| Cabinet<br><br>22 February 2023 | TOWER HAMLETS |
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| **Report of:** Ann Sutcliffe, Place | **Classification:**<br>Part Exempt |

**Harriott Apsley & Pattison House Regeneration Scheme - Delivery Routes**

| | |
|---|---|
| **Lead Member** | **Councillor Kabir Ahmed, Cabinet Member for Regeneration, Inclusive Development and Housebuilding** |
| **Originating Officer(s)** | Karen Swift (Director of Housing), Rupert Brandon (Head of Housing Supply) & James Walsh (Housing Regeneration & Newbuild Coordinator) |
| **Wards affected** | Stepney Green |
| **Key Decision?** | Yes |
| **Reason for Key Decision** | The decision will result in the local authority incurring capital expenditure of above £5 million. |
| **Forward Plan Notice Published** | Yes |
| **Exempt information** | This report and/or its appendices include information that has been exempted from publication as the Monitoring Officer:<br>• has deemed that the information meets the definition of a category of exempt information as set out in the Council's Access to Information Rules; and<br>• has deemed that the public interest in maintaining the exemption outweighs the public interest in disclosing the information.<br><br>The exempt information is contained in<br><br>• *Appendix 1 – financial appraisals*<br><br>The exempt information falls into this category:<br><br>3. Information relating to the financial or business affairs of any particular person (including the authority handling the information). |
| **Strategic Plan Priority / Outcome** | Providing homes for the future. |

**Reason for Urgency**

This report is being submitted after the statutory deadline due to the requirement for additional time to consider the options within the report. The report is required to be presented to the February Cabinet meeting in order to ensure the regeneration of Harriott, Apsley & Pattison House proceeds at pace and work to prepare the procurement phase of the project can get underway immediately.

**Executive Summary**

This report considers the delivery options for the Harriott, Apsley & Pattison House (HAP) Regeneration Scheme and recommends the scheme is progressed under a development partnership agreement.

**Recommendations:**

The Mayor in Cabinet is recommended to:

1. Approve the use of a development partnership approach for delivering the HAP Regeneration Scheme.

2. Note the indicative programme in the report for procuring a developer partner

3. Note the expected commencement of the scheme's buy-back programme in February/March 2023 and issuing of an initial demolition notice to suspend the right to buy, approval for both elements was granted by Cabinet in Dec 2021.

## 1 REASONS FOR THE DECISIONS

1.1 In order to progress the Harriott Apsley & Pattison House Regeneration Scheme into its procurement phase, clarity is required on the route for delivery, which will dictate the nature of the funding and contractual arrangements for the scheme.

