Medway COUNCIL
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CABINET

10 APRIL 2018

MEDWAY DEVELOPMENT COMPANY LTD UPDATE

Portfolio Holders:	Councillor Alan Jarrett, Leader
	Councillor Howard Doe, Deputy Leader and Portfolio Holder for Housing and Community Services
	Councillor Adrian Gulvin, Portfolio Holder for Resources
Report from/Author:	Perry Holmes, Chief Legal Officer

Summary

This report updates Cabinet as shareholder about the need for capital funding to be added to the Council's capital programme and proposals to amend the governance arrangements for Medway Development Company Ltd (MDC) in order to take advantage of tax efficiencies in the development of property.

1. Budget and Policy Framework

1.1 The responsibility for agreeing budgetary provision and additions to the Capital Programme is for Council.

1.2 The responsibility for managing the Council's land is a matter for Cabinet as is the provision and management of housing.

1.3 Medway Council is the sole shareholder of MDC and changes to the company's constitution must be agreed by Cabinet.

2. Background

2.1 Cabinet approved the Business Case submitted at the 5 September 2017 meeting for the creation of a new company to be called Medway Development Company Limited.

2.2 Cabinet agreed to delegate authority to the Chief Legal Officer, in consultation with the Leader, to finalise the Articles of Association in a form similar to those established for an independent, non *Teckal* company (decision no. 92/2017 refers). It was incorporated with the model Articles to enable an efficient set up.

2.3 MDC was incorporated on 24 October 2017 and Councillor Howard Doe and Councillor Adrian Gulvin were appointed as directors. Additional directors Jonathan Sadler and Barbara Richardson have been recruited externally and are to be formally appointed to the Board by the Chief Executive of Medway Council in accordance with his delegated authority (decision no. 97/2017 refers).

2.4 MDC has recruited a Head of Operations, Lewis Small, who is taking forward the initial projects identified in the Business Case presented to Cabinet. He has created a first draft Business Plan for the MDC Board at its inaugural meeting, to progress the first three schemes. A copy is attached as exempt Appendix 2. There are nine other schemes identified. Capital funding is now needed for a variety of enabling activity such as producing architect's drawings for planning applications. The Business Case estimates that over an initial five year period, funding of £120 million will be needed to unlock twelve Council owned sites. This investment represents capital expenditure and it is proposed to add this to the capital programme, to be funded from borrowing in advance of the future receipts generated.

2.5 The Board has reviewed the Business Case agreed by Cabinet on 05 September 2017 and considers that to enable the generation of the maximum return for the Council whilst delivering housing units principally in Medway, an alternative *Teckal* structure for the company should be pursued which is more tax efficient.

2.6 The Public Contract Regulations 2015 codify the so-called "Teckal Exemption" at regulation 12 allowing public to public contracts without procurement where three criteria are met:

1. The contracting authority exercises over the body control which is similar to that which it exercises over its own departments.

2. More than 80% of the activities of the body are carried out in the performance of the tasks entrusted to it by the controlling contracting authority.

3. There is no direct private capital participation in the controlled body.

2.7 Criteria 1 is met because the Council has appointed Directors to the Board of MDC. Criteria 2 is met since MDC will carry out 80%+ of its activities for Medway Council. Criteria 3 is met as the capital funding will be from the Council.

3. Options for the amending MDC's constitution

Option 1: To agree a change to the governance structure of the company as follows:

3.1.1 This option is recommended. Amend MDC's Articles of Association and governance arrangements to reflect the *Teckal* test:

- The Council exercises a control which is similar to that which it exercises over its own departments;
- more than 80% of the activities of the company are carried out in the performance of tasks entrusted to it by the Council or other Council controlled companies; and
- there is no direct private capital participation in the company;

3.1.2 The proposed new governance structure is set out in detail at the exempt Appendix 1. MDC would act as the Council's managing agent in developing its owned sites. The provision of these public services would be directly awarded to MDC by the Council in accordance with the *Teckal* procurement exemption. The services to be provided by MDC would include:

- Potential site identified and high level appraisal and viability test;
- Feasibility/ business case budget established and approved by MDC board;
- Complete site surveys and develop planning drawings / tender documents;
- Submit planning and tender the construction works;
- Tenders reviewed and approved by MDC board

3.1.3 MDC is able to deliver the majority of these services in-house but may require some external support from the Council from such teams as Capital Projects, Category Management and Legal Services.

