration to become more financially resilient and less dependent on funding from Central Government. By being financially resilient the Council can then ensure it continues to provide vital local services to its local community at existing service levels.
- 4.2 An opportunity for the Council to generate additional revenue is for the Council to make use of its asset base for housing development. If the Council built properties it could use the properties to generate long term revenue streams from rental income. Traditionally the Council has sold land and property to housing providers and developers to obtain capital receipts. Whilst this will still remain an important part of the way the Council meets its priorities, establishing a wholly owned Craven Council company will allow the Council to generate its own revenue streams from suitable development sites to then invest in protecting and supporting front line services.

# AGENDA ITEM 6

- 4.3 One of the most significant housing changes in the UK housing market in the past decade or more has been the rise in the private rented sector. This trend seems likely to continue due to a combination of affordability and a relatively low new housing supply. The private rented sector offers organisations such as local authorities an investment opportunity and several councils are venturing into this market as a way of developing income streams.
- 4.4 There is an opening for Craven Council to deliver quality, well located and managed private rented housing that meets the Council priority for housing and provides a financial return. Future tenants will also benefit from the knowledge their landlord, the Council, is holding the property for the long term, giving them peace of mind, security of tenure and a quality level of service.
- 4.5 To protect the Council from Right to Buy rules the Council must transfer the properties into a third party trading company after they are built. The trading company would manage the rental of the properties with surpluses from rental income paid in dividends back to the Council.

The trading company will also lease from and manage assets acquired by the Council for investment income under the Acquisition, Regeneration and Investment Strategy. The key strategic objective for the trading company is therefore 'to manage assets to generate a revenue stream'.

## **5 Rationale for Establishing a Council Owned Trading Company**

- 5.1 The proposal to establish a trading company is based on a high level analysis of the most appropriate means by which the Council can maximise income and retain and grow capital value from property development and asset acquisition.
- 5.2 Alternatives to establishing a trading company explored were i) do nothing, ii) in-house iii) private sector partnership iv) outsource. The reasons for discounting these options being;
  - i) Do nothing is not an option. The Council has a number of assets that could be used to realise additional income streams. If the Council does not act now to generate additional income it will simply not be able to sustain the same level of services it currently provides, will have to stop providing some services and/or increase council taxes, fees and charges.
  - ii) If the Council was to manage the letting of its own developed properties houses owned and let by the Council would be subject to Right to Buy rules.
  - iii) A private sector partnership would place limits on the Council's control, can take significant time and resources to establish and would lead to a sharing of profit.
  - iv) Control and one hundred per cent profit is transferred to the private sector.
- 5.3 The advantages of establishing a wholly owned Council trading company include;
  - Ability to generate income from market rent properties
  - Ability to generate investment income from the acquisition of property

# AGENDA ITEM 6

- Ability to generate a revenue stream for the General fund through interest from loans, rental income, services charges to maintain public realm, offsetting costs from the secondment of Council staff to the company and additional new homes bonus.
- The Council benefits from any increase in value of the trading company's assets
- Homes leased to the company are not HRA properties and not subject to right to buy.

## **6 Operation of the company**

- 6.1 The company will be known as 'Craven Asset Management Limited' and will be 100% owned by the Council to ensure any profits from development on Council owned land goes directly to the provision of services in the district and not to private investors.
- 6.2 The company will manage properties for investment and market rent.
- 6.3 The Council will undertake due diligence, including the commissioning of third party valuations, and complete the acquisition of properties. The company will lease the investment acquisitions and the homes developed for rent from the Council and pay the Council a rent.
- 6.4 The company will market and manage the rental of investment acquisitions and the homes developed for rent.
- 6.5 Properties let by the company will be let on Assured Tenancies and will not be subject to Right to Buy, or to the allocations provisions of Part VI of the Housing Act 1996.
- 6.6 In terms of developing larger sites, the Council may seek a development partner to share benefits and risk and form a joint venture. In these instances the Council will invest the land into a joint venture and cover the costs of all preparatory work surveys etc. The Council will tender for a developer who will invest design and construction costs. Once constructed the properties would be leased to the Council owned trading company.
- 6.7 The company may draw on Council resources for its support service needs in compliance with state aid requirements.  
  
