Rother District Council

Report to:	Cabinet
Date:	6 November 2023
Title:	Blackfriars Housing and Infrastructure Project
Report of:	Director – Place and Climate Change / Deputy Chief Executive (interim)
Cabinet Member:	Cllr McCourt / Cllr Jeeawon
Ward(s): **Append**	All
Purpose of Report:	This report provides an update to Members on the progress of the Blackfriars Infrastructure project and the latest financial position. Members are also being asked to consider some recommended amendments to the Shareholders Agreement between the Council and Rother District Council Housing Company Ltd (the Company) and the Company Articles of Association.
Decision Type:	Key
Officer Recommendation(s):	**Recommendation to COUNCIL:** That

1) the updated capital budget requirement for the Blackfriars Infrastructure scheme of £21m be approved, to be funded as outlined within paragraph 15 of the exempt report (exempt Appendix 5); and
2) the Council's Chief Executive be granted delegated authority in their capacity as the Company Shareholder Representative to finalise and agree the proposed amendments to Rother District Council Housing Company Ltd Articles of Association and Shareholder Agreement proposed in Appendices 2 and 3.

AND

It be **RESOLVED** That:

3) the position in respect of the Service Level Agreement (SLA) and Working Capital Agreement (WCA) be noted;
4) the recent Housing Company Board decision to apply to the Planning Committee for removal of the s106 planning obligation and to deliver 200 market homes and the potential impact this has on the scheme financing be noted.

Reasons for recommendations:

- The Blackfriars Programme continues to be financially challenging due to the marginally viable status. The infrastructure costs are now more established, and the increased budget requirement requires regularising to complete this first phase of the project;
- The Company, as a private entity, must ensure the housing scheme generates some level of surplus to provide continued business justification to proceed. The report sets out the latest financial position of the Company. Based on current costs and values, the only viable option available to proceed with at this time, is to deliver the 200 homes as open market sale; and

- To agree amendments to the Articles of Association and Shareholder Agreement included for consideration within this report along with an update regarding the status of the draft Service Level Agreement (SLA) and draft Working Capital Agreement (WCA).

Introduction

1. The purpose of this report is to update Members on;

   - Progress of the Blackfriars Infrastructure project following the July Cabinet report and recommend to Council the updated budget position;
   - The latest overall financial position (including the housing scheme) following progress of the redesign and negotiation with Wates;
   - The housing delivery options recently considered by the Board of Rother District Council Housing Company Ltd (the Company) to proceed with a viable housing scheme; and
   - The latest progress in respect of agreeing the SLA and WCA with the Company.

2. To summarise, the report demonstrates positive progress of the infrastructure project and redesign of the housing scheme, afforded by the delay of construction of the road. The biggest risk to the Blackfriars Programme continues to be the marginally viable status of this historically stalled site and the increased infrastructure costs necessary to deliver a scheme, against a backdrop of challenging market conditions, threatening the success to achieve the principal aim to deliver 200 homes, as committed in the Rother District Council Housing Company (The Company) business plan (2022-2025) and the aspiration to deliver additional housing within the Corporate Plan.

3. At the time of reporting, the preferred housing delivery option previously approved by the Company Board, to include 130 affordable homes and 70 as open market sale, is not viable, generating a significant deficit as summarised in the report. In this scenario, there would be no surplus available to help absorb the deficit on the infrastructure delivery or to manage the ongoing project risk of further cost increases. Whilst it is expected a development appraisal will fluctuate over the lifetime of a programme of this scale, the deficit is considerable, and the position is not currently sustainable for the Company to proceed on this basis.

4. The Company has considered various options to demonstrate a profit-making scheme required of a commercial entity. This has included revisiting the earlier baseline position of delivering a policy compliant number of affordable homes (70 affordable homes). This is also insufficient to close the viability gap. In conclusion, the only viable option to provide sufficient business justification to continue the housing project at this stage, is to remove the s106 planning obligation, with the view to delivering 100% open market sale. This will increase the value of the site enabling the Company to proceed with a scheme and to secure the necessary loan funding arrangements for continued business justification and to achieve the business aim of increasing supply of housing.