3.1.4 MDC would charge the Council a fee to cover company costs such as staff, premises, insurances etc. The investment return from successfully delivered projects would then be accounted for in the Council's usual financial regime with no Corporation Tax liability. In the early stages, it is expected that MDC will deliver projects that are neutral cost; however in later years MDC may make profits upon which it would pay Corporation Tax.

3.1.5 The Council would directly fund the capital costs of developing each site and retain the receipts for sold units at the end of each development project. The Council can rely on a number of statutory powers to fund the developments but the decision to increase the Council's budgets for capital expenditure is a Full Council decision.

3.1.6 Once MDC has exhausted the scope for developing Council owned land, it can then refocus its business activities on commercial trading with third parties for profit. The governance structure for MDC can then revert back to a non *Teckal* structure.

3.2 **Option 2: Do nothing**

3.2.1 This option is not recommended. MDC would continue to operate in accordance with the approved Business Case agreed by Cabinet on 05 September 2017 as an independent non *Teckal* company. Officers consider that on balance, the advantages of changing the company structure outweigh the disadvantages.

3.3 **Option 3: Wind down MDC**

3.3.1 This option is not recommended. It is anticipated that the Council will carry out some commercial activity in the future with third parties for the sole purpose of making a profit in the property sector and the Council can only do this through a company. The flexibility to switch to more commercial third party trading at a later date will either have to occur within the 19.9% of commercial activity allowed in a Teckal company or will require a further amendment to the constitution of the company. This is something that can be reviewed later as the company develops.

4. Options for the making additions to the capital programme

4.1 **Option 1 Do nothing**

4.1.1 This approach is not recommended as it will hinder MDC taking forward the development of Council owned sites as proposed.

4.2 **Option 2 Propose the addition to the capital programme**

4.2.1 This approach is recommended to unlock Council sites, to enable development with a number of safeguards in place and decisions to be taken on a site by site basis by Council Officers in consultation with Cabinet members.

5. Analysis

5.1 The MDC Board of Directors now considers that a company that fully meets the Teckal control test in the early years will allow the Council and to maximise profits from property sales by reducing tax liability. This provides the following benefits:

- The direct award of contracts for the supply of public goods, services and supplies *to and from the Council* without the requirement to formally tender under the Public Contract Regulations 2015, including SLAs for support services;

- Off-setting the company’s costs for the supply of services to the Council against its potential corporation tax liability;
- Eliminate stamp duty land tax liability as land transfers will not be required between the Council and the company;
- Lower costs of borrowing as the company will not require funding to acquire Council sites.
- Reducing the risk of giving the company illegal state aid.

5.2 However, the risks and disadvantages of making MDC *Teckal* compliant are as follows:

- MDC will become a “contracting authority” for the purposes of the Public Contract Regulations 2015 and must formally tender contracts over the EU thresholds when *not* buying from the Council (e.g. works contracts);
- Decisions reserved to the shareholder will require Cabinet decisions to be made, which may impact on the company’s ability to be commercially reactive, however this is a low risk as the sites to be developed are Council owned;
- As the Council is to retain the freehold title, right to buy rights are more likely to accrue for tenancies on any leasehold properties built and let;
- MDC will be required to provide more than 80% of its activities for Medway Council and less than 20% of its activities for third parties, which may impact of developments outside of Medway in the short term;
- There can be no private sector investment in a *Teckal* company;

6. Advice

6.1 If Cabinet is minded to agree the change to the governance structure of the company, Cabinet will then need to consider the decisions to be reserved to the shareholder to enable the company to meet the Teckal control test.

6.2 The additional role and the responsibility of the Cabinet (representing the Council Shareholder) will be to make decisions reserved to the shareholder in the Articles of Association. These decisions can mirror the decisions currently reserved to Medway Commercial Group Ltd which is a *Teckal* company. The list of matters reserved for shareholder approval, in relation to MCG, is set out at Appendix 1.

