APPENDIX A

LOCAL PARTNERSHIPS

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Llywodraeth Cymru
Welsh Government

EXETER CITY COUNCIL: REVIEW OF EXETER CITY LIVING

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1 CONTEXT

1.1 Background

Exeter City Living (ECL) is a housing delivery vehicle which was incorporated in June 2018 and is a wholly owned subsidiary of Exeter City Council (ECC). The vehicle was established in order to address market failure in the availability of social housing by delivering new homes to a high environmental standard, and with the intention that any profits realised are sown back into improving the local community.

In the five years since ECL was established, there have been a number of significant policy changes and challenges faced by ECL.

ECL was established when the provision of council housing was constrained by national policy regarding the ability of councils to borrow against the housing revenue account, a policy which was reversed in October 2018.

Since the establishment of ECL, there has also been a series of national shocks including uncertainty in the trade terms associated with the United Kingdom's departure from the European Union, the global pandemic, the invasion of Ukraine by Russia, the fall in sterling and recent dramatic increase in the Bank of England's base rate (from 0.1% in December 2021 to 4.25% in March 2023).

To date, ECL has borrowed around £9m from ECC. Due to a range of factors, including the limited scale of development and the prioritisation of Passivhaus design principles, ECL no longer anticipates generating capital receipts for land, and only nominal development profits.

The review of ECL by Local Partnerships is a project which has been requested by ECC as an independent review. The review will be on behalf of ECC and presented to ECC, though will involve consultation with relevant officers at ECL.

1.2 Scope of the report

ECC is keen to ensure that its relationship with ECL is underpinned by effective governance arrangements. As such ECC commissioned Local Partnerships to undertake a short, independent review, the purpose of which is to:

- Examine ECC's arrangements for governance and oversight, focusing on:
    - ECC representation on the ECL Board in terms of skills, experience, relevant knowledge, and segregation.
    - Identifying areas where greater transparency may be required.
    - How ECL's output priorities (financial returns vs Passivhaus standards vs affordable homes etc) are set, managed, and communicated.
    - ECC internal governance for authorising expenditure on projects.
    - ECC decision making process and delegated approval process.
    - Perceived communication issues around briefing and reporting.
    - The appropriateness of the skills and experience on the ECL Board Structure.
    - Whether the Management Agreement can be reviewed and updated to make it more workable.
    - How ECL financial performance is reported within ECC and aligns with ECC's financial planning.
- Identify any necessary additional client support arrangements.

- Assess if ECL is achieving its stated objectives and providing value for money, considering:
    - Development costs charged to each project; and
    - The administration of ECL and the associated companies.
- Identify key risks to ECC (including financial risks).
- If there are material concerns around the governance and performance of ECL whether there are recommendations that could make it a viable development vehicle in the short to medium term.
- Whether there is a reasonable likelihood of ECL being able to pay down it's £9.8m of outstanding debt in the foreseeable future and whether ECC should consider winding down the vehicle if it is not meeting its stated objectives.
- Whether ECC could and should provide further financial support and whether it could utilise CIL or commercial property revenues to fund the vehicle.
- If ECL isn't likely to become a self-sufficient commercial vehicle, in the short to medium term future, whether there is the scope and potential to transfer the development skills assembled over to ECC.
- Whether the work being undertaken for the Housing Revenue Account ("HRA") would be better delivered in house.
- The implications for the Brownfield Land Release Fund ("BLRF") monies secured if the vehicle is wound down.
- How ECL staff resources could be re-allocated within existing ECC departments.
- If the recommendation is for the vehicle to be wound down what alternative delivery strategies could be available to the Council.
- Recommendations and proposals for future work required.

1.3 Approach

Our work was principally undertaken through two stages.

1.3.1 Document review

We reviewed a wide range of documentation including:

- Key Executiveand Scrutiny reports
- ECC Business Plan and other key documents relating to performance to date
- Key governance documentation such as the Management Agreement, Articles of Association, Shareholders Agreement and any financial agreements
- ECC's Medium-Term Financial Plan
- The original business case which resulted in the creation of ECL
- ECL audited accounts

1.3.2 Consultation meetings

This stage involved ten consultation meetings with a range of elected members, senior ECC officers, ECL Board members, and ECL staff.

These meetings enabled us to gather a range of views on the performance of ECL, its fitness for purpose to achieve wider objectives for ECC, ECC's oversight and governance of ECL and the risks and management of risks.

2 STRATEGIC APPROACH

2.1 Policy Context

ECC has identified a major programme of brownfield regeneration, known as Liveable Exeter - a 20 years development programme that will be examined in the context of the Local Plan process.

The Liveable Exeter vision envisages densification of the urban form to achieve the number of homes required to meet Exeter's housing need over the next twenty years.

Presently the City of Exeter has provided for house building in large urban extensions at the edge of the city, e.g. Monkerton / Hill Barton, Newcourt, and Pinhoe - that is the strategy of the current local plan.

The volume of house building (mainly in large urban extensions at the edge of the city) has been high.

The Local Plan requires a minimum of 75% of the growth in student numbers to be met by purpose-built student accommodation. Since 2006/07 the number of students studying at the University has increased from just over 11,000 to 23,500 in 2020/21.

The numbers of students requiring specific accommodation in the period increased by 11,500. During this period just over 8,000 bed spaces in purpose-built student accommodation has been provided. This demand for student accommodation has driven up rental levels and is driving high demand for land that comes available in the central area of Exeter.

2.2 Objectives

The strategic objectives which ECC set ECL were clearly set out in the original Cabinet reports which approved the establishment of ECL in 2018. These were:

1. To deliver new homes, more affordable homes in the City.
2. To contribute to a greener city through delivery of low carbon, Passivhaus standard homes, green infrastructure etc.
3. To contribute to a safer city through regeneration of estates and reinforcement of 'urban villages' across the city.
4. To provide Exeter City Council with a return on capital investment and a new revenue stream.
5. To unlock sites not viable for private sector delivery.
6. To intervene in the market, providing commercial developments benefitting the City (such as increased business rates).

