

## Eden District Council

## Executive

22 January 2019

**Heart of Cumbria Limited Update**

<b>Portfolio:</b>	Leader Portfolio
<b>Report from:</b>	Director of Finance
<b>Wards:</b>	All Wards
<b>OPEN PUBLIC ITEM</b>	

**1 Purpose**

- 1.1 To provide an update on Heart of Cumbria Limited, particularly with reference to audit recommendations raised at the 2017-2018 year end.

**2 Recommendations**

- 2.1 That the performance targets at paragraph 3.3.2 be approved.
- 2.2 Progress against other recommendations be noted.

**3 Report Details**

- 3.1 Heart of Cumbria Limited is the Council's wholly-owned Private Limited Company. Five recommendations were made by the External Auditor (Grant Thornton UK LLP) around arrangements in place for the Company in the 2017-2018 Audit Findings Report (see Accounts and Governance Committee agenda, 26 July 2018, report F54/18). These are discussed in turn below:
- 3.2 **The Council needs to ensure that appropriate tenancy management arrangements are put in place for the affordable homes scheme.**
- 3.2.1 At the time of auditing the 2017-2018 accounts, the first 7 properties were at the final stages of acquisition and being made ready for tenants. At that time, there was some uncertainty around the tenancy management arrangements. The Council has not operated a housing stock since 1997 and does not have a specific rental management system that could have been used to support the Company.
- 3.2.2 During the project development, discussions were held with local Registered Housing Providers, but no firm commitments were made. The Heart of Cumbria Limited Directors acknowledged the need for professional support with tenancy management. Following a tender exercise, they engaged H and H King estate agents to advertise and manage the tenancies. In addition, there was support from the Council's housing team to ensure the affordability criteria were met at the outset. This arrangement has resulted in all 7 properties being successfully let. At the time of writing, all rental monies due to the Company have been received.
- 3.2.3 In terms of maintenance, this is being delivered through the Council's contractor with a Council officer acting as liaison. Any works done by the contractor for the Company will be charged directly and time spent by Council staff will be recharged at cost. As the properties are new, the need for maintenance has been low and should remain low in the short to medium term.

**3.3 SMART targets to allow the Council to monitor the performance of Heart of Cumbria Limited should be finalised and approved.**

3.3.1 At the September 2018 Heart of Cumbria Board meeting, four SMART targets were set by the Directors. The Council is recommended to approve these targets as the basis for monitoring the Company for 2018-2019. They are designed to cover a small number of key performance areas of the Company so that variances against them would indicate underlying issues in acquisition of the properties, ability to let the properties, ability to generate the income targets assumed in the plan, or the ability to be and remain financially sustainable.

3.3.2 The targets and the projected outturn against these is set out below:

Table 1: Smart Targets 2018-2019

Target	Expectation
Acquire at least 7 affordable units during the year.	Target met and expect to exceed with a further 6 properties scheduled later in the year.
Have each property tenanted for at least 26 rental weeks during 2018-2019.	4 properties started their tenancy in September, with 3 in October. The average number of weeks is 25.86.
Based on the assumed rents in the business case, to generate at least £20,500 gross rental income by 31 March 2019.	The anticipated gross rental is £21.8k, although the letting period was marginally below target, the rental levels were slightly higher than in the original business plan.
Operate without a revenue deficit up to 31 March 2019.	Expect to meet this target.

3.3.3 A similar set of targets will be produced to cover 2019-2020 to reflect any changes to the size of the portfolio. These targets reflect the active projects of the Company to date; namely the acquisition of 81 affordable units in Penrith. Should any further initiatives be taken forward by the Company, these may require further different targets, appropriate to the key performance drivers of any new scheme.

**3.4 The financial model should include more sensitivity analysis on the key assumptions.**

3.4.1 A sensitivity analysis on the business case is presented at Appendix A. This shows the impact of fluctuations in the key underlying variables in the business case, including rental income, rate of void/bad debts, management and maintenance costs. The analysis helps to flag where the key risks are in the business plan. The single largest element of the plan is income. This reinforces the importance of ensuring that the levels of income are closely monitored and regularly reviewed.