6.3 Medway Council is already represented on the board of directors and the chair will have a casting vote and a public sector veto to ensure that the board cannot take any decision which is not in the best interests of the Council.

6.4 The proposed new structure provides better value for money for the Council.

7. Risk management

Risk	Description	Action to avoid or mitigate risk
Teckal (i.e. procurement exempt) contracts made between MDC and Medway Council do not represent value for money	The wider market or the in-house teams are able to provide better savings and benefits than MDC	National building rates are available for the Council to test value on a scheme by scheme basis.
MDC unable to take quick decisions on developments, acquisitions and disposals affecting it's ability to be agile in a competitive and fluctuating commercial environment	Strategic and key decisions are reserved to the shareholder requiring a Cabinet decision and Council timescales for reports and publishing of notices.	This is a low risk in short term as the sites to be developed are Council owned.
Tenants exercise their right to buy of General Fund properties or LATCO properties (if extended to Local Authority Housing Companies as predicted)	Financial risk to the Council as a potential lender, lack of investment return and increased borrowing costs. As a *Teckal* company, likelihood of right to buy applying increases.	The Company produces a medium term financial plan which allows flexibility in delivery and factors in a given percentage of "right to buy" sales.
Overall loss of tax efficiencies and cost savings by simultaneously operating multiple *Teckal* companies	The new proposed structure is similar to the set up for MCG. Whilst there are benefits in ring fencing property development activity from the other services that MCG provides, if both MCG and MDC make a profit, both companies will pay corporation tax.	Tax advice will be taken by the Company and the Council.

8. Financial Implications

8.1 The £120 million required to fund the five year programme will be met from borrowing. As this represents a capital investment, the Council's capital financing requirement (CFR) will increase accordingly. As the intention will be to sell the homes built to generate capital receipts, there is no requirement to fund a minimum revenue provision and the interest incurred during the construction phase may be treated as a capital cost.

8.2 Cabinet previously delegated authority to the Chief Finance Officer, in consultation with the Leader, to provide funding to the Company through state aid compliant loans, subject to appropriate due diligence to verify the Company's on-going viability and the viability of projects for which the loans are being provided and loan agreements between the Council and the Company setting out pre-conditions for draw down as well as performance measurements (decision no. 93/2017 refers). Although loans are not required for the first 12 sites to be developed, the Company may require such funding in the future to develop sites owned by third parties.

8.3 Officers consider that the remaining delegation to the Chief Finance Officer should be amended as follows:

8.3.1 Cabinet previously delegated authority to the Chief Finance Officer in consultation with the Leader, to release funding to the Company for each agreed scheme in the Company's Business Plan subject to financial due diligence and appropriate loan agreements (decision no. 94/2017 refers). Cabinet is recommended to amend this delegation to allow the Chief Finance Officer in consultation with the Leader to agree the business case for each site and to release funding for the development of each site subject to financial due diligence and the availability of capital funding.

9. Legal Implications

9.1 The legal implications are set out the body of the report.

9.2 Officers consider that the original delegation to the Chief Legal Officer should be amended as follows:

9.2.1 In the Employee Scheme of Delegation (Part A), Cabinet has delegated to the Chief Legal Officer, in consultation with the Leader, Portfolio Holder for Resources and Chief Finance Officer to acquire, manage, let and dispose of suitable investment properties where funded from provision made for this purpose in the Council's Capital Programme (Para 6.14).

9.2.2 Subject to Full Council approval to add to the capital programme of a facility for £120 million over the next 5 years, Cabinet is asked to approve the addition of this sum to the existing delegation which will negate the need for the following delegation what Cabinet had agreed on 5 September 2017:

- To identify, declare surplus and dispose of assets at commercial rates that are state aid compliant or to agree suitable equity arrangements that reflect commercial rates of return to the

Council, to the company in line with its Business Plan, in consultation with the Leader (decision no. 95/2018 refers).

10. Recommendations

10.1 Cabinet recommends to Full Council the addition to the capital programme of a facility for £120 million over the next 5 years to enable development.