Furthermore, the rationale that has been given for the existence of ECL over time seems to have changed on several occasions, without the Council taking stock.

For example, in May 2020, ECL was describing its rationale as

- Enabling the Council to capture more value from development (rather than private developers doing so)
- Allowing the Council greater control over the nature of development
- Enabling the Council to respond to the Climate Emergency and Net Zero

- ‘Creating disruption in the market’ *[a new objective which the Council never set ECL]*
- Ensuring development continuity
- Mitigating risk

By February 2022, when the 2022-23 Business Plan was developed, development of homes to a passivhaus standard had become ECL’s default position and net zero urban regeneration seems to have become the central focus of activity. However, these critical shifts in the focus of ECL’s work seem to have taken place without proper consideration by members (over and above approval of the business plan), and without consideration of the tensions between them.

While each of the original objectives for ECL are in themselves entirely legitimate objectives, over the course of our work, it became apparent that there were unresolved tensions between these objectives, particularly given the challenging nature of the sites which ECL have been tasked with developing. For example, while objective 5 (the unlocking of sites not viable for private sector delivery) may be possible – for example through a council owned company foregoing some or all of the developer margin on developments – it is unlikely that this could be achieved at the same time as objective 4 (delivering a return on capital investment and new revenue stream). This tension between objectives is further exacerbated by objective 2 (a commitment to low carbon homes), which is highly likely to increase costs and therefore reduce returns. Given the financial shocks since the establishment of ECL in 2018, delivering returns is in any event significantly more challenging.

While it may be possible, at a programme level, to achieve all six objectives, with different developments contributing to different objectives (for example the development of a lucrative site cross-subsidising less viable sites and still enabling a return to the council) this does not appear realistic given the pipeline of sites which ECL have been requested to bring forward, with significant viability challenges.

The interviewees we spoke to all agreed that there were unresolved tensions between these objectives. There appeared, from our interviews, to be an emerging view that delivery of a financial return was a secondary objective, behind delivery of new homes on identified sites, as long as sites were not being delivered at a loss to the council.

It is our view that ECC should confirm its priorities for housing interventions, which it is looking to ECL – or alternative arrangements – to deliver.

ECC should agree a refreshed, prioritised set of strategic objectives which it is trying to achieve through its interventions in the housing market.

2.3 Governance and communication

When ECC was established, there was an initial expectation that ECC would be comprised of a number of companies, namely:

- Exeter City Group Ltd - the holding company;
- Exeter City Living Ltd - the development company;
- Exeter City Homes Ltd - the residential property company; and
- Exeter City Living Property Ltd - the commercial property company

Under this model, ECL, as a development company, would generate surplus for future investment. Exeter City Homes (ECH) would be a housing company managing PRS housing. ECH and Exeter City Living Property Ltd would lie dormant until full council gave approval to operate. To date, these have not been actioned, and as such our review focused only on ECL.

The scheme of delegation for ECL clearly sets out the respective roles in approvals, as set out in the table below:

Table 1: Delegation Arrangements

Body	Approval
Council	- Business Plan adoption - Expenditure of more than £500k - Operating outside of Business Plan - Issuing of loans - Winding up - Contracts (which may impact Teckal status) - Constitutional amendments - Setting up JVs - Asset disposals outside of business plan
Shareholder Representative (ECC Chief Executive)	- Business Plan amendment - Expenditure up to £500k - Use of surplus profit - High risk contracts - Financial operation - Appointment of directors & MD
ECL Board	- Funding applications and agreements - Financing (within Business Plan) - Contracts (within Business Plan) - Bonus schemes - Management of staff and consultants - Assets disposals outside of Business Plan

We heard a range of views on the existing governance arrangements for ECL – with some interviewees feeling that ECL would benefit from being ‘unshackled’, while others felt that the Council had insufficient visibility of the decision making processes. We heard that the Board of ECL has the requisite skills on board to enable delivery, but that there were perceived issues around remoteness from the Council’s wider decision-making processes.

A previous review of governance for ECL had led to the introduction of ECC’s s.151 officer onto the ECL Board, a decision which was – correctly, in our view, due to potential for conflict of interest - subsequently reversed.

The governance arrangements for council owned companies should seek to ensure a balance between:

- The company having sufficient freedoms to achieve its objectives

- The council having sufficient control to ensure that its investment is protected, appropriate returns on investment can be obtained and that the activities of the entity are aligned with the values and strategic objectives of the council.

In our view, the delegation arrangements as set out above strike an appropriate balance between these objectives.

However, we did also hear concerns about the lack of elected member understanding and engagement with the work of ECL, particularly in relation to those functions undertaken by the Council as Shareholder Representative.

Clearly any recommendations on governance arrangements are reliant on ECC deciding to retain ECL as a wholly owned company, but should it choose to do so, we feel that there would be some merit, for the purposes of transparency, scrutiny, and understanding, in the establishment of a shareholder committee.

Should ECC decide to retain ECL, it should consider the establishment of a members Shareholder Committee in order to enable more transparent scrutiny of ECL. Terms of reference could include:

- **Oversight of decisions requiring approval by the Council, such as business plan approval**
- **A mechanism to communicate the shareholder's views to ECL**
- **A means to evaluate the effectiveness of the ECL board and the delivery of performance against strategic objectives and the business plan**
- **An articulation of what success looks like in terms of achieving social/ economic outcomes and/or financial performance**
- **A holistic review of risk to the council offered by ECL activities**

2.4 Performance

2.4.1 HRA

At the point of establishment in 2018, the aim was for ECL to deliver five smaller housing developments, replacing 16 poor quality homes and designing and building 115 net additional homes. 43 of those homes were to be in the first 12 months.