3.4.2 Voids were raised as a particular issue by the external auditors. If the void rate was twice the figure assumed in the business plan (10% rather than 5%, or 8 properties at any one time either vacant or not paying), the payback period would increase from the base model of 47 years up to 55 years. The non-collection of rent reported by Eden Housing Association for 2017-2018 was 2.5%. The Company's assumption of 5% is reasonable on that basis. At the time of writing this report, there have been no missed payments and all properties are let.

- 3.4.3 Other key variables in the plan, which were identified as risks in the original business case, such as the interest rates and the property purchase price, have been fixed through the contract with Persimmon and the finance package agreed with the Council.
- 3.4.4 Should further opportunities be brought forward by the Company, sensitivity analysis will be included to help with interpretation of the financial model and identification of risks.
- 3.5 Safeguards should be maintained where Members are also on the Board of Heart of Cumbria Limited.**
- 3.5.1 The Council's Constitution was amended in May 2018, so where there are potential conflicts of interest, the advice of the Monitoring Officer should be sought.
- 3.5.2 The Monitoring Officer is obliged to provide advice on the appropriateness of participation by Members who are also directors of the Board, having regard to the Guidance on Bias and pre Determination which is set out in the Constitution. To date, the Monitoring Officer has advised that Members who are also Directors may participate, but should not vote in relation to Council business regarding the Company.
- 3.5.3 The Company Secretary will advise Company Directors about the appropriate course of action in the case of conflicts arising in terms of Company decision making.
- 3.6 Produce a robust risk register and monitor and present to Members on a regular basis.**
- 3.6.1 The corporate risk register now includes an item devoted to the Heart of Cumbria Ltd. The relevant extract is included at Appendix B. This provides details about the key risks and mitigations and also provides the opportunity for scrutiny by Members with the potential to ask for more information or further assurances around the operation of the Company.
- 3.6.2 The establishment of SMART targets and presentation of the business case sensitivity analysis also forms part of the overall governance arrangements to identify the key risks and monitor performance in those key areas. This is to help manage the overall risk that the Company does not achieve its aims or becomes unsustainable.
- 3.6.3 The Company has also established a risk register with key operational risks. These are reviewed as a standing item at each Board meeting.
- 3.6.4 Right to Buy was flagged as a specific risk by the external auditors. This does not apply to the Company. Should statutory changes be made such that it did apply, there is a risk that the stock of affordable houses to let could reduce without a compensating reduction in cost or ability to replace with a similar unit from the sale proceeds.
- 3.6.5 Right-to-Buy is one strand of Government policy within a number of related policies around the use of receipts and replacement of rental stock. Further detail is set out in Appendix C. How these policies could be applied to a private company, operating in a different regulatory, tax and funding environment is not clear. Should the full suite of policies become applicable to the company, this could have a significant impact on the business plan. This system is currently under review by Central Government and developments will be monitored closely.

## 4 Policy Framework

4.1 The Council has four corporate priorities which are:

- Decent Homes for All;
- Strong Economy, Rich Environment;
- Thriving Communities; and
- Quality Council.

4.2 The proposals set out in this report are relevant to the Quality Council corporate priority.

## 5 Consultation

5.1 The Board members of Heart of Cumbria Limited have been consulted on the items discussed within this report.

## 6 Implications

### 6.1 Financial and Resources

6.1.1 Any decision to reduce or increase resources or alternatively increase income must be made within the context of the Council's stated priorities, as set out in its Council Plan 2015-2019, as agreed at Council on 17 September 2015.

6.1.2 The report presents no options that would directly impact on the Council's budget.

### 6.2 Legal

6.2.1 The report has no direct legal implications. The detailed implications relating to specific recommendations are noted above.