It is proposed that the Company will initially use Council accommodation and resources in its operations and will reimburse the Council for doing so. The proposals should not have any direct implications for staff as it is not proposed that any staff will transfer to the Company. Staff may at times be working on Company business, but that time and resource will be charged to the company. Service Level Agreements will be completed with the Council regarding use of Council staff and resources with the rates of re-imbursements detailed
- 6.8 The Council may second to the company officers to support the company's operations depending on skills required. By seconding staff TUPE will not apply.
- 6.9 Job outlines will be provided for each Member of the Board. These will include specific guidance on the involvement of Members and Officers in Council-owned companies. The guidance will address the conflict of interest risks likely to arise where Members and Officers hold both Council and Council-owned company roles (unpaid and paid) and set out clear advice on how these should be managed.
- 6.10 Separate letters of employment will be issued to Members and Officers appointed to the Board to confirm the Council has appointed them and that the Council may remove them. No Members

# AGENDA ITEM 6

or Officers appointed to the Board will be remunerated in addition to their remuneration as Members and Officers of Craven District Council.

- 6.11 A business case for each proposed acquisition, each proposed development, any other trading activity and the role of the trading company in each project will be presented to the Council's Policy Committee for approval.
- 6.12 The funds for each acquisition and each development and the model for delivery will be specified in the business case.
- 6.13 Funds, if required by the Company, will be provided to the company by way of a loan from the Council subject to such funding being in line with the Council's financial strategy. The Council's Section 151 in consultation with the Leader, Lead Member for Financial Resilience and the Council's Monitoring Officer will agree the Heads of Terms of loan agreements.

## **7 Governance of the Company**

- 7.1 It is proposed the Trading Company will be a Company Limited by Shares and as such meets the requirements of the Localism Act 2011. The share issue will be a £1 ordinary share. The Company will have its own legal identity and also have the benefit of limited liability.
- 7.2 The Articles of Association must be approved by the Full Council.
- 7.3 The Company must legally appoint directors to ensure the company does everything it is obliged to do by law and that decisions are made in the best interests of the company.
- 7.4 A board of directors consisting of the following Members and Officers will be established;
  - 3 Non Executive Members of Craven District Council
  - 1 Independent Non - Executive
  - Chief Executive (Company's Managing Director)
  - Director of Services (Company's Commercial Director)

The Council's Section 151 Officer is not a board Member but will be responsible for managing and monitoring the company's performance from the Council's perspective.

The Board will receive financial advice from the Council's Senior Accountant who would not be a member of the board.

- 7.5 The Council's Section 151 Officer will assess the Company's viability and the viability of any project for which loan funding will be used for.

The Section 151 Officer will also regularly monitor and analyse financial information generated by the company during the lifetime of each loan to ensure the Company is not in breach of key financial requirements including i) a demonstration that any loan will be repaid ii) there is confidence the projected rental stream can be maintained and iii) evidence is provided that each loan's terms are state aid compliant.

- 7.6 The Council would retain the right (under the company's Articles and any Shareholder Agreement) to appoint and dismiss all of the company's Directors.
- 7.7 The Directors have ultimate responsibility for directing the activities of the company, ensuring it is well run and delivering the outcomes for which it has been established. Their role includes:

## AGENDA ITEM 6

- Setting of budgets, policies and plans for the company
- Monitoring performance of the company
- Ensuring compliance with company's objects, purposes, values and legislation

7.8 All Directors will need to comply with their statutory duties under the Companies Act 2006 including a duty to act in the best interests of the Company and to avoid conflicts of interest. Council members and/or employees appointed as Directors will need to be aware that potential conflicts of interest may arise when carrying out their roles for the Councils and when acting as Directors for the Company. Member Directors will still also be bound by the Members' Code of Conduct, in so far as this Code does not conflict with their legal obligations as Directors. An outline of these duties, responsibilities and liabilities will be provided to the Directors as part of their letters of appointment.