Very shortly after the establishment of ECL - on 29 October 2018 - the government confirmed that the HRA borrowing cap was abolished with immediate effect.

As a result, stockholding local authorities such as ECC who have an HRA are no longer constrained by government controls over borrowing for housebuilding and are able to borrow against their expected rental income, in line with the Prudential Code.

Inevitably, this represented a major change to the intended relationship between ECC and ECL, as ECL moved away from direct delivery of homes which ECC would manage through the HRA, to a development agency service, managing the delivery process on behalf of ECC.

Given this change – so early in the company's life - some interviewees were of the view that a pause and review would have been helpful at that time.

Performance in delivery of HRA schemes has in some cases been challenging.

Three HRA schemes are now complete. These include a development of three homes at Anthony Road, which was not originally envisaged as an HRA scheme, but the HRA stepped in to purchase the properties when ECL was unable to sell those properties on the open market. As they were not designed for the HRA, we heard a view that more properties could have been developed for the HRA at a cheaper rate, but we also heard a view from ECL that there was interest from RSLs.

Thornpark Rise (a 9 unit scheme), and Bovemoors Lane (10 units) were developed for and acquired by the HRA and are also now complete.

Construction of Hamlin Gardens (21 units) is well under way, with the scheme now 40% developed and and an estimated completion date of September 2023 (this scheme was originally scheduled for completion in December 2019).

Completion of the Hamlin Gardens scheme will lead to the delivery of the 43 homes for the HRA some three years after the Council originally expected to reach that stage.
A further scheme has now been developed at Vaughan Road (88 units). This scheme, for which a contract has now been awarded for Phase 1, was originally intended to be for open market rent. However, due to viability issues, and the opportunity to lever external funding for social rent through the Affordable Homes Programme, this scheme will now be an entirely HRA scheme. For this scheme, a December 2024 completion date is scheduled.

We consistently heard from interviewees that the skills which the ECL staff team brought to the delivery of these HRA developments were highly valued, and instrumental in bringing these developments forward.

However we also heard that there had been costs incurred to the HRA which may have been avoidable. These include the HRA stepping in to acquire high specification properties at Anthony Road which could not be sold on the open market (though ECL believe that they could have been sold to other RSLs), and the appointment of various consultants outside of the control of the Council, through the HRA (though we heard from ECL that they believe that these appointments saved the HRA money).

While there is no doubt that ECL has added value to the HRA through its ability to develop sites, there does not appear to be a robust process in place to ensure that the HRA is securing value for money for its investment.

Without, for example, a job recording system, it is not possible to accurately determine how much staff time has been spent on HRA sites, or the balance between HRA and other sites. Should ECL continue to deliver works on HRA sites on behalf of the council, a form of time recording system will need to be introduced.

Should ECL continue to deliver work on behalf of the HRA, the Council should request that it introduces a form of time recording system for work undertaken for the HRA, to enable it to ensure appropriate levels of charging to the HRA, and assess value for money.

2.4.2 Brownfield Land Release Fund

The development pipeline for ECL was boosted by a number of successful BLRF bids were secured in 2021-22:

Table 2: Successful BLRF bids

Scheme Name	BLRF Grant Funding
Bonhay Meadows	£1,009,970.00
Exeter Canal Basin	£600,000.00
Mary Arches Car Park	£1,310,000.00
Belle Isle	£637,417.00
Cathedral & Quay Car Park	£2,373,183.00
Total	£5,966,470.00

Section 3 of this report (and the accompanying Appendix 1) gives more details on the significant delivery challenges faced in taking forward these sites. These have included the need for wider masterplanning exercises, community opposition, archaeological and structural issues, contamination, the relocation (or retention) of existing tenants, and sites needing vacant possession (which may require CPOs), and unsuccessful procurement exercises. At this stage, none of these schemes are as yet on site.

There have been several issues in this part of the pipeline arising from insufficient alignment between ECL and ECC. This has included, for example, assumptions being made by ECL about vacant possession which ECC had made no budgetary provision for, and bids for BLRF being submitted with insufficient visibility for ECC.

The BLRF funding secured – which will be drawn down when needed to fund works undertaken on sites - is dependent on the council commencing work on site, or transferring land (which could be to ECL) within certain deadlines, though the actual developments enabled by BLRF can be delivered at any 'reasonable time'. ECC should review each site on a site by site basis to consider what works can realistically be commenced, for developable sites, in order to ensure that the funding agreements for BLRF do not lapse.

2.4.3 Summary

To date, all developments that have been completed or taken forward by ECL have been HRA schemes. Since the removal of the HRA borrowing cap in October 2018, shortly after ECL's establishment, any of these schemes could have been delivered by the Council directly, as part of an HRA development programme.

Delivery of the BLRF funded schemes is proving extremely challenging due to the nature of the sites and viability challenges (more detail is provided in Section 3 and Appendix 1 of this report).

Currently, while the staff team at ECL is clearly adding value in bringing sites forward, the establishment of ECL as an entity is not adding value to the delivery of HRA schemes over and above that which could have been achieved through deploying the same resources as part of a directly delivered HRA development programme.

3 DEVELOPMENT PIPELINE

We have engaged with officers of ECL which has provided useful insight with respect to the current housing pipeline. The table provided at Appendix 1 provides a high-level overview of the sites which ECL is seeking to bring forward in line with company objectives. These sites are a combination of sites, which are currently held in the Housing Revenue Account (HRA), the General Fund and in third party ownership.

With the exception of Vaughan Road which appears to be progressing, all of the remaining sites comprise of predominantly constrained brownfield sites, public open space or comprise of sites which are not yet within the entire control and/or ownership of ECL.

It is evident from the anecdotal information provided that the sites are challenging, either as a result of abnormal costs associated with their development, for example; challenging topography, contamination due to previous uses or other known or potential constraints such as archaeological. As a result of these identified challenges and risks, the sites within the pipeline are either suffering from delays, are stalled or have been paused.