### 6.3 Human Resources

6.3.1 There are no Human Resources implications.

### 6.4 Statutory Considerations

Consideration:	Details of any implications and proposed measures to address:
Equality and Diversity	There are no implications
Health, Social Environmental and Economic Impact	There are no implications
Crime and Disorder	There are no implications
Children and Safeguarding	There are no implications

### 6.5 Risk Management

Risk	Consequence	Controls Required
The Company does not have appropriate arrangements in place to address the issues raised by External Audit.	Potential risks to the Company and Council are not appropriately managed.	Put in place arrangements to identify and manage the risks and reporting of progress.

## **7 Other Options Considered**

7.1 The options are set out above. No other options are suggested.

## **8 Reasons for the Decision/Recommendation**

8.1 The report presents an update on implementation of recommendations made by External Audit at the 2017-2018 year end.

### **Tracking Information**

<b>Governance Check</b>	<b>Date Considered</b>
<b>Chief Finance Officer (or Deputy)</b>	19 December 2018
<b>Monitoring Officer (or Deputy)</b>	19 December 2018
<b>Assistant Director</b>	19 December 2018

**Background Papers:**      **Audit Findings Report 2017-2018 on the Accounts and Governance Committee agenda, 26 July 2018**

**Appendices:**              **Appendix A - Sensitivity Analysis**  
                                 **Appendix B - Extract from EDC corporate risk register**  
                                 **Appendix C - Further details around Right to Buy issues**

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The text below is an extract of a paper considered by the Heart of Cumbria Board on 29 October 2018.

### **“Sensitivity analysis on business case**

As part of the 2017-2018 Audit Letter, one recommendation was for a sensitivity analysis to be carried out on the business plan to illustrate where the main risks were. The key variables in the model have been flexed to illustrate the impact on the payback period that variances against the budgeted figures would have.

The table below shows the payback period when the base model is flexed by the percentages below for each of the factors set out. The payback period in the base model is 47 years.

#### **Sensitivity Analysis**

	Adverse variance of:				
	1%	5%	10%	20%	30%
Gross Rent (total £)	48	51	57	73	111
Void cost lost income	47	47	47	48	49
Maintenance cost	47	48	49	52	54
Management fee	47	48	50	53	55
Discount rate	47	48	48	50	52
Service charge	47	47	48	49	50
Annual contribution to refurbishment costs/property	47	48	49	51	54
Base model discounted payback (years)	47				

Voids were raised as a particular issue by the external auditors. In addition to the figures above, if the void rate was twice the figure assumed in the business plan (10% rather than 5%, or 8 properties at any one time either vacant or not paying), the payback period is 55 years. The non-collection of rent reported by Eden Housing Association for 2017-2018 was 2.52%. The model's assumption of 5% seems reasonable on that basis, albeit with a small housing stock, fluctuations in the management of individual properties may have a larger impact.

Overall, the most sensitive figure is the rental income. This is as expected, being the largest single amount in absolute terms. It emphasises the importance of ensuring rents are reviewed regularly and benchmarked against the market levels. Mitigating this risk is the evidence that the demand for the properties has been greater than the current supply, at the current rental levels (80% of the local market rates).

Other key variables in the plan, such as the interest rates and the property purchase price, have been fixed through the contract with Persimmon and the finance package agreed with the Council.

The Board are asked to note that sensitivity analysis on the business plan was requested by the Eden District Council external auditors as an important illustration of the risks within the business model. This analysis is to be presented in an update report to Eden District Council in January, along with the SMART targets and other relevant updates.”

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## Extract from the Corporate Risk Register

## Risk Assessment: Risk F9 – Heart of Cumbria Limited

Description of risk:	This is a new delivery model for the Council involving a significant level of investment. Robust arrangements are required to ensure the Council protects its investment. This means having arrangements to gain sufficient assurance that the company is operating effectively.
Responsible Officers:	Chief Executive, Deputy Chief Executive, Director of Finance.