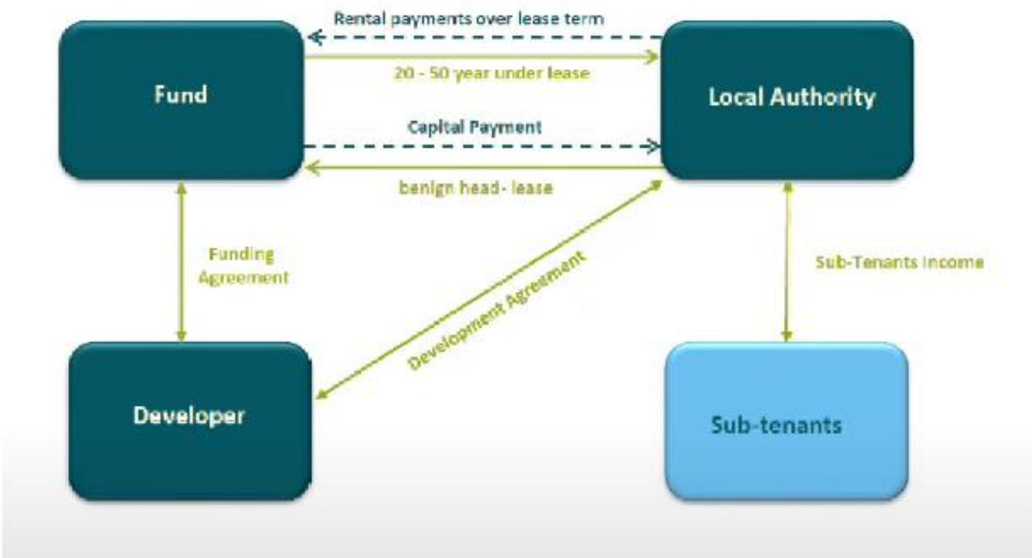
## 2 ALTERNATIVE OPTIONS

2.1 A variety of options have been explored for the scheme's delivery. The two primary alternatives to using a development partnership are the income strip or land sale route.

**Income Strip (or Sale & Lease Back) Model**

2.2 The income strip model is similar to a sale and leaseback arrangement. This is where an investor (typically an institutional fund) forward funds the proposed development. The council commits to take a long occupational lease (typically between 35-50 years) with the investor. The lease from the investor to the LA includes standard full repairing and insuring terms with a fixed rent subject to annual increases linked to RPI or CPI with a cap (maximum rent increase) and collar (minimum rent increase). The lease commences at practical completion lasting for the term, assumed in this assessment of 40 years. The Council would let and manage all tenures, including the private units (232 homes), which would all be let as private rent. This would require the council to create a private rented sector (PRS) business internally and create the associated infrastructure and brand to secure a good flow of private tenants over the duration of the lease.

2.3 Importantly, and unlike the traditional sales and leaseback arrangement, at the expiry of the lease, the council has the option to acquire the reversionary interest of the land/asset for £1. Thereby at the end of the lease, without upfront cost of development, the council gains control of the asset unencumbered, and the investor benefits from a fixed return on their investment during the lease term. In this arrangement an external developer would enter into a development agreement with the investor/fund to build the development. The investor will provide the development funding and the external developer will take on all the development risk in return for a developer profit.




*Source: Typical Income Strip Structure - Arlingclose*

2.4 With little or no upfront financial cost, this model can be attractive to public sector organisations, with constrained financial capital reserves, but benefiting from a substantial asset base. With minimal upfront capital requirement, in theory the council could undertake a wider programme of projects than deliverable under more capital-intensive models of delivery such as direct delivery or joint venture.

2.5 It should be noted that officers are not aware of an income strip model being used before by a local authority for a multi-phase regeneration scheme with the added complexities of insitu residents requiring decant and an existing tenant on the site (RCCM) requiring a new facility to be built for them. It is therefore difficult to predict the level of appetite the market may have for this model on this site. Also, due to the more complex nature of an income strip deal, the timeline for procuring the scheme would be slower than other models. Additional contract documents are required to be generated for the tender pack and once the tender has been issued, more time must be allowed at the various stages to accommodate the intensive dialogue required with bidders and adjustments to their proposals based on clarifications from their initial responses. It is estimated this would lead to a start on site date of 1year and 1 month later than under a development partnership.

2.6 The income strip model carries significant risks in return for less pressure on the council's capital programme and it is these risks that have led to it being discounted as an option. There is a significant risk to rental income achievable for the completed units. Rents payable by LBTH to the investor are linked to CPI. Affordable rents may not increase in line with RPI/CPI owing to changes in rent policy (both national and/or local). Equally market conditions may deviate significantly from anticipated projected CPI (typically 3%) over the full term of the lease. This presents significant medium to long term financial risk if the council's income stream (rents) did not keep up with the level of lease payments required to the investor over 40yrs, potentially exposing LBTH to an increasing deficit in the scheme's financing as this divergence compounds over the term of the lease

2.7 Historic notable examples which would have presented financial constraint to the council's rental income include the Welfare and Work Reform Act of 2016, where a 1% affordable rent reduction from 2016-2020 was applied to the council's income stream. The net income gap between rents received and paid is compounded over time and can create significant shortfalls and present an ongoing liability to the council.