Development delivery is further exacerbated on several of the pipeline sites where vacant possession has yet to be secured and there are third party interests, for example, with respect to the Mary Arches Car Park and sites adjoining the Cathedral and Quay Car Park (Belle Isle Depot), on which infrastructure improvements would be required. . These issues add to the complexity of project delivery on already challenging sites in a difficult economic climate.

It is evident that these are not straightforward sites and the challenges now being encountered are affecting lead-in times, planning and development delivery timeframes, with a potential resultant increase in costs. These challenges are compounded further as construction costs continue to increase due to inflationary pressures on transport, materials, labour and finance. These factors may result in schemes ultimately proving financially unviable (without grant subsidy) and/or unable to come forward due to the high development costs relative to the anticipated income likely to be generated. Concurrently, in terms of securing a viable and sustainable business, the failure to deliver viable schemes results in delayed returns on investment through delayed sales receipts and rental income.

In addition to the current pipeline of sites, ECL is currently working on an additional 4/5 sites within the HRA with a view to taking them to Council Executive and Full Council in June and July 2023. Stage 1 reports have been completed and it is envisaged that these sites will contribute to new homes supply and the target number of 500 homes.

3.1 Pipeline site identification

With respect to the pipeline, we are informed that a gateway model is in place to manage risk exposure. This gateway process involves ECL considering development options in conjunction with architects and undertaking early feasibility design work at Gateway 1 prior to proceeding to the next stage, following sign off and the provision of quotes with subsequent Gateways thereafter.

With respect to site identification, we are advised that the initial 6-8 sites within the HRA, were readily identified by ECC as potential, viable opportunity sites, with ECL being

ECC's developer of choice. These included garage sites, although it is acknowledged that these proved to be challenging on financial viability grounds.

Additional sites for ECL which are outside the HRA and in the General Fund, are identified by ECL, but ECC does not appear to have an overall pipeline of sites for future development (either by ECL or others), and it is our view that the identification, development, and management of such a pipeline would be greatly helpful to the council in delivering its housing development objectives

These delivery constraints are set against the high-quality design aspirations and the objective to deliver to Passivhaus or Net Zero standards as the default position (unless instructed by the Shareholders on specific sites), which further increase development costs and adversely impact financial viability.

3.2 Development appraisals and viability

We heard that ECL does not utilise industry standard development appraisals such as ProDev or Argus, which are typically used by developers, local authorities and the construction industry. We also heard that development viability appraisals, whenrequested by ECC, arenot forthcoming.

Development appraisals are an essential component of decision making and provide an indication of the viability of scheme proposals early in the development delivery process. These are refined at each stage as more due diligence is undertaken, but essentially provide an early estimate of the profitability of development, potential land receipt and / or need for gap funding subsidy to enable the proposals to come forward. In addition, they can inform the mix, type and tenures of homes that will ensure an optimum scheme is delivered in terms of balancing the need to meet housing needs and financial viability. They inform decisions in terms of what compromises may need to be considered or whether schemes should proceed at all to the next stage, with the associated additional investment required. Consequently, it is concerning that development appraisals are not being provided upon request for major scheme proposals which leads to a lack of transparency.

3.3 Brownfield Land Release Fund

Several sites have the benefit of BLRF which has been secured, however, this is time limited and schemes will either need to start on site, or land transferred to ECL in order to secure the funding. Failure to transfer the land or start works on site within timescales would risk clawback of the funding commitment. The proposal to consider disposal to ECL for minimal consideration, with overage provisions built in to recover value if planning consent eventually realises that value, is an approach that has been mooted. However, the risks involved would need to be carefully considered, not least due to the specific site challenges highlighted, how these are to be mitigated, and the potential for costs to increase further. Also, with respect to land transfer and determining best consideration, we understand that agreeing values ahead of scheme proposals being determined is a potential issue for ECC.

3.4 Summary on pipeline

It is expected that ECL schemes are intended to be viable, but it appears that the sites within the pipeline are challenging sites and experiencing deliverability challenges. In many instances the sites are reliant on some form of public sector subsidy, such as secured BLRF, with future BLRF bids anticipated in order to unlock sites for development on eligible sites. In several instances, this funding is at risk.

The process for identifying sites suitable for the ECL pipeline appears to be slightly ad-hoc and reactive as opposed to having a robust and systemic approach in place for the development of a pipeline of sites, including site sifting and appraisal. This presents a potential underlying weakness in identifying viable sites for the ECL, particularly when considered in the context of high quality, passivhaus design and steeply escalating costs of construction and difficulties often encountered securing competitive tenders. This issue is a widespread issue in the UK and Local Partnerships is aware of many councils encountering this issue with some councils experiencing significantly increased tender prices between identification of a preferred contractor and contract close.

Local Partnerships has supported councils over the past 10 years to set up new vehicles, review performance and support improvement actions. We have learned that defining a committed pipeline of council land that gives a basis of a forward programme of investment, preferably for 3-5 years is essential but often difficult to achieve. A financial viability appraisal should be prepared using industry standard appraisal tool such as Argus Developer for the sites under consideration. This should involve an initial high-level analysis of development constraints, an indicative capacity layout plan, high level costings and market review.

The Council should review its development pipeline, identifying which sites should be included in a forward programme of investment over the medium term, taking into account viability and deliverability considerations.

We would also highlight that whilst necessary control mechanisms are needed, we have found from our research elsewhere that councils wish to have in place processes that can sometimes jar with the ambitions of wholly owned companies who benefit from having the freedom to deliver their Business Plan.