## I Risk Rating Without Controls

Potential negative outcome:	Significant financial and reputational loss for the Council; negative impact on the supply of affordable housing in the district.				
Outcome Rating A	Slight 1 <input type="checkbox"/>	Moderate 2 <input type="checkbox"/>	Serious 3 <input type="checkbox"/>	Major 4 <input checked="" type="checkbox"/>	Catastrophic 5 <input type="checkbox"/>

What is the likelihood of risk occurring?	<p>Significant work has been done by the Company and the Council to ensure that the operation is successful. Factors that mitigate the operational risks to the business case for 81 affordable dwellings include:</p> <ul style="list-style-type: none"> <li>the need for affordable housing in Penrith. Evidence was gathered in the business planning and has been evidenced through the level of demand for the first 7 units, all of which are let;</li> <li>the finance package with the Council and the deal with Persimmon although committing the company to the acquisition of 81 properties has fixed two of the main variables, namely the cost of finance and the cost of the properties; and</li> <li>the investment, although significant, is phased over a number of years allowing time to refine arrangements.</li> </ul> <p>This is a new delivery model for the Council involving a significant level of investment. The Company is still in an early stage operationally; External Audit have recommended that further work needs to be completed around:</p> <ul style="list-style-type: none"> <li>arrangements for management of risk,</li> <li>how the Board members interact with the Council;</li> <li>management of the properties long term; and</li> <li>illustrating the main assumptions within the business plan and the impact on the overall performance should the actual figures differ from those in the model.</li> </ul>				
Likelihood Rating B without controls	Unlikely 1 <input type="checkbox"/>	Possible 2 <input checked="" type="checkbox"/>	Likely 3 <input type="checkbox"/>	Probable 4 <input type="checkbox"/>	Imminent 5 <input type="checkbox"/>

Resultant Risk Rating without controls: (A x B)	Unacceptable	12	<input type="checkbox"/>	15	<input type="checkbox"/>	16	<input type="checkbox"/>	20	<input type="checkbox"/>	25	<input type="checkbox"/>
	Above Acceptable	6	<input type="checkbox"/>	8	<input checked="" type="checkbox"/>	9	<input type="checkbox"/>	10	<input type="checkbox"/>		
	Acceptable	1	<input type="checkbox"/>	2	<input type="checkbox"/>	3	<input type="checkbox"/>	4	<input type="checkbox"/>	5	<input type="checkbox"/>

## II Risk Rating With Existing Controls

Existing	
Controls:	<p>There are a number of controls over the operation of the Company and the Council's investment, including:</p> <ul style="list-style-type: none"> <li>a formally constituted Board with regular minuted meetings,</li> <li>financial monitoring and risk registers reported to the Board;</li> <li>Company updates reported to Council and Committees</li> <li>equity to the Company is to be fully paid from reserves; there will be ongoing MRP attached to the loan finance, but this will only start as the loans are granted. The 'paid for' equity is around 20% of the total acquisition cost of the properties, so provides a significant buffer in terms of financial exposure.</li> <li>the loans are secured on the houses through a fixed charge. The houses will be revalued annually so it will be clear how their value relates to the level of EDC investment.</li> <li>the level of investment, although significant, is judged to be proportionate to the size of the Council.</li> <li>external legal and accountancy advice has been used to ensure compliance with company reporting and tax legislation.</li> <li>professional lettings agents are being employed to manage the advertising, letting and rent collection.</li> <li>The scope of Central Government housing policy will be monitored.</li> </ul>



<b>Likelihood Rating C with existing controls</b>	Unlikely 1 <input type="checkbox"/>	Possible 2 <input checked="" type="checkbox"/>	Likely 3 <input type="checkbox"/>	Probable 4 <input type="checkbox"/>	Imminent 5 <input type="checkbox"/>
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<b>Resultant risk rating with existing controls in place (A x C):</b>	Unacceptable	12	<input type="checkbox"/>	15	<input type="checkbox"/>	16	<input type="checkbox"/>	20	<input type="checkbox"/>	25	<input type="checkbox"/>
	Above Acceptable	6	<input type="checkbox"/>	8	<input checked="" type="checkbox"/>	9	<input type="checkbox"/>	10	<input type="checkbox"/>		
	Acceptable	1	<input type="checkbox"/>	2	<input type="checkbox"/>	3	<input type="checkbox"/>	4	<input type="checkbox"/>	5	<input type="checkbox"/>
Controls Adequate?	Yes	<input type="checkbox"/>	No	<input checked="" type="checkbox"/>							