5. Concurrently, the Company has undergone a review and refresh of previously agreed governance documents from 2018. As part of this review, a small number of amendments have been agreed by Officers, in principle, to incorporate in the Shareholder Agreement and Articles of Association. The changes have been reviewed by both the Company and Council's respective legal teams, and the intention is to update the current governance documents with the proposed amendments summarised in appendix 1 with the updated documents contained within appendix 2 and 3, subject to Member approval.

Background

6. Members are aware that Blackfriars has been a marginally viable high-risk project from the outset, and that position enabled the Council to successfully apply for Homes England Housing Infrastructure Funding (HIF) in 2018.

7. Considerable progress has been made on the infrastructure project since this time, led by the Council. This includes ecology surveys/mitigation work, archaeology, ground investigation surveys and Compulsory Purchase of the housing land required to deliver 200 new homes and deliver a road from the north of the site at Harrier Lane to the Spinney at the south. The construction of the road followed onsite in April 2022. The Housing Company is responsible for the delivery of the Housing phase and has been working with its main contractor Wates, to revise the existing scheme, add sales values, and reduce costs to support the viability of the overall Blackfriars Programme.

Road Update

8. Despite the challenges relating to increased costs and delays of the infrastructure project previously reported in July, the road and infrastructure is progressing, with a significant element of the road now built. Construction of the major embankment at the Spinney is due to commence in October, providing the second access to the south of the site. Despite some initial delays caused by the housing redesign, the infrastructure redesign elements have all progressed and there are minimal changes required to the road and drainage. The biggest impact of change is on the design and statutory approval processes relating to the major embankment in field 1, which has been agreed in principle.

9. By March 2024, the road and drainage will be completed, with only the remaining embankment work to complete. The current programme assumes completion of the road by September 2024, with a return visit expected post completion of the housing, to avoid damage to the topcoat of the new road.

Housing Update

10. The Company decided to progress with a redesign in February 2023 during the pause period afforded by the delay of the infrastructure project. The redesign is expected to improve the commerciality of the housing scheme, primarily achieved by reducing the size of dwellings in line with nationally approved space standards and increasing the number of bedrooms/houses to provide a better mix of housing to meet current need. It should be noted however, that no option considered at the time provided a commercial profit level normally expected of a scheme, and still carried considerable risk for this reason.

11. Following several pre-planning meetings and a public consultation event in June, the final redesign was submitted to planning in July 2023. RIBA Stage 3 designs are complete, and progress has been made on RIBA Stage 4 designs, dealing with the main technical design element of the process. There is still work to be done to progress the planning application before determination is expected by January next year. At the end of this process the Company will hold a comprehensive set of designs, should the Board decide a retender is required pending the outcome of negotiations with Wates to deliver the new scheme, as the preferred route, subject to delivering a viable scheme. The Company's view is that a retender will not delay a start on site for a housing contractor because the road must be suitably progressed in any event.

Market Conditions

12. There continues to be financial challenges for residential development as seen in the wider market, with increased labour and materials costs; rising interest rates and levels of inflation impacting on affordability. This has had an adverse effect on the Blackfriars

housing project, reducing the market values previously assumed in the February 2023 appraisals used to inform the decision to proceed with a redesign. Registered Providers (RPs) are also reducing their development programmes, being more cautious about where they spend their resources and how much they spend on existing stock and new development, resulting in reduced bids compared with previous offers received.

13. The Company continues to engage RPs, and new offers have been sought on several options included in this report. Namely selling 100 of the homes for affordable housing or 130 as previously approved by the Board. It must be noted that of the three RPs who engaged with the process, none were interested in acquiring the policy compliant 70 nil grant homes only. They require a minimum of 100 homes and only one of the three parties would be interested in buying less than the 130 homes previously on offer.