We would assert that generating profit in house building is a complex challenge which relies on rigorous cost control (at the level of individual components and packages of works) and a mature sub-contractor supply chain. Well-established house builders protect their profit margin by micro-managing these aspects of the development process for example by:

- national component buying teams who drive down prices to fractions of one penny and forward buy in bulk
- loyal sub-contractor networks who have often worked with the house builder for many years and where the builder is able to generate a pipeline of work for their specialist suppliers
- rigorous in-house processes and systems that monitor spend daily with managers called to account.

We have found elsewhere that other councils have underestimated the challenges of generating cross-subsidy profit and that it is not always possible for councils to exert the same levels of efficiency using the building contractor tender route.

Finally, we would highlight research undertaken by University College London (UCL) in 2017, 2019 and 2021 has traced the involvement of councils in the direct delivery of new homes. UCL found that in comparison with 2017 and 2019, the number of councils with companies, which may include housing companies and property companies of various forms and objectives, has increased from 58% in 2017, 78% in 2019 to 83% in 2021.

Within these figures, there is an amount of churn with council companies, opening, closing, and re-opening. UCL consider that this increase in the number of council companies may relate to the increasing use of JVs to deliver housing, and this has increased from 57% in 2019 to 72% in 2021.

This research[1] indicates that the number of new homes delivered by local authorities directly in 2021(from all means, and of all tenures), being a total of 20,249 homes, which is considerably higher than the 8,992 homes reported in the 2018 survey (published in 2019).

Some key messages of relevance from this research are as follows:

- Almost half of new homes delivered by councils were full market value homes for sale or private rent, indicating that councils are aiming to utilise the cross-subsidy model of offsetting the cost of affordable units
- In all cases where direct delivery is progressing at pace, the council has identified a pipeline of multiple sites it owns which is forward committed to the programme
- Councils are adopting a more systematic approach to reviewing their land that could be made available for direct build in either the HRA, via a JV or in a wholly owned Local Housing Company
- The most frequently quoted reasons for not progressing with direct build are lack of suitable land and viability challenges
- The number of council companies that are based on a joint venture (JV) has increased from 57% in 2019 to 72% in 2021. Some councils like Oxford City Council, BCP and Brighton and Hove have multiple JVs
- JVs with Housing Associations were more common than JVs with developers and JVs with builders, even less common.

[1] https://www.ucl.ac.uk/bartlett/planning/sites/bartlett_planning/files/morphet_and_clifford_2021_-_local_authority_direct_delivery_of_housing_iii_report43.pdf

4 FINANCE

4.1 Financial overview

ECL was incorporated on 12th June 2018 and capitalised with a loan from ECC of £2.2m. This was the first of four loans that have been extended to the company, totalling £10.85m. The table below shows the value of each of those loans.

Table 3: Summary of loans

<table>
<tr><th>Loan number</th><th>Amount Approved (£’000s)</th><th>Approval</th><th>Purpose</th><th>Amount Drawndown (£’000s)</th></tr>
<tr><td rowspan="2">1</td><td rowspan="2">4,350</td><td rowspan="2">2018/19 business plan</td><td rowspan="2">Working capital</td><td>2,200</td></tr>
<tr><td>2,150</td></tr>
<tr><td>2</td><td>5,000</td><td>2019/20 business plan</td><td>Barnfield Road site</td><td>5,000</td></tr>
<tr><td>3</td><td>15,640</td><td>Clifton Hill Opportunity Paper</td><td>Clifton Hill site</td><td>1,500</td></tr>
<tr><td>Total</td><td>24,990</td><td></td><td></td><td>10,850</td></tr>
</table>

ECL’s potential income is drawn from four sources as follows:

1. Sale of new build residential units on the open market;
2. Sale of new build residential units to ECC’s Housing Revenue Account (HRA);
3. Development consultancy services to ECC and other councils; and
4. Property management relating to six flats within the Guildhall shopping centre

It incurs the costs associated with developing and constructing new build units, albeit these are capitalised on the balance sheet as ‘work-in-progress’ (WIP) and not recorded as a cost in the company’s profit and loss account until the associated sale income can be recognised i.e. when the sale has been legally completed with the buyer. For HRA units, the revenue can be recognised as the units are built out because the sales have been legally agreed with ECC in advance. For open market sales, the revenue for each unit can only be recognised once the unit is purchased which may not be until after it is built.

ECL does consultancy work for the council in terms of investigating the development viability of council owned sites and gets paid for that work. It has also done similar work for another Devon council i.e. Teignbridge District Council. ECL also performs a property management function on behalf of ECC for six flats that are part of the Guildhall shopping centre that the council owns.

As at 31 March 2023, which represented the fifth year end since the company’s incorporation, the company had accumulated losses of £4.5m and utilised £9.3m of cash, leaving it with a balance of £1.5m.

The table overleaf sets out where this cash has been used.

Table 4: Summary of cash utilised

Use	Amount (£'000s)
Accumulated losses	4,527
Repayment of loans	754
WIP on the balance sheet	4,041
Total	**9,321**

The approach to capitalising the company has been unorthodox and if the company is to be retained it will need re-structuring to ensure it complies with local authority capital finance regulations as well as tax and subsidy control regulations. At present, long-term loans are being used to fund the working capital requirements in the company, which in turn are providing an income source back to the council via service level agreement arrangements for support services such as finance, legal and procurement.