7.9 A scheme of delegations will be developed to clarify decisions that can be taken by Directors.

7.10 In order to 'trade for a commercial purpose' the Council must establish a trading vehicle such as a limited company. Operating a trading arm through a company vehicle such as a Limited Company will require that the Directors of the company operate in accordance with UK Company law. Although the company has limited liability, the Directors of that company may individually face claims for wrongful operation of the company. It is therefore recommended that the Council indemnify the Directors through appropriate Directors Liability Insurance both whilst acting as a director and for a period of six years following cessation as a company director.

### 8 Next Steps

8.1 Subject to Members approving the establishment of the company the next steps and indicative timings are set out in table 1 below.

| <b>Action</b>  | <b>Timescale</b>                                 |
|--|--|
| Establish Company<br>Approve Articles of Association   | Council 25 <sup>th</sup> May 2016                |
| Appoint Directors to the Board   | Council 25 <sup>th</sup> May 2016                |
| Consideration of business case for the development of 40+ housing site   | Policy Committee 13 <sup>th</sup> September 2016 |
| Council Procures Developer   | January 2017                                     |
| Developer starts on site   | April 2017                                       |
| Commence Lease of Properties to Trading Company  | Sept 2017  |
| Note: Potential acquisition opportunities may arise at any time. The Council's Policy Committee will consider each acquisition opportunity as it arises. |  |

Table 1

## 9 Financial Implications

- 9.1 The proposal involves the setting up of a company (100% Council owned), with the Council leasing the completed properties to the Company.
- 9.2 Set up costs to establish the Council owned trading company will be less than £1,000 and can be met within existing approved revenue budgets. A supplementary estimate may be required at a later date depending on the extent of the tax and legal advice required.
- 9.3 Once operating the company must be profitable. However in the set-up stages it may require financing to bridge the period up to receipt of sufficient rent to sustain the company This will be provided by a loan from the Council to the Company. Borrowing costs would be met by the Company. Only as much loan as reasonably needed shall be provided.
- 9.4 Any lending to that company would be at commercial rates using either capital reserves or borrowing obtained by the Council at the lowest available rates which may be the Public Works Loan Board. Due to state aid controls, the loan to the company would be at market rates enabling the Council to make a surplus from repayment of the loans.
- 9.5 The funding required to develop land, the construction and on-going management of the properties will be identified by each business case. The business case will also set out the any funding arrangements for the development.
- 9.6 Section 24 LGA 1988 provides the Council with the power to provide a wide range of financial assistance to the company including making a grant or loan to it and as the company is a body corporate the Council may under Section 24 (2)(d) acquire share or loan capital in it.
- 9.7 If the Council intends to borrow to lend to the Company regulation 25 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (SI 2003/3146) treats the giving of a loan by a local authority to a third party i.e. the trading company as capital expenditure. As such it would need to be confirmed by Full Council.
- 9.8 The Council is entitled to dispose of land to a third party provided it complies with Section 123 of the Local Government Act 1972. This requires it to obtain a consideration which is not less than the best it could reasonably obtain. It can dispose property at an "under-value" using Circular 06/03 (the Local Government Act 1972). The "under-value" must not exceed £2m and the Council's purpose in making such a disposal must be to contribute to the economic social or environmental well-being of the authority's area and/or its residents.
- 9.9 The report proposes that the company be created as a company limited by shares. There are other company structures including Company Limited by Guarantee, Co-Operative and Community Benefit Societies which are more commonly used for not for profit purposes. The Company Limited by Shares is therefore considered to be the most suitable vehicle for the Council as it provides the ability to generate profit through trading and the Council will be the only shareholder.