Financial Update

14. The projected cost of the infrastructure project remains a significant risk challenging the success of this project.

15. However, whilst the increase of infrastructure costs and delays to the road project have been the principal reason for movement, from a marginally viable scheme to projected deficit, the situation is now further complicated by the current preferred housing scheme (to deliver 130 affordable homes) no longer generating the surpluses (or at least breaking even) required by the Company to proceed as previously envisaged. This is a consequence of the national picture, including the downturn in market conditions, increased labour, and materials costs, borrowing rates and inflationary impact on build costs.

16. Since the July 2023 Cabinet report the impact on the financial appraisal can be summarised as follows;

Rother District Council – Infrastructure Project

- Additional contingency of £1.1m, increasing the estimated cost reported to Members in July from £19.9m to £21.0m. It should be noted that this represents a 5.5% contingency and is based on the recommendation of the Employers Agent (EA) and may not be fully realised.

Housing Company – Housing Project

- A reduction in open market sales values and reduced affordable housing offer included in the s106 planning obligation;
- An increase in the projected contract costs with Wates;
- Following the recent changes to subsidy control requirements, the Council as sole funder has had to revise the anticipated interest charge for the loan, with future forecasts using an estimate of 9% as part of progressing the Working Capital Agreement (WCA) and Development Funding Agreement. It should be noted however, that the Council is currently seeking further external advice regarding this element, and it is therefore still subject to change and final agreement; and
- As part of the planning application, the Company must also assume responsibility of the Community Infrastructure Levy (CIL) liability, with payments triggered by commencement of the phased housing scheme, adding further cost to the housing scheme.

Improving the financial position

17. The Council and Company continues to work collaboratively to improve the overall financial performance of the project. Below summarises key activities and resource involved in this process;

- ✓ Improved Cost control; The road and housing scheme both have a new Employers Agent (EA) to improve contract, risk, cost, and programme management;
- ✓ Resource from the Council's Capital Finance Team providing oversight and scrutiny;
- ✓ Additional HIF funding request has been submitted to Homes England for consideration, alongside a request to extend key project milestones;
- ✓ Exploring other funding opportunities;
- ✓ Exploring other cost saving opportunities to include; removing external works from the housing contract to be delivered by civil engineers;
- ✓ Requesting updated RP offers with and without the s106 planning obligation;
- ✓ Fixing the new contract sum reducing risk;
- ✓ Company review of housing delivery options (outlined below);
- ✓ Financial Viability Assessment to remove the s106 planning obligation to demonstrate a viable scheme to continue with at this time;
- ✓ Improved programme management to manage the interface between the housing and road contracts;
- ✓ Recruitment of Non-Executive Directors to the Company Board to further strengthen the strategic leadership expertise required by a commercial entity; and
- ✓ Having the appropriate development expertise employed by the Company to robustly challenge costs and navigate the Company through complex negotiations.

Options Appraisal - Housing Delivery

18. The Company has continued to review various housing delivery options to achieve as many Company business objectives as possible, summarised below, notwithstanding the principal aim; **to increase supply of new housing in Rother.**

- Delivery of new housing supply
- Construct the homes to high environmental standards
- Deliver minimum policy requirements of affordable housing
- Quality of homes (Nationally Described Space Standards)
- Provide a return to the Company for future schemes

19. The options considered by the Company have focussed on those that are currently deliverable in practice in the scope of the Business Plan and within the required programme period. Due to the commercial sensitivity of the financial appraisals, a summary outcome of the Options is included in the table below and financial data is included in the attached confidential Appendix 5. Members should note that the risk appraisal below is that which has been considered by the Company Board in its decision to proceed with Option 2 and is not an assessment of the Council.

Option	**Affordable Housing**	**Open Market Sales**	RED = Not Viable/deliverable AMBER = Marginally Viable GREEN = Commercially viable
Option 1) Preferred Option Redesign	130	70	
Option 2) 100% OMS Redesign Redesign	N/A	200	

Option 3) 50:50 Open Market Sales and affordable Redesign	100	100	
Option 4) Planning Policy Compliant – Redesign	70	130	
Option 5) Planning Policy Compliant - Consented scheme	70	130	
Option 6) Abort Project (Road and Housing)	0	0	

20. The first four options (1 – 4) are based on delivering the redesign that remains subject to planning approval. This follows the Company Board's approval to proceed with the option to redesign the scheme earlier this year. Option 5 revisits the project baseline, to include the former consented scheme and delivery of a policy compliant level of affordable housing (70 affordable homes). As with all options appraisal, the option to do nothing must be weighted in the balance of continuing to proceed with a project, included under Option 6.