### III Risk Rating Following Action Plan

<b>Risk Assessment Action Plan</b>	
Action Required:	<p>External Audit raised the following recommendations to improve the arrangements around the Company:</p> <ul style="list-style-type: none"> <li>The Council needs to ensure that appropriate tenancy management arrangements are put in place for the affordable homes scheme.</li> <li>SMART targets to allow the Council to monitor the performance of Heart of Cumbria Limited should be finalised and approved.</li> <li>The financial model should include more sensitivity analysis on the key assumptions.</li> <li>Safeguards should be maintained where Members are also on the Board of Heart of Cumbria Limited.</li> <li>Produce a robust risk register and monitor and present to Members on a regular basis.</li> </ul>
By Whom?	Management Team
Target Date:	These will be followed up by external audit through 2018-2019. Progress has been made against these and an update report is planned to be taken to Council in January 2019.
<b>Likelihood Rating D with controls in place</b>	Unlikely 1 <input checked="" type="checkbox"/> Possible 2 <input type="checkbox"/> Likely 3 <input type="checkbox"/> Probable 4 <input type="checkbox"/> Imminent 5 <input type="checkbox"/>

<b>Resultant Risk Rating with Action Plan in place (A x D):</b>	Unacceptable	12	<input type="checkbox"/>	15	<input type="checkbox"/>	16	<input type="checkbox"/>	20	<input type="checkbox"/>	25	<input type="checkbox"/>
	Above Acceptable	6	<input type="checkbox"/>	8	<input type="checkbox"/>	9	<input type="checkbox"/>	10	<input type="checkbox"/>		
	Acceptable	1	<input type="checkbox"/>	2	<input type="checkbox"/>	3	<input type="checkbox"/>	4	<input checked="" type="checkbox"/>	5	<input type="checkbox"/>
Controls Adequate?	Yes	<input checked="" type="checkbox"/>	No	<input type="checkbox"/>							

## **Risk Factors around Right-to-Buy**

Right to Buy was flagged a specific risk by external audit. The stock is considered to be immune from Right to Buy under the current law. Should statutory changes be made such that it did apply, there is a risk that the stock of affordable houses to let could reduce as a result. In terms of the financial impact, it is difficult to quantify. There are a number of factors which would influence the level of impact which are set out below.

### **Cost floor**

Under Right to Buy, eligible tenants may receive a discount on the market value if they wish to purchase their home. There is a cost floor provision that applies. It has the effect that a landlord does not have to sell the property for less than they have spent building, acquiring, repairing or maintaining it over the 15 years prior to the Right to Buy application (where acquired after April 2012). This is based on the actual amounts spent and is not indexed. This would offer some protection over the level of receipt.

### **Use of capital receipts**

There are restrictions around the use of receipts from Right to Buy sales. Central Government is currently consulting on the rules around this, including the percentage of receipt applicable for any replacement units. Depending on the outcome of the consultation, freedoms around retention and use of the receipts may be increased. Should restrictions remain in force, it is possible that not all of the receipt would be available to either repay the debt or invest in a new unit.

### **Taxation and funding**

Local Authorities with housing that is subject to Right to Buy face the challenges of reduced stock, discounted receipts and restrictions over the use of those receipts, as set out above. They also benefit from other factors. These include the ability to reclaim VAT, no corporation tax liabilities and the potential to access other sources of central government funding. It may be that any amendment to the scope of the Right to Buy policy would also bring some of these benefits.