10.2 Cabinet approves the amendments to the MDC governance structure as outlined in option 1 of the report and Exempt Appendix 1 to reflect the Teckal test and notes that Cabinet previously delegated authority to the Chief Legal Officer, in consultation with the Leader, to finalise the Articles of Association (decision no. 92/2017) and that Cabinet now approves the form of Articles of Association similar to that of MCG Ltd, as set out in Appendix 1 to the report.

10.3 Cabinet approves the draft Business Plan as set out in Exempt Appendix 2 to the report.

10.4 Cabinet approves the amendments to the Employee Delegation Scheme as set out in paragraphs 8.3.1 and 9.2.2 of the report.

11. Suggested Reasons for Decision

11.1 To enhance the generation of new and alternative investment returns for the Council and to deliver housing units principally in Medway.

Appendices
Appendix 1 - Matters reserved for shareholder approval

Exempt Appendix 1 - Medway Development Company Limited Project development approval and structures

Exempt Appendix 2 – Medway Development Company Limited Business Plan

Background Papers:
None

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Appendix 1 - Matters reserved for shareholder approval

1.1 The matters listed below shall not be carried out without the prior written consent of all shareholders at the relevant time and each shareholder shall use their/its respective rights and powers to procure, so far as legally able, that no such matter is carried out with regard to the Company without the prior written consent of all shareholders:

1.1.1 vary in any respect the articles of association or the rights attaching to any shares; or

1.1.2 grant any option or other interest (in the form of convertible securities or in any other form) over or in the share capital, redeem or purchase any of its own shares or effect any other reorganisation of share capital; or

1.1.3 permit the registration of any person as the holder of shares other than Medway Council; or

1.1.4 issue any loan capital or enter into any commitment with any person with respect to the issue of any loan capital; or

1.1.5 make any borrowing other than from bankers, reputable financial institutes and any public body in the ordinary and usual course of business; or

1.1.6 apply for the listing or trading of any shares or debt securities on any stock exchange or market; or

1.1.7 pass any resolution for its winding up (unless it has become insolvent) or present any petition for its administration; or

1.1.8 engage in any business other than as provided in or permitted by the annual Business Plan; or

1.1.9 endorse the Business Plan or amendments to the Business Plan, or enter into any contract or commitment not provided for in the Business Plan or carry out any activity that is outside of the usual course of business provided for in the Business Plan; or

1.1.10 form any subsidiary or acquire shares in any other company or participate in any partnership or joint venture (incorporated or not); or

1.1.11 close down any business operation or dispose of or dilute its interest in any of its subsidiaries for the time being; or

1.1.12 amalgamate or merge with any other company or business undertaking; or

1.1.13 enter into any transaction or arrangement of any nature whatsoever with any of the directors or any person who is connected to any of the directors (as defined in section 252 of the Act); or

1.1.14 enter into any arrangement, contract or transaction outside the normal course of its business or otherwise than on arm’s length terms; or

1.1.15 give notice of termination of any arrangements, contracts or transactions of a material nature outside the normal course of its business or materially vary any such arrangements, contracts or transactions; or

1.1.16 make or permit to be made any material change in the accounting policies and principles adopted by the Company in the preparation of its audited and management accounts except as may be required to ensure compliance with relevant accounting standards; or

1.1.17 declare or pay any dividend; or

1.1.18 make any loan (otherwise than by way of deposit with a bank or other institution the normal business of which includes the acceptance of deposits) or grant any credit (other than in the normal course of trading) or give any guarantee (other than in the normal course of trading) or indemnity; or

1.1.19 factor or assign any of the book debts of the Company; or

1.1.20 appoint any agent or other intermediary to conduct any of the Company’s business operations; or

1.1.21 establish or amend any profit-sharing, share option, bonus or other incentive scheme of any nature for directors, officers or employees otherwise than provided for in the Business Plan; or

1.1.22 establish or amend any pension scheme or grant any pension rights to any director, officer, employee, former director, officer or employee, or any member of any such person’s family otherwise than provided for in the Business Plan; or

1.1.23 appoint or remove any director.