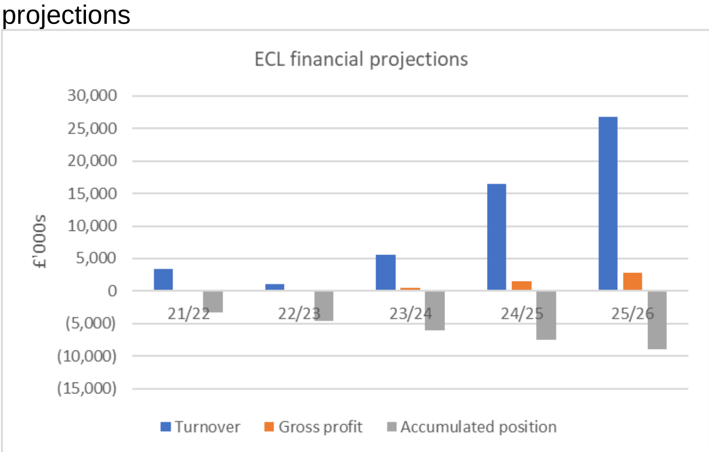
The funding structure of the company should mirror that which would be realistically achievable if the company was a stand-alone entity operating in the development market seeking funding from third parties. On that basis, the first loan of £4.35m should have been injected as equity with subsequent cash injected as development finance secured against the specific sites on which the cash was spent. The retrospective conversion of this loan to equity should be considered.

The latest financial statements for the company for the year ending 31 March 2023 show a loss-making company with net liabilities of £4.5m. In effect, ECL can only continue to operate with a commitment from the council that it will continue to underwrite ECL's losses by extending more capital to it. The caveat to this concern is that ECL does own a site, Clifton Hill, which was sold to it by ECC for a price significantly lower than its open market value. On this basis, the company may be able to realise sufficient cash to meet its debt obligations, but it would require a significant change in approach to the development strategy for Clifton Hill.

4.2 Reporting and alignment of financial performance

An annual business plan is prepared by ECL which projects a financial position over the subsequent three years. The graph below sets out the latest projections alongside the financial performance for the previous two years.

Graph 1: Financial projections



There are three key observations to highlight which are:

1. The expectation that development activity and sales will ramp up significantly during 2023/24 and the subsequent two years despite the on-going site, market and economic challenges.
2. The sufficiency of gross profit being earnt from the turnover figures, averaging just over 9%.
3. As a corollary of above, the projected losses being accumulated by the company

Alongside the business plan, an updated profit and loss account and balance sheet are reviewed by the ECL Board at their bi-monthly meetings, and these are driven by a set of Excel spreadsheets which record actual income and expenditure. The budget projections for both are also updated periodically based on the latest status of the development pipeline.

It is clear that there is adequate oversight of the cash requirements of the business by the management of ECL and ECC. A gateway process is in place which requires the council's shareholder representative to sign off at each key investment phase for each site with any expenditure of £500k and above requiring ECC approval.

The impact of ECL's cash needs on ECC's capital finance requirement is reported on an annual basis within ECC's capital strategy which is approved by members as part of the annual budget setting cycle.

4.3 Key financial risks to ECC

There is both a budget and reputational risk facing ECC as a result of the current and projected financial position of ECL. The table below reflects the position in the graph above showing how the losses facing the company are expected to accumulate over the next three years.

Table 5: Accumulated losses

£'000s	23/24	24/25	25/26
Accumulated position	(6,026)	(7,521)	(8,934)

These are losses that are funded by ECC borrowing and which will need to be written off unless ECL can raise sufficient cash to repay the council. We have referenced the position with Clifton Hill above and it is clear that ECC recognises the critical juncture that it is at with the commissioning of this review. If ECC continues to extend finance to the company without a clear line of sight on how that will be repaid then it is clearly breaching Prudential Borrowing regulations by the fact that it is engaging in financing activity that is unaffordable. It is also contravening basic finance principles by borrowing long-term debt to finance day to day operating activity. As noted earlier, this activity is also underpinning income streams back into ECC for services provided to the company which, unless ECL becomes profitable is a questionable position because it is effectively converting an element of debt borrowed by the council into income for the council[2].

4.4 Short to medium term viability

We have commented elsewhere on the challenges facing the sites in the ECL development pipeline. The only way that ECL can become a viable development vehicle is if it can be confident of developing out a substantial number of sites at a significantly

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[2] For the financial year ended 31 March 2023, the council charged the company £162k for finance, legal and planning services.

higher margin than currently projected. However, the conditions facing the development market in terms of supply chain costs and pressures, skill shortages, rising interest rates and softening housing prices would hinder this. ECL could re-orientate itself to solely focussing on delivering HRA sites and strategic development activity on certain council surplus sites to maximise disposal value. This is activity that could be undertaken within the council and would remove the overheads costs that come with operating in a company. The table below shows the breakdown of company expenditure classed as Administrative Expenses in the 2022/23 accounts.

Table 6: Summary of administrative expenditure

2022/23 spend	£'000s
Seconded staff	385
Consultants	195
ECL staff	25
Staff training	12
Staff expenses	5
Subscriptions	7
Non-executive costs	30
IT	28
Office consumables	47
Marketing	21
Audit	12
Hospitality	5
Insurance	3
Sub-total	**775**
Payments to ECC for support services	162
Total	**937**

The total figure of £937k should be reduced by the value of services drawn from the council to fairly reflect what is addressable by way of savings and clearly elements such as audit fees and non-executive fees would be saved. A reduced scope and level of activity would also enable savings to be made in the other elements, albeit we are not able to quantify those.

4.5 Repayment of outstanding debt

The financial projections in the latest business plan clearly show that there is no likelihood of ECL being able to trade out of its loss-making position in the foreseeable future and that continuing to operate as currently configured will only exacerbate the situation. There has been £10.85m lent to the company. Taking into account the work undertaken by ECL in bringing sites forward, as well as the administrative expenses in Table 6 above, the remaining £1.5m represents the cash left in the company as shown overleaf.

Table 7: Summary of cash position

	£'000s
Cash borrowed	10,850
Cash spent	9,321
Remaining cash	1,529

Of the £4m of WIP on the balance sheet, £2m represents the Clifton Hill site and may have a disposal value significantly higher than this figure, though ultimate valuations are likely to depend on a review of the sale restrictions (such as those around the development of purpose built student accommodation on council land). We are not able to comment on whether the remaining £2m of WIP is realisable but this can only occur through sale of the developments on which it has been incurred, all of which, with the exception of Clifton Hill, are owned by ECC. The reality is that ECC could offset the WIP against its borrowing and may be able to realise sufficient value from Clifton Hill to cover the losses of £4.5m incurred to date but, as highlighted above, the potential headroom that may be offered by Clifton Hill needs determining and, irrespective of its scale, it is being diminished by the on-going day to day operating losses being incurred by the company.