21. The outcome of this assessment is clear, demonstrating there is currently only one marginally viable option to proceed with at this stage of the project, that being Option 2; to allow the project to continue on the basis all 200 homes can be delivered as open market sale. All remaining options currently fail to generate a scheme surplus required for the Company Board to approve the scheme and for the Council to minimise its losses on the road project. This is based on the best available data known at the time of reporting.

22. Whilst Option 2 produces what is the Company (and Councils') least preferred option, due to the loss of affordable housing, the Company, as a private entity, is required to ensure it is delivering a viable scheme to achieve its core aim to increase housing supply in Rother. This option is currently the 'best worst-case' scenario to proceed with at this time, that will provide sufficient business justification to;

- ✓ Continue to deliver the project to achieve delivery of 200 good quality new homes in Rother;
- ✓ Secure the loan facility required to deliver the housing scheme; and
- ✓ Opportunity to review market conditions and the financial appraisal to further assess the potential for inclusion of affordable housing post planning determination.

Former Consented Scheme (Option 5)

23. As part of reviewing the options to proceed with a redesign, the Company considered the impact of delivering the formally consented scheme (the project baseline). This option was previously discounted by the Company Board because the redesign continues to outperform the old scheme, despite the recent viability challenges and the consented scheme is financially worse off compared with the new scheme. The inflationary impact caused by the delayed start (from May 2022) is a significant contributory factor to the deficit projected on delivering the former consented scheme, that must be factored into the appraisal. See also Appendix 5, Option 5.

24. In summary, the redesign is the preferred option because;

- The redesign is more viable and is expected to achieve at least £3.4m additional sales value compared to the old scheme;
- The housing mix has been updated to better align with current local need for both market and housing need;
- The previous dwelling sizes were oversized above national space standards, meaning the cost to value ratio was high; and
- There have been omissions identified in the existing contract signed with Wates, meaning considerable, yet unquantified, additional costs incurred to deliver the previous scheme to the standards required

25. It is also important to note that planning approval for the revised scheme has not yet been determined and this report is without prejudice of the statutory planning process and will be the subject of separate consideration by Planning Committee.

Abort Project /Sell the site (Option 6)

26. The Blackfriars housing site has been stalled for some 60 years, demonstrating successive market failure. Despite Council investment of the road infrastructure, the site is not capable of generating a return typically required by traditional commercial developers, where the strategic driver is profit over supply. In practice, if the land were to be sold this would normally result in either the site becoming stalled again (if sold at all) or delivered as 100% open market sales (OMS) with no prospect of delivering affordable housing because the Council has no influence over a third-party developer (without further reducing land value). There is the added risk that the £8.7m Homes England HIF grant funding would be withdrawn, if the project stalls or is left to the market to deliver at some unknown time, failing to unlock the 200 new homes predicated in the grant funding agreement.

27. If a local authority owned company is unable to deliver a policy compliant scheme, where supply of new homes is the priority over profit margins (notwithstanding the need for a private entity to make some level of surplus), it is probable that a standard developer would have already challenged this. Even when market conditions improve, once an affordable housing planning obligation is omitted successfully, there is rarely a requirement for a developer to revisit this. A review mechanism is often requested and can result in a commuted sum provision towards delivery of affordable housing offsite. A key benefit of the Company delivering this scheme, is that affordable housing will remain a priority objective as committed in the adopted Business Plan and regardless of the planning obligation being omitted or not.

28. In practice if the site were to be sold, current valuations suggest a potential site value could be achieved of up to £2.2m. This is likely to be a speculative value only and would not recover the costs already expended and committed on the project as demonstrated by Option 6 included in Appendix 5. Leaving the Council (and Company) in deficit, with no further opportunity to realise any value from the site to recover those costs, and no control over how, or if the site will ever be delivered.