2.8 The council would be responsible for managing the properties which includes operational costs and repairs & maintenance. There is a further risk that there may be periods of reduced occupancy and a level of bad debt due to sub tenants not paying rents on properties. It should be noted that the council has no experience or expertise in running a premium Private Rented Sector arm within its lettings/management service. Given the higher rent levels for these 232 units, any loss of income due to voids would carry a higher impact on the council's expected rental income, therefore requiring a more efficient and market facing voids management service to be created. This represents a further risk to the council's income over the 40 year lease, compared to other models where the developer carries the sales risk at the outset and the risk to the council's income is removed through the use of a fixed price.

2.9 Equally, inflationary costs or major repair requirements during the period of the lease could require a greater share of the rent than allowed for under the lease terms (typically 25-30%). Again, this risks the council falling into annual deficits related to the project. This may be mitigated by factoring in occupancy rates, bad debt, and sinking fund into the annual rental income before entering into the lease agreement with the investor, but some unknowns such as the fire safety remediation required post the Grenfell tragedy, present a substantive risk.

2.10 These risks are mitigated to some degree through a cap and collar on the rent inflation. However, external political or market forces dictating a structural long term deviance from the 3% inflation mid point assumed can compound a net rent deficit.

2.11 Market uncertainty in the form of fluctuation in interest rates, build costs, and inflation present a degree of uncertainty to the viability and market interest in such a model in the context of complex urban regeneration. In practice there is no reason for an income strip / sale and lease back model not to be applied to an estate regeneration proposal, typically to date, however, such models of development have been utilised on cleared and more straight forward sites. Therefore appetite for deploying this model on this site, especially given the current economic climate may be weak and result in a costly procurement exercise returning no bidders able to satisfy the council's financial and regulatory standards.

2.12 It should be noted that the investor will be responsible for sourcing the contractor, with the council having no control over the appointment. Typically, investors will source the cheapest contractor, are not restricted by public sector procurement regulations, and may not necessarily opt for the quality and financial stability of a tier 1 or 2 contractor.

2.13 It should be noted that officers have become aware of one significant change required to the figures for the income strip appraisal shown in appendix 1 since the preliminary appraisal was carried out in Nov 2022. This appraisal incorrectly assumed that the 36 replacement social rent units – intended for the existing tenant decants – could be financed within the income strip deal. However, in order to satisfy the terms of the Resident's Ballot of 2020, these tenants must retain the Right To Buy over their new properties. It would not be possible to grant a RTB for the units within the income strip as these units will be held under a 40 year lease, which is too short to be eligible for the right to buy. Extracting these units from the income strip deal is essential and will have an impact on the model's financial performance. This is something that would further reduce any financial benefit the income strip might deliver in the short term.

2.14 There are a further 22 hidden households within the estate who will have voted in the ballot and are expecting to have the right to buy option on their new home as part of their rehousing into the development once they become secure tenants. The same principle would apply with regards to the lease restriction preventing the right to buy on these homes and these units would therefore also need to be removed from the income strip element of the deal in order to deliver on this expectation. The remaining 90 additional affordable units to be built could be financed through the income strip route, on the understanding that they will be let to tenants without the option of a right to buy.

**Land sale with contract**

2.15 This structure is effectively a land sale option, with controls over affordable housing output and design quality set within the disposal contract. However as the council has committed to keeping all residents as council tenants/leaseholders, the Council would need to identify within the contract a 'market value' fixed price to purchase back the affordable housing.

2.16 This option eliminates sales & construction risk. However, the primary disadvantage of this option is that is it loses much of the estate's land from the Council's portfolio and would thereby create potential long term conflicts over maintenance, service charges and management of the estate, due to having two landlords on the site (LBTH & Developer). The council would also lose any influence over the quality of the non-affordable areas and have only minimal input into the affordable units. This would also contradict residents expectations, who voted for regeneration on the basis that the estate would remain a council owned and managed estate.

## 3 DETAILS OF THE REPORT

3.1 Officers have reviewed a variety of different routes to deliver the construction of the HAP Regeneration Scheme with the Mayor and have evaluated them based on cost, risk and quality. Tender documents were due to be issued in late spring 2023. We anticipate this could still be achieved in June using the development partnership model.