The Council should commission a review and valuation of the Clifton Hill site with a view to understanding the financial implications of disposal options for the site, with a view to repayment of the debt owed from ECL to ECC.

4.6 Further financial support

The availability of finance is not an issue for ECL while ever it is owned by the council. We have noted the issues with respect to the current funding structure and how debt would need converting to equity to put it on a conventional, market footing. Certainly, CIL could not be used to fund the working capital needs of the vehicle and commercial property revenue would be at the expense of funding other council activity and therefore carry the same opportunity cost as the current finance approach.

Ultimately, the issue is that prevailing circumstances, many of which are beyond ECC's control, mean that ECL represents an expensive, high-risk delivery mechanism which ECC cannot afford to continue funding.

5 CONCLUSION

5.1 Future of ECL

As commissioned by ECC, we have considered the options for the future role for ECL, the delivery vehicle which was established by ECC in 2018.

We have considered this from a number of perspectives, including fit with strategic objectives, progress to date, the nature of the future development pipeline, and financial considerations.

It is very important to recognise that within a few months of the establishment of ECL, a key part of its rationale – development of affordable homes outside of the HRA ringfence – was no longer a reason for its existence, once the HRA borrowing cap was lifted. It is also important to recognise the major financial shocks which ECL has had to deal with since it was established, including Covid and the Ukraine War, and the severe inflationary pressures in the economy. These have made for an extremely challenging context within which any organisation, particularly a new entrant to the market, would have struggled to deliver new homes.

Furthermore, all of the feedback that we have received from interviewees has been positive about the skills and working styles of the ECL staff team.

Nevertheless, our central recommendation about the future of ECL is based on a number of factors which we observed in our review, including:

- The disappearance (with the removal of the HRA borrowing cap) of the main rationale for establishment of the company has not been replaced with a compelling justification for its retention.

- The original strategic objectives for ECL, while individually valid, are in unresolved tension with each other (for example developing unviable sites, to a high design standard, while delivering a financial return to the council). This has led to a lack of clarity for ECL. While this tension can only be resolved by ECC, these objectives could, in any event, be achieved through other operating models – such as a focus on an HRA development programme and an internal team within ECC with the ability to bring forward sites for development.

- To date, the only delivery of schemes which has been achieved has been on HRA land. Although there have been delays to some schemes, ECL staff have made these developments possible. However, these schemes could have been delivered as part of an HRA development programme and (on schemes such as Anthony Road), closer integration with HRA requirements from the outset would probably have delivered better outcomes.

- The barriers for delivery of the remaining pipeline, such as it is, appear at best very high, and quite possibly insurmountable. Development on brownfield sites in Exeter is challenging. To date, ECL have not been able to deliver these sites. There have been examples of insufficient coordination between ECC and ECL on these sites, for example around masterplanning exercises, picking up the costs for vacant possession, and submission of BLRF bids: some ECC officers to whom we spoke felt that bids had been submitted without ECC knowledge, though ECL do not accept this. Nor do ECL have any ‘easy wins’ within the pipeline, which could have enabled ECL to develop its approach and labour and supply chains.

Regardless of what happens to ECL, these sites will still be there, and will still need professional expertise and capacity to bring them forward, but it may well be that this is best done through other routes to market.

- Currently there is no plausible strategy for the repayment of the loans provided by ECC to ECL. ECL is currently making ever accumulating losses, while making repayments out of the capital sums loaned to ECL. Clearly this can not continue. Early actions, for example around disposal of land owned at Clifton Hill, will help to cover (or at least mitigate) the financial loss to ECC.

- There remain multiple high probability and high impact risks, which will be difficult for either ECC or ECL to manage. These include (but are not restricted to):

    - site specific risks around viability (see section 3 and Appendix 1)
    - inability to bring the business to scale quickly enough
    - the risk of default on the repayment of the loan from ECC to ECL
    - ongoing macroeconomic and inflationary pressures
    - uncertainty around the demand for the type of properties being developed by ECL (as at Anthony Road)

We recommend that ECC winds down operations of ECL, through a managed process which:

- **Transfers the current ECL staff team back to ECC, to form a delivery team which can bring forward the current ECL sites for development within the context of the 'Liveable Exeter' policy, and closer integration with the council and its priorities.**

- **Enables the council, through an independent valuation of the land in ECL ownership, to make arrangements for the disposal of sites for development in a way which will remove (or mitigate) financial losses to ECC arising from its loans to ECL.**

- **Develops a phased pipeline of sites (ideally to cover the next 3 – 5 years) which can realistically be brought forward to the market, based on accurate viability information.**

- **Takes into account the BLRF funding requirements, and for deliverable sites, makes a site by site assessment on how best it can meet those requirements through commencement of work on site or disposal.**