# AGENDA ITEM 6

- 9.10 The income generated and expenditure incurred by the trading company will be detailed in the business cases presented to Members on the individual development projects as they are brought forward.

This return is generated from interest on loans, rental income, service charges on public realm, efficiencies from offsetting the secondment of Council staff to the Company and additional new homes bonus income.

- 9.11 It is expected the company will make a trading loss in year 1 due to set up costs, the time required to procure the builder, construct the houses and complete the transfer of the leases to the trading company. Thereafter any surplus will be paid to the Council as a dividend against which any borrowing costs that were required to fund the initial housing development will need to be offset.
- 9.12 The Company will have a separate bank account. Loans will prevent cash flow implications when the company begins trading. The Company will use the Council's financial facilities and ensure all income expenditure, Corporation Tax and VAT is correctly coded to the Company.
- 9.13 The Company will be responsible for the engagement of an external auditor and audits will be carried out as part of the Council's own internal audit programme. It will also be required to ensure compliance with the requirements of Companies House.

## 10 Legal Implications

- 10.1 Section 1 of the Localism Act 2011 provides local authorities with the power to do anything an individual may do subject to a number of limitations (this is referred to as the General Power). A local authority may exercise the General Power for its own purpose, for a commercial purpose and/or for the benefit of others.

Section 4 of the Localism Act 2011 requires that where a local authority exercises/uses the general power for a commercial purpose it must do so through a company.

- 10.2 Under Part V of the Local Government and Housing Act 1989, the Council also has a power to establish companies which can be wholly controlled or influenced by the Council. The company will be wholly owned by the Council and under Part V will be subject to the Local Authorities (Companies) Order 1995.
- 10.3 Regulation 2 of the Local Government (Best Value Authorities) (Power to Trade) (England) Order 2009 (the Order) which requires a business case to be prepared and approved by the Council before a company starts trading. For this purpose a business case means a comprehensive statement as to:
- a) The objectives of the business;
  - b) The investment and other resources required to achieve those objectives;
  - c) Any risks the business might face and how significant these risks are; and
  - d) The expected financial results of the business, together with any other relevant outcomes that the business is expected to achieve.

## 11 Risk Management

- 11.1. The main risks and their mitigations are set out below:-



# AGENDA ITEM 6

- Risk. Changes in the market conditions of developing, selling and renting of homes could lead to a continuous reduction in property rental levels. The impact would result in not being able to rent or sell homes for prices indicated, and may result in high working capital and insufficient asset cover for loans.

Mitigated by the ability to reduce rental rates if need be, change tenure mixes and robust assessment of demand and supply before initiating phases of schemes.

- Risk. An increase in development build costs, resulting in development schemes becoming more expensive and less viable leading to a reduction in viability of the portfolio.

Mitigated by the testing of the viability assessment and the requirement for each development scheme to be approved by the Council's Policy Committee prior to commencement.

- Risk. The portfolio size fails to meet economies of scale, with the result the company is not able to carry level of overheads and therefore would be less viable.

Mitigated by ensuring the pipeline of development in early years is being carefully identified and closely monitored by the Council and the future Company Board. Ongoing committed costs will be minimalised.

- Risk. An increase in void turn round times/relet times greater than model assumptions, resulting in income from rent is reduced and company's cash flow to service debt is compromised.

Mitigated through a rigorous maintenance and management agreement, seeking to shift and mitigate this risk to a third party.

## **12 Contributions to Corporate Priorities**

The proposals in this report support the Council priorities of 'Financial Resilience' by ensuring the Council remains sustainable and can continue to deliver essential front line services. It also contributes to the 'Enterprising Craven' priority by stimulating economic growth through housing development.

## **13 Appendices**

Appendix A: Articles of Association

## **14 Author of the Report**

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