3.2 The range of options presented to the Mayor along with indicative costings are summarised in this report and Appendix 1. Based on work to date officers are recommending a development partnership as the most suitable option.

**Development Partnership**

3.3 Here, in lieu of a land receipt, the affordable housing would be returned to the Council upon completion at nil cost (if viable), or if this was unviable at a significantly subsidised price. The affordable housing effectively is offered at a nil or reduced price in lieu of a land price. The private housing is retained by the developer until all the units are sold under a long leasehold basis. The developer's stake in the scheme then expires and only the council as freeholder and private leaseholders remain. Such structures are common amongst estate regen or infill schemes within the local authority and Registered Provider sector. The relationship is more akin to a standard JCT build contract for the affordable, with control over the design elements through specification, employers' requirements, on-site inspections from Clerk of Works and Employers Agent.

3.4 This form of development partnership eliminates sales risk for the council; reduces construction risk and cost by giving the developer greater control than through the direct delivery option; reduces the council's capital finance commitment as the cash flow for the private homes is provided by the developer; maintains control over the design and quality of the affordable units and common areas/landscape; all land and buildings revert to the council upon sale of private units ensuring smooth future management and maintenance of the estate by one landlord (LBTH).

3.5 A development partnership deal has been recommended by officers as the most suitable route for delivering the HAP regeneration scheme, and would be contracted through a development agreement. This option minimises the council's financial exposure to fluctuations in the market and wider economy by securing a fixed price for the construction and sale of homes via a development agreement, with the developer financing the majority of the construction costs, in exchange for the income they receive from selling the homes for private sale. This option ensures a high quality for the affordable units by enabling direct influence over the choice of developer/contractor and harnessing the pace and efficiency of a developer partner. This ensures the council will have the ability to select a partner with proven experience of delivering complex large scale, multi-phase regeneration schemes.

3.6 The disadvantages of this option include: some developer finance cost requirements are incurred, however LBTH would intend to reduce these by financing the first phase of the scheme which is entirely affordable housing. There is an acceptable loss of control over the quality of private housing element of the scheme verses the direct delivery model.

**Estimated Programme & Next Steps**

3.7 Using existing information, an outline programme is provided below based upon delivering the scheme under development partnership approach:

| Stage | Date |
|---|---|
| Procure legal advisors to prepare draft contracts for tender | Feb-April |
| Prepare tender pack<br>- Finalise Employers requirements<br>- Draft legal agreements, building and plot leases, etc<br>- Collateral warrantees | Feb-May (4 months) |
| Issue 1st stage tender / PQQ | June |
| Tenders received | Jul (1 month) |
| Sifting of bidders | Aug (1 month) |
| Issue 2nd stage tender / ITT (4 bidders max) | Sept |
| Tenders received | Dec (3 months) |
| Clarifications period | Jan 24 (1 months) |
| MAB/Cabinet Approval of successful bidder | Feb-24 |
| Contract signed | Apr 24 (2 months) |
| | |
| Start on site (demolition) | May-24 |
| Completion of Phase 1 homes (first new homes delivered) | 2026 (2.5yrs) |
| Completion of Phase 2 Homes | 2029 (3yrs) |

3.8 Some minor changes to the scheme's design and specifically regarding the community centre arrangement are currently being explored and will be addressed through a revision to the original planning application over the coming months. An application is expected to be submitted in April/May 2023.

3.9 A further report will be presented to Cabinet in late 2023 to address the scheme's use of Compulsory Purchase Order powers and any rights of light impediments

3.10 The Mayor has stipulated that the tender evaluation process must include a weighting of 10% for social value. This will be incorporated in the scoring criteria along with input from members of the estates' residents' panel.

## 4 EQUALITIES IMPLICATIONS

4.1 The equalities impacts of this project were considered under the December 2021 Cabinet report and a full EQIA attached. This report is not considered to change any of those impacts and therefore no specific considerations are highlighted beyond those considered in the previous report.

## 5 OTHER STATUTORY IMPLICATIONS

5.1 This section of the report is used to highlight further specific statutory implications that are either not covered in the main body of the report or are required to be highlighted to ensure decision makers give them proper consideration. Examples of other implications may be:

- Best Value Implications,
- Consultations,
- Environmental (including air quality),
- Risk Management,
- Crime Reduction,
- Safeguarding.
- Data Protection / Privacy Impact Assessment.

**Best Value Implications**

5.2 The value for any leases required to be granted for the build and sales phase of the scheme will have their value determined competitively through the procurement process in order to guarantee best value is obtained.

5.3 **Risk Management**

The majority of models in the report seek to contain the council's financial exposure through the use of a fixed price contract. This is particularly the case for the Development Partnership. Construction, planning and sales risk are all transferred to the developer through a fixed price contract, with an overage agreement able to capture any above market performance in income generated by the scheme.

Under the alternative option of income strip, higher build costs and inflationary pressures or lower open market rent returns than those assessed, present a risk to scheme viability. While risk and the Council's exposure to risk, cannot be eliminated in any delivery model, unlike the other delivery models assessed, the risk profile for the income strip option last through scheme delivery and continues through the lease back (40 year) period.

## 6 COMMENTS OF THE CHIEF FINANCE OFFICER

6.1 This paper reviews delivery options for delivery of the Harriott, Apsley & Pattison House Regeneration Scheme. The paper recommends a development partnership as the proposed approach for this scheme. An Income strip model is not recommended for this scheme and would have risks, amongst the most prominent being the impact of Government policy on future rental income. A land sale with contract is not recommended for this due to reduced control of the site and going forward.

6.2 Delivery through a Developer Partnership Agreement involves the affordable housing element of the development transferring upon completion to the Council at nil cost or a subsidised price depending on viability, in lieu of a land receipt. The developer retains the private housing until it is sold. The financial risk is lower than alternatives, such as the income strip model, with sales risk being retained by the developer, lesser impact of Government rental decisions as there is a shorter development period when compared with the lease agreement of the income strip and no ongoing lease to pay. This option requires a greater initial capital investment, although this is minimised as the cashflow for the private homes is provided by the developer.

6.3 Harriott, Apsley & Pattison House is a very complex development and the decision as to the best delivery vehicle is not a straightforward one, with financial risks and benefits to each option. Although financial risk is not the only factor in recommending a delivery model for this scheme, it is a key consideration. If the Developer Partnership Agreement is agreed as the proposed way forward, the appropriate specification would need to be modelled and costs of capital investment considered in terms of the HRA business plan to ensure the overall long-term viability of the HRA, as well as the financial viability of the scheme. The council will need to consider the risks of potential changes to key assumptions: delivery, income, void rates, interest rates, legislation changes and length of leases in order to mitigate where appropriate. It will also be important to ensure the Council is clear over the level of control over the development and subsequent management of properties

## 7 COMMENTS OF LEGAL SERVICES

7.1 The Council has the legal power to enter into an arrangement as described in the report.

7.2 The Council will undertake a competitive exercise to determine the development partner in accordance with the Public Contracts Regulations 2015. This is because whilst in part the nature of the development is land based, the level of control that the Council will require over the affordable housing will be sufficient to qualify the arrangement as a Public Works Contract for the purposes of the Public Contracts Regulations 2015.

7.3 Traditionally the private housing would be mainly the concern of the developer only as this is a significant source of remuneration for the developer. However, the Council should consider the level of control the Council may want over the private dwellings albeit that increased control by the Council would affect the commerciality of the overall arrangement and may lead to an increased cost to the Council overall.

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**Linked Reports, Appendices and Background Documents**

**Linked Report**

- Cabinet Report - Harriott, Apsley & Pattison House Regeneration Scheme – 21st Dec 2021

**Appendices**

- Appendix 1 – Financial Appraisal [exempt]

**Background Documents – Local Authorities (Executive Arrangements)(Access to Information)(England) Regulations 2012**

**Officer contact details for documents:**
N/A