6 SUMMARY OF RECOMMENDATIONS

No.	Recommendation
1	**We recommend that ECC winds down operations of ECL, through a managed process which:** • **Transfers the current ECL staff team back to ECC, to form a delivery team which can bring forward the current ECL sites for development within the context of the 'Liveable Exeter' policy, and closer integration with the council and its priorities.** • **Enables the council, through an independent valuation of the land in ECL ownership, to make arrangements for the disposal of sites for development in a way which will remove (or mitigate) financial losses to ECC arising from its loans to ECL.** • **Develops a phased pipeline of sites (ideally to cover the next 3 – 5 years) which can realistically be brought forward to the market, based on accurate viability information.** • **Takes into account the BLRF funding requirements, and for deliverable sites, makes a site by site assessment on how best it can meet those requirements through commencement of work on site or disposal.**
2	**ECC should agree a refreshed, prioritised set of strategic objectives which it is trying to achieve through its interventions in the housing market.**
3	**Regardless of the future operating model for bringing sites forward for development the Council should prioritise the introduction of industry standard development software, to be used across both the Council and any delivery vehicles, which will enable it to assess viability of development.**
4	**The Council should review its development pipeline, identifying which sites should be included in a forward programme of investment over the medium term, taking into account viability and deliverability considerations.**
5	**The Council should commission a review and valuation of the Clifton Hill site with a view to understanding the financial implications of disposal options for the site, with a view to repayment of the debt owed from ECL to ECC.**
The following recommendations would only apply if the Council decided to retain ECL in its current form:	
6	**Should ECC decide to retain ECL, it should consider the establishment of a members Shareholder Committee in order to enable more transparent scrutiny of ECL. Terms of reference could include:** • **Oversight of decisions requiring approval by the Council, such as business plan approval** • **A mechanism to communicate the shareholder's views to ECL**

No.	Recommendation
	• **A means to evaluate the effectiveness of the ECL board and the delivery of performance against strategic objectives and the business plan** • **An articulation of what success looks like in terms of achieving social/ economic outcomes and/or financial performance** • **A holistic review of risk to the council offered by ECL activities**
7	**Should ECL continue to deliver work on behalf of the HRA, the Council should request that it introduces a form of time recording system for work undertaken for the HRA, to enable it to ensure appropriate levels of charging to the HRA, and assess value for money.**

Appendix 1

Site	Description	Site Issues/Risks
Vaughan Road	Former tower block site (now cleared) held within the HRA located within a wider estate regeneration area. Being delivered in three phases to enable mid-sized contractors to tender for the phase scheme. Considering densification of site via later phase development which would replace older bungalows. Looking to bid into BRLF. Will deliver 80-120 houses on vacant site.	Contractor secured for first phase and development is progressing. ECL plans to include phases 2 and 3 within the current work package, which is subject to Full Council approval. All phases are due to complete by December 2024.
Clifton Hill	Site of former leisure centre with planning permission for 42 units. This is a challenging site with level changes impacting on development costs. Following a failed procurement and contractor supply chain issues, the site has been put to a separate contractor to examine alternative design/engineering solutions and identify associated cost savings, including simplified unit types.	Stalled site. Delivering a viable scheme may remain a challenge in the absence of gap funding.
Mary Arches Car Park	This site is allocated in Local Plan. BLRF bid is submitted and proposals are currently at RIBA Stage 1/feasibility stage. Development would contribute to Liveable Exeter ambitions. There are two halves to the scheme proposals. Phase 1 relates to the MSCP site with a concept plan for 100 build to rent homes to be held by either ECL or PropCo.	Scheme requires the securing of vacant possession of two ground floor units , however, in relation to one unit, there is the potential need to effect CPO powers which, if required, will impact on the timing of delivery and will incur additional costs. BLRF has been secured for the demolition works and in line with funding conditions the development will need to start/or land transferred by 31 March 2024. Archaeological digs will be required which is a potential risk to this subsequent phase of development in terms of delays and costs. ECL propose they negotiate disposal with the City Surveyor and then pay

Site	Description	Site Issues/Risks
		Best Consideration when the option is exercised. (determined via an independent valuation). This is to preserve BLRF funding
Exeter Canal Basin	Exeter Canal Basin is held within the General Fund. ECL is in the process of assembling scheme proposals with a view to submit for planning in June 2023. Capacity for 37 units including four duplexes and apartments (3 and 4 storey). ECL is to provide the results of their options analysis to inform ECC decision making. Aspirations are for the scheme to retain the Exeter Watersports centre and contribute towards net zero targets.	Viability is a potential risk and is to be determined in conjunction with the options analysis and a land value/land receipt confirmed. There are issues related to securing vacant possession of existing buildings
Bonhay Meadow	Bonhay Meadow is held in the General Fund. This is an area of open space which is council owned. Set in Liveable Exeter Strategy this area is seen as a significant regeneration area.	Proposals are paused. We are advised that this is a sensitive site, due to some resistance to development from planning and political sensitivities regarding building on open space. There are also some concerns which have been flagged from the Environment Agency. BLRF has been secured but is at risk with transfer of land or start on site by 31 March 2024 a funding requirement. ECL proposing land be transferred to ECL and leased back to ECC to protect the BLRF. However, this is a risky strategy as it is possible that the site remains undeliverable in view of the issues highlighted.
Cathedral & Quay Car Park	The site is held in the General Fund. Council car park with structural issues. Need to look at the options for delivering this site. Workstage 2 end of this month. Capacity for 31 units. Potential for off-site affordable housing and 100% market sale onsite.	Project has been paused. Key risks associated with development include: £2m BRLF which is at risk. Need to transfer land or start on site by March 31st.
Belle Isle Depot	Site in council ownership (still operational depot). Site has	£0.637m BLRF secured. Project dependencies linked to need to secure

Site	Description	Site Issues/Risks
	capacity for 32 units, and is intended to deliver family homes/apartments for sale, to a Passivhaus or Net Zero standard, and Improve the national cycle route experience.	alternative premises for the depot, and vacant possession of the existing depot which remains operational, and development viability. Significant contamination is likely.
Glasshouse Lane	This site is in third party ownership. Open space/park situated within a council estate area . Restrictive Covenant associated with use as Church. Review of open space – planners indicate this is not needed. Capacity for 24 affordable units.	The site is outside ECC and ECL control. Securing planning is a risk. Community resistance is anticipated due to previously poorly managed private sector housing development in the area. In order for planning to prove successful it has been indicated that this will need to be an exemplar scheme which may impact on development costs and development viability. This needs to be examined.

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