Direct Council Investment in Affordable Housing Provision

29. The Council may choose to explore at a future date, the possibility of investing in social housing stock at Blackfriars. This could be achieved by the Council acquiring homes from the Company directly, using its existing RP status and, for example, entering an SLA with a preferred RP to manage the homes.

30. To deliver a policy complaint number of affordable homes, this would require a bid submission of at least c£30m to deliver 70 affordable homes, and additional funding required to reconcile the wider programme finances. This is obviously a significant risk for the Council to commit to in addition to delivery of an already high-risk infrastructure project and at a time where wider Council finances are already under significant pressures from a £3.8m revenue budget deficit projected for 2024/25.

31. For these reasons, it is recommended that currently, the Company will continue to engage with the RP's showing an active interest in delivering affordable housing provision at Blackfriars, whilst progressing removal of the s106 planning risk. This is with the aim of incorporating some affordable housing provision where finances permit, revisiting the housing schemes included for example, under **Options 1, 3 and 4** as outlined in this report.

Risk

32. Proceeding with Option 2 is not without risk, indicated by the amber rating in the above table, confirming this scheme is only marginally viable. The conservative assumptions used to inform the financial appraisals will help to offset some of this risk, that can be refined at a later stage where key risks to delivery are reduced/omitted increasing project certainty (i.e. once Wates commence on site). Added to this, the Company will review phasing options, to limit the increased sales risk, and to improve the cashflow assumptions.

33. As reported above, market conditions are notably challenging at this current time and do not necessarily reflect the economic situation in two to three years' time, when homes are due to complete and be sold. Based on the UK Housing Market Update (October 2023) Savills reports that '…the medium-term outlook has improved, with a sense of finely balanced economic stability'. The Mainstream house price forecast suggests a 6.5% increase during 2026, when the homes are currently expected to complete (noting a 3% increase assumed over 5 years from 2023 to 2027). The Council has also absorbed a significant level of risk associated with delivering the housing project, by investing in the major onsite infrastructure requirements which is steadily completing now.

34. The overall project risks are covered in more detailed in the attached risk register at Appendix 4.

Governance Update

35. Following a governance progress update reported to Audit & Standards Committee in December 2022 several recommendations were approved (minute AS22/42 refers), aimed to refine and improve the overall governance arrangements of the Company. This work has progressed in conjunction with delivery of the Blackfriars housing scheme. In response to this report a company governance health check review was undertaken and several actions have progressed as outlined below.

36. In addition, the Company has been an established entity for some 3 years and it is considered good practise to undertake a review of governance arrangements periodically to ensure these comply with any amendments to legislation and relevant case law.

37. Consequently, several amendments were advised to be made to the Articles of Association and Shareholder Agreement, consistent with businesses run as a private legal entity, as described in the existing Share Holder Agreement (SHA). The changes proposed have been reviewed by both respective legal teams. Officer's view is that the changes now mutually agreed by both legal teams should be agreed and remain consistent with the purpose of the Company to operate as a commercial entity, as described in the founding SHA.

38. The proposed amendments are summarised in appendix 1 while appendices 2 and 3 reflect the recommended changes for consideration. The ultimate aim is to strike an appropriate balance between allowing a company the freedom to manage its activities and ensuring that it is accountable for its actions.

39. Further to this, as part of the Audit and Standards Committee's Annual Report to Full Council on 23rd September 2023 it was also noted and agreed that;

9. The Committee must also be aware of the Shareholder Representative's role and ensure that is being performed satisfactorily. There is a balance to be struck between ensuring that the company has enough freedom and flexibility to operate commercially to achieve its objectives whilst at the same time providing Members with assurance that there is sufficient oversight to protect the Council's investment.

10. The first report in relation to the RDCHC's governance arrangements was considered by the Committee in July 2022. To ensure that these arrangements continue to receive the focus they deserve the Committee is proposing to request an Annual Report from the Shareholders Representative Group, to provide the Committee with a high-level update regarding progress, governance arrangements and improvements in March of each year. Internal Audit are due to present their findings from the first governance audit on the Company later this year so a follow up report from the Shareholders Representative Group in March will be timely and enable an update to be provided at that point.

40. The Council and the Company are working on finalising a Working Capital Agreement (WCA) and wider Development Funding Agreement with our legal advisors and this provides a further opportunity to review and assess governance arrangements.

41. The Service Level Agreement (SLA) is in the process of being finalised. The draft WCA has also now been shared with the Company and it is hoped that this can be agreed and signed off by both parties by the end of the year and a previous delegation is being sought as part of this report to enable the Deputy Chief Executive (interim) to finalise the terms of this with the Company.

Recommendations

42. As summarised by the financial performance above and included within confidential Appendix 5, the preferred housing scheme (Option 1) is projected to generate a significant project deficit. Option 2 provides a viable housing scheme the Company has approved to proceed with, capable of generating some level of surplus that could be used to reduce the wider infrastructure project deficit, in addition to the net interest received by the Council.

43. It is recommended that the Council approves the updated Blackfriars Infrastructure budget and notes the housing delivery scheme (Option 2) to remove the affordable housing s106 planning obligation without prejudice of the planning determination process. This will ensure the core aim of the project is achieved, to deliver 200 new homes in Rother whilst minimising the deficit on the project, as far as possible and based on today's market conditions. This is on condition the affordable housing provision will remain under review by the Company and Council.

44. Following the Company governance review, several updates to the existing Articles and Shareholder Agreement are deemed necessary and have been agreed between the Council and the Housing Company as summarised in Appendix 1.

Next steps

45. Below summarises the next key stages of the project plan over the coming year, until commencement of the housing scheme and completion of the road (to base coat and permanent kerb stones).

	High Level Project Plan	Expected Completion Date
1)	Review housing and infrastructure programme costs and values	October to November 2023

2)	Cabinet Meeting - Blackfriars report	
3)	Housing Company to submit a Financial Viability Assessment	
4)	Full Council – to approve infrastructure budget	December 2023 to January 2024
5)	Homes England update (not confirmed)	
6)	Determination of s73 Planning application	
7)	Contract negotiation/retender complete	
8)	Register Provider Tender – review bids and update appraisals	February to March 2024
9)	Field 1– construction of the major embankment begins	
10)	RIBA Stage 4 Designs – continued	
11)	Preplanning commencement conditions	April to June 2023
12)	Housing Contractor mobilisation period	
13)	Field 3 - Access opens at the Spinney	
14)	Completion of embankment Fields 1	July to September 2024
15)	Completion of Road (phase 1)	
16)	Unencumbered access available to Field 1 - Construction of Housing to commence	

Conclusion

46. Despite the increased value generated by the redesign, it is not currently viable to deliver a policy compliant level of affordable housing at Blackfriars and provide the surpluses needed to close the viability gap, required to return the programme to breakeven position as envisaged from the outset.

47. The increased infrastructure costs continue to challenge the viability of the scheme and further Homes England funding has been applied for in attempt to improve this position. In the meantime, the total budget for the road has been reviewed together with outstanding risks to delivery. The budget now requires regularising in order that the infrastructure works can complete.

48. The delay to the housing scheme, combined with increased build costs and change in market conditions reducing the values expected, has compelled the Company to take a more commercial view of the housing delivery option to proceed with at this time. As outlined in the report, only one option currently demonstrates a viable position to achieve the core business aim, to deliver 200 new homes in Rother.

49. This requires the omission of the s106 planning obligation risk, that could enable the site to be delivered as 100% open market sale, should this be required to optimise the total gross value of the site. The outcome of the redesign planning application remains a separate decision to be considered by the Planning Committee.

50. The Company remains committed to work with the Council to review the market conditions and provision of affordable housing as the scheme processes, subject to being able to demonstrate to its Company Board and Council as Shareholder (and sole funder of the scheme) a viable scheme that generates some level of surplus (or at the very least a break even position) needed to justify continuation